2 The East Asian developmental states

In the post-World War II period, the leading economies of the East Asian region have experienced a historically unprecedented rate of economic growth and commercial expansion. Some of the emerging economies in the region achieved higher growth rates than those of Western economies in comparable periods of the development process. Today, Japan and the East Asian NICs have levels of GDP per capita comparable to those of the richest nations of the world. Their largest companies are engaged in a phase of dramatic regional and, in some cases, global expansion. The "recent" cases from East Asia have come to exemplify the modern concept of the developmental state. Knowledge of the developmental state is largely derived from a number of descriptive studies which each focus on one case or another rather than a general model. Although it might be questionable whether it is possible to treat the East Asian countries as a whole, for the purpose of this study, the similarities between Japan, Taiwan and Korea are highlighted, while still acknowledging that there are significant differences between them. From this, a distinct model of East Asian development can be derived.

2.1 Debate on the beneficial role of the state

By the end of the 1970s, statists acknowledged the economic success of Japan, Korea, Taiwan, Singapore and Hong Kong, as the result of proactive state involvement.\(^{23}\) Except for Hong Kong, the governments of all these states have actively used industrial policy to accelerate and direct economic development.\(^{24}\) Distinct from trade policies, industrial policy is defined as "government efforts to alter industrial structure to promote productivity-based growth".\(^{25}\) Industrial policy aims to promote technological innovation and to catch up with international best practices.\(^{26}\) Far from being a novelty of East Asia, industrial policy has been an integral part of the economic policies of many advanced capitalist countries during the post-war period.\(^{27}\) In the United Kingdom (UK), industrial policy was discussed controversially when the Labor government introduced industrial policy programs in the late 1970s.\(^{28}\) The de-industrialization debate in the UK perceived industrial policy as one way to stop the progress of de-industrialization and revive the economy.\(^{29}\) During the 1980s, studies of various European countries' policy approaches to overcome the industrial

\(^{23}\) Refer to Evans (1989), p. 563.
\(^{24}\) Refer to Robins (2002), p. 293.
\(^{26}\) Refer to Naseem (2003), p. 636.
\(^{27}\) Refer to Chang (1994), p. 56.
\(^{28}\) For further information refer to Blackaby (1979) and Matthews and Sargent (1983).
\(^{29}\) For further information refer to Singh (1977) and Rowthorn and Wells (1987).
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crisis of the late 1970s emerged.\footnote{For further information refer to Pinder (1982), Jacquemin (1984), Cox (1986) and Duchêne and Shepard (1987).} The issue of industrial policy, however, was debated most strongly in the United States of America (USA). In the early 1980s, the Harvard Business Review served particularly as the major forum.\footnote{For reviews of the debate refer to Norton (1986) and Thompson (1989).} Strategic-trade policy literature has also been influenced by (and has influenced) the industrial policy debates.\footnote{For further information refer to Kirzkowski (1986) and Krugman (1988).}

Despite successful state-led growth in the East Asian countries, by the end of the 1970s, economic theorists as well as practitioners demanded free market and laissez-faire policies which soon became the dominant view of international bodies such as the International Monetary Fund and the World Bank.\footnote{For further information on the recent politics of the World Bank refer to e.g. Easterly (2001). His book combines modern growth theory with experiences from his fieldwork for the World Bank.} For the neoclassicals, economic success is achieved by the efficiency of market mechanisms and policies emphasizing openness, private enterprise and the minimal role of government.\footnote{For further information refer to Ricardo (1817).} Since Smith (1776), liberal political economy has contended that the government should not directly intervene in firm's decisions, but monitor and enforce the regulatory environment in which firms compete for survival and profits. Public choice theory adds that politicians and bureaucrats should not directly intervene in firms' business activities, because they will use their power to further their personal interests, such as the maximization of political support and re-election, rather than the firm's efficiency.\footnote{For further information refer to Buchanan (1980) and Shleifer and Vishny (1994). Krueger furthermore postulates that political decision-makers tend to pursue rent-seeking activities instead of maximizing societal welfare. Rents are defined as excess returns over opportunity costs. Rent-seeking is the attempt to redistribute the rights or entitlements to such returns through political action. Refer to Krueger (1974).}

Consequently, the neoliberals contend that governments should only intervene in the economy to overcome inherent market failure. Hayek (1945) argues that it is impossible for governments to have the necessary information to plan and coordinate economic activities effectively, even if their bureaucrats possess the best knowledge
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available. The government’s proper role is to help create and maintain an environment in which resource allocation is effectively determined by price signals. This entails a policy regime that sets the framework for the functioning of the market and a small public sector. Influenced by this line of argumentation, government failures in the 1980s led to deregulation, liberalization and privatization in a large number of developing economies.

The World Bank, being an adherent of the neoclassical theory, has been tardy in extending praise to the East Asian model. In 1992, however, it emphasized for the first time the role of the state and its institutions in general, and good governance in particular. However, not until the World Bank’s publication of “The East Asian Miracle: Economic Growth and Public Policy” in 1993, was the decisive role of the governments of East Asia with their active state interventionism acknowledged by some neoclassicals.

In 1997, the debate on the beneficial role of the state revived as the Asian financial crisis revealed an institutional shortcoming of Asian capitalism. Despite ample evidence of decisive government industrial policy in the region of East Asia, economists remained divided in their interpretation of the developmental role of East Asian governments for a long time. The economists disagreed on whether it is government initiatives or market forces which have constituted the primary causal factor in stimulating modern economic development and productivity growth. Accordingly, the development debate was mostly framed in terms of stark, simplistic alternatives, as a kind of contest between the power of the state versus the power of the free market.

The Asian financial crisis cannot be used to discredit the whole model of East Asian development. While the crisis revealed the risks of politicizing the economic system, this does not imply that economists and politicians cannot learn from the East Asian experience. The questions that must be addressed are: under what circumstances is

37 For further information refer to Hayek (1945). Nee et al. add that it does not make any difference whether the government unit is a central ministry or local government bureau. No individual government official has the requisite knowledge to outperform the market mechanism in general. Refer to Nee et al. (2007), p. 22.
39 The World Bank (1993) study “The East Asian Miracle” had to be sponsored by the Japanese themselves as they wanted to highlight the role of the state behind the miracle. Additionally, at the annual meeting of the World Bank/International Monetary Fund in the fall of 1991, Attila Karaosmanoglu, at this time vice president and managing director of the World Bank, said that the East Asian NICs and their successful emulators are a powerful argument that a more activist, positive governmental role can be a decisive factor in rapid industrial growth. He added, what is replicable and transferable must be brought to light and shared with others. Refer to Stiglitz (2002), p. 91. The view of the World Bank is manifested in the “World Development Report 1997: The State in a Changing World”.
state intervention likely to be successful, and which factors determine the effectiveness of industrial policy? More specifically, how can the state remove the privileges of particular firms, and ensure that the rents created by state intervention encourage productive activities? What is needed is clarification of the quality of state involvement in industry promotion. Therefore, the necessary conditions and measures for successful state-led economic growth have to be specified. The key issue then becomes not whether, or how much, states should intervene, but rather what makes some states more effective than others in developing their economy.

2.2 The developmental state theory

The growth of some East Asian states has exemplified the active role of the state in economic transformation. The principal idea behind it may yet be traced to much earlier times. A long tradition of scholarship has focused on the historical role of the state in industrialization, and defended the proposition that an active and effective state apparatus is an essential element in successful industrialization.42

2.2.1 Early recognition of the state’s role in industrialization

List (1885) emphasized the strategic role of the state in harnessing domestic and international market forces in the national interest. He examined how Germany had been able to develop a manufacturing industry at a time when British manufacturers were far in advance.43 He was one of the pioneers of the infant industries conception.44 Even more important was his idea of a national system of political economy.45 It attacked Smith’s unlimited freedom of trade and the liberal principle of laissez-faire.46 List and the German Historical School essentially argued, based on the concept of historicism, that universal economic laws were non-existent, and thus states had the right to intervene in the economy.47 Especially in the case of late-developing countries, the promotion of national economic development was regarded as being critical to their success in “catching-up” with the industrialized, developed

42 Refer to Evans (1989), p. 566.
43 Refer to List (1885), p. 39 ff.
44 The infant industry argument says that developing sectors of the economy need protection against international competition in order to establish themselves. Refer to List (1885), p. 224 ff.
46 Decisive for Smith’s laissez-faire approach is the following quotation: “The statesmen who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted to no council and senate whatever, and which would nowhere be so dangerous as in the hands of man who had folly and presumption enough to fancy himself fit to exercise it.” Quoted in Hayek (1976, reprinted in 1994), p. 63 and Smith (1776), Book Four, Chapter V, p. 540 ff.
47 Refer to List (1885), p. 172 ff.
world. On a theoretical level, not simply mere exchangeable value, but productive forces account for the wealth of a country. List formulated a theory of economic development that was based on the promotion of "productive powers" through the state which contrasted with Smith's free enterprise system.

Weber (1911) called attention to established market societies, and argued that the operation of large-scale capitalist enterprises depended on the existence of the kind of order that only a modern bureaucratic state could provide. Weber emphasized that capitalism and the bureaucratic state apparatus belong intimately together. He argued for the fundamental value of bureaucracy as one of the institutional foundations of capitalist growth. Weber pointed out that bureaucrats were only concerned with fulfilling their assignments and contributing to the achievement of the goals of the apparatus as a whole. For him, use of the privileges of office for maximizing private interests was a feature of earlier prebureaucratic forms. The bureaucracy needs to be a corporately coherent entity in order to support markets and capitalist accumulation. In this coherent entity, individuals see the promotion of corporate goals as the best means of maximizing their individual self-interest. Individual incumbents have to be insulated to some degree from the demands of society in order to achieve corporate coherence. The enhancement of insulation is achieved by conferring a distinctive and rewarding status on bureaucrats. Also central to the bureaucracy's effectiveness is its concentration of expertise through meritocratic recruitment and the provision of opportunities for long-term career rewards. Altogether, Weber stressed the fundamental role of an authoritative bureaucracy as a prerequisite to the operation of markets, and thus as one of the institutional foundations of capitalist growth.

Polanyi (1957) too elaborated on the positive attributes of state intervention in economic life and addressed state intervention in the economy from a sociological point of view. He discussed Smith's "natural propensity to truck, barter and exchange one thing for another" and criticized the proposition that exchange was a "natural" activity that required only minimal institutional underpinnings. As he conceived it, the

48 List was a liberal nationalist and his concept of economic nationalism - which was often but unjustifiably regarded as "neo-mercantilist" - together with the ideas of the German Historical School, provided an intellectual stimulus for Meiji Japan. Consequently, Japan's leadership systematically fostered economic growth and industrialization, and turned Japan into a state, where national economic development was the prime objective. Refer to Sohn (1998), p. 17.
49 List takes up Smith's expression of "productive powers" which in sum, according to Smith, causes the condition of nations and develops this term further. Refer to Smith (1776), Introduction, p. XXIV ff and List (1885), p. 133 ff and p. 163 ff.
50 Refer to Weber (1911), p. 973 ff and pp. 1394-1395.
51 This thesis always had to contend with the historically prior and ideologically powerful classical view of Smith's laissez-faire government role.
53 Refer to Smith (1776), Book One, Chapter II, p. 14 ff.
successful rise of the market in the UK required intervention by the state: "The road to the free market was opened and kept open by an enormous increase in continuous, centrally organized and controlled interventionism." From the beginning, the market was intertwined not just with different kinds of social ties, but with the interventionist policies of the state.

Gerschenkron's work (1962) on late developers complemented Weber. Asserting that late developers faced different conditions than the early industrializers, Gerschenkron illustrates why a strong state is likely to push industrialization forward in particularly backward countries. Whereas individual entrepreneurs largely contributed to the industrialization and development of the UK, in the first "late" industrializers – Germany, Switzerland, Italy, France, Austria, the Austrian-Hungarian Empire and Belgium – universal banks played the major role in kickstarting industrial expansion. Banks stepped in, because entrepreneurs in these countries had little capital with which to build up large firms. The banks provided not only funding for industrialization, but also took key investment decisions in the firms in which they invested, and limited competition among their financial offspring. In the even more backward Hungarian and Russian states, the state stepped in as the chief investor in industry due to the weak financial system. The state incorporated the role of entrepreneur and banker alike. The state created, funded and directed much of the new industrialization. In order to catch up in their economic development, late industrializers were forced to rely on the power of the state. While in Weber's model, the government simply provides a suitable environment, Gerschenkron's state is actively organizing a crucial aspect of the market.

Altogether, in Gerschenkron's reasoning, the more backward a country, the greater the role played by the state in increasing the supply of capital to the nascent industries and in providing guidance. As a consequence, active state involvement is seen to be of little importance to early developers, or once a country has industrialized.

Hirschman (1958) analyzed the state's entrepreneurship. Based on his observations of the "late late" developers of the 20th century Third World, entrepreneurship in the sense of willingness to risk the available surplus by investing it in productive activities is lacking, namely, "the ability to make and carry out development decisions" and "the

54 Refer to Polanyi (1967), p. 140.
55 According to Gerschenkron, "[I]n several very important respects the development of a backward country may, by the very virtue of its backwardness, tend to differ fundamentally from that of an advanced country." Gerschenkron (1962), p. 7.
56 Ibidem, pp. 5-30.
57 Ibidem, p. 16.
The state therefore has to lead entrepreneurial activities in order to transform (potentially) existing savings into available productive activities. By providing "disequilibrating" incentives the state induces private capitalists to invest and, at the same time, to be ready to alleviate bottlenecks that are creating disincentives to investment.

Altogether, by puncturing the myth of the original industrial revolution as a purely private process, these interpretations have brought the state to the fore in the analysis of European industrialization. The outlined comparative historical visions were the beginnings of a positive vision of how an effective state might act and be organized.

### 2.2.2 Origin of the East Asian capitalist developmental state theory

Developing these visions of an active state further and laying special focus on East Asia, in 1981, Johnson introduced what was to become a focal point in future debates over the role of the state in industrialization. It was only with the publication of his work on the East Asian states and Japan in particular that the phrase "developmental state" made its formal debut, and that a serious attempt was made to conceptualize it.

Johnson argued that Japan's developmental state and its changing of industrial structure was a central element in explaining the country's post-World War II economic miracle. Johnson traced the emergence of Japanese industrial development back to 1868 and the Meiji era (1868–1912), where Japan first began to be "plan rational and developmental". He distinguished the "developmental orientation" of such a "plan rational" state from both the "plan ideological" state of the Soviet-type command economies and from the "regulatory orientation" of typical liberal-democratic or even social-democratic states.

Johnson can be regarded as the "father" of the developmental state approach. He discussed in detail the attributes and qualities of the developmental state, but did not, however, offer an isolated definition. As this seems necessary at the beginning

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60 Refer to Hirschman (1958), pp. 35-36 ff.
61 Ibidem, p. 65 ff.
62 Refer to Rueschemeyer and Evans (1985), p. 44.
63 Refer to Johnson (1981).
64 Refer to Johnson (1982), pp. 9-10, p. 3 ff and p. 31 ff.
65 Ibidem, p. 23.
66 Ibidem, pp. 18-19.
67 Ibidem, p. 17 ff.
of the analysis, the definition of Leftwich (1995), who examined features of different developmental states,\(^{68}\) delivers insight:

"Developmental states may be defined as states whose politics have concentrated sufficient power, autonomy and capacity at the center to shape, pursue and encourage the achievement of explicit developmental objectives, whether by establishing and promoting the conditions and direction of economic growth, or by organizing it directly, or a varying combination of both."\(^{69}\)

Developmental states are mainly the states in East Asia, above all Japan, and additionally Taiwan, Korea, Hong Kong and Singapore. Japan, Korea and Taiwan are the most typical cases in terms of wide state intervention among Asian countries, compared with more laissez-faire Hong Kong and, to a lesser degree, Singapore, and the resource-rich countries of Southeast Asia. Hence, as Hong Kong and Singapore are special cases of developmental states,\(^{70}\) here, only Japan, Taiwan and Korea are examined.

The developmental state's capacity refers to the ability of policy-making authorities to pursue domestic adjustment strategies. These strategies are set up in cooperation with organized economic groups and intend to upgrade or transform the industrial economy.\(^{71}\) Accordingly, the idea of the developmental state is indicative of the role of the state and its policies as well as the internal relationships that constitute the state itself. The state has an important legitimate part to play in determining the course and content of national economic development. In addition, the developmental state is suggestive of a particular constellation of political and economic relations. This implies relations amongst the personnel that constitute the state, and between the state and society and the business sector, respectively.

The East Asian capitalist developmental states - although they are neither communist nor laissez-faire - exhibit characteristics of the neoclassical minimalist state and the centrally planned Leninist state.\(^{72}\) Neither a pure state-centered nor market-centered explanation takes into consideration the East Asian experience. The developmental state plays an activist, rather than minimalist, role and is characterized, above all, by the synergy of state and market, or "guided markets" (refer to Figure 3).

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\(^{68}\) Leftwich is one of the few authors who attempted to build a general model of the developmental state which is not confined to the East Asian region. In his model, six major components define the developmental state model: a determined developmental elite; relative autonomy; a powerful, competent and insulated economic bureaucracy; a weak and subordinated society; the effective management of non-state economic interests; and repression, legitimacy and performance. As developmental states Leftwich includes Botswana, Korea, Taiwan, Singapore, China, Indonesia, Thailand and Malaysia. Refer to Leftwich (1995), p. 405.


\(^{70}\) For further reading refer to Perkins (1994).

\(^{71}\) Refer to Weiss (1998), p. 4.

\(^{72}\) Refer to Oi (1995), p. 1132.
2.2.3 Different developmental state approaches

Various scholars have based their analysis of developing countries' transformation processes on the developmental state theory. The three most influential concepts are Johnson's developmental state approach as well as its enhancement by Amsden (1989) and Wade (1990).^73

Johnson's "capitalist developmental state":

As Johnson (1982, 1987) analyzed, the foremost and single-minded priority of state action is economic development in terms of growth, productivity and competitiveness.^74 In order to avoid a conflict of goals, no commitment to equality and social welfare is made.^75 The developmental states' goals are rendered concrete by comparison with external reference economies which provide state elites with models for emulation. State intervention is firmly committed to private property and the rules of the market. Johnson contends that

"[S]erious industrial policy must be long-run in focus, consistent in its various aspects (monetary, regulatory, environmental and so forth), and operated through mutually supportive policy instruments."^76

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^73 For further information refer to Amsden (1989) and Wade (1990).
^74 For further information refer to Johnson (1982, 1987).
Industrial policy has to be aimed at cost and price competitiveness in world markets, not just the domestic market. As it directs some resources to high-priority sectors, industrial policy must have the power to demand from these high-priority sectors to meet performance goals. In addition to his concept of industrial policy, Johnson bases his approach of the "capitalist developmental state" on institutional arrangements common to high growth East Asian capitalist countries.

According to Johnson, the combination of strategic industrial policy with a specific institutional setting leads to the successful economic transformation of the developmental state. Johnson established crucial features of the developmental state such as market-conforming state intervention in the economy and a small depoliticized elite bureaucracy organized in a pilot organization.

Amsden’s approach of “getting prices wrong”:

Amsden (1989) suggests that Korea grew rapidly because it got prices wrong, but in ways that nurtured firm-level learning and innovation. Her analysis runs parallel to Johnson’s, however, she introduces new aspects of the developmental state approach.

In line with Gerschenkron and Hirschman, she conceives that in backward countries, the level of international competition, the technology gap, the investment barriers and savings deficiencies, are so problematic that government intervention is needed to address these hurdles. She adds that “late industrialization” East-Asian style requires state intrusion beyond Gerschenkron’s state that has the role of an investment banker or Hirschman’s “disequilibrating investments”. According to Amsden,

“The first industrial revolution was built on laissez-faire, the second on infant industry protection. In late industrialization the foundation is subsidy which includes both protection and financial incentives. The allocation of subsidies has rendered the government not merely a banker, as Gerschenkron conceived, but an entrepreneur, using the subsidy to decide what, when and how much to produce.”

79 For further information refer to Amsden (1989).
81 It should be noted that what Amsden labels “late industrialization” is the mid-twentieth-century industrialization that Hirschman called “late late industrialization”, as distinct from Gerschenkron’s nineteenth- and twentieth-century “late industrialization”.
In late industrializing countries, the state is to mediate between market forces. Its role is to intervene in order to address the needs of both savers and investors, and of exporters and importers, by creating multiple prices. For reference, some interest rates are higher than others and importers and exporters face different prices for currency. Hence, in striking contrast to the logic of neoclassical development theory ("getting prices right"), a high degree of government intervention occurred in the developmental states to distort relative prices ("getting prices wrong") in favor of economic growth. By this policy, the desired level of investment was directed towards greater investment and was able to materialize in the strategic sectors. "Getting prices wrong" therefore contributes to a successful industrial policy and rapid economic development.

Wade's "governed market" theory:

Wade (1990), like Amsden, builds upon the original formulation of Johnson. He brings into focus the Taiwanese industrial policy. Wade makes significant contributions towards understanding the nature of strategic industrial policy and its impact on industrial performance. He proposes a "governed market theory of East Asian success" which specifies Johnson's model of the developmental state. Taiwan's industrial success can be ascribed to the "governed market", a series of policies that

"enabled the government to guide – or govern – market processes of resource allocation so as to produce different production and investment outcomes than would have occurred with either free market or simulated free market policies."

Subsequently, the role of the state in Taiwan's development has been to guide the market, rather than "follow" it. The essence of the governed market theory can be ascribed to three proximate causes: very high levels of productive investment, making for fast transfer of newer techniques into actual production; more state investment in certain key industries than would have occurred in the absence of

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85 Due to these price distortions, the state generated an industrial structure different from what the market would have produced on its own. Refer to Amsden (1989), p. 14 ff.
86 For further information refer to Wade (1990).
87 Wade (1990), pp. 24-29.
88 Wade bases his findings on case studies.
89 Refer to Wade (1990), pp. 26-27.
90 Ibidem, p. 303.
government intervention and the exposure of domestic firms to international competition (in foreign markets if not at home).  

Altogether, the classic case studies, using the developmental state approach, focused on different aspects of government-led economic transformation. It is thus important to elaborate on the institutional organization in the developmental states as well as the measures of state-led growth, and build an integrative model of East Asian development.

2.3 The developmental states' institutional and bureaucratic organization

The developmental states' industrial policy was supported by specific political, institutional and organizational arrangements pertaining to the state apparatus, private businesses and their mutual interaction. The political elites in the developmental states aimed at rapid economic development and had far-reaching power and authority to plan and implement efficient policies.

2.3.1 Depoliticized elite bureaucracy

As Public Choice Theory states, politicians tend to seek popular support in the short run as their goal is to win the next election; and there will never be a shortage of private claimants on the government, regardless of their economic performances and prospects. Industrial policy and the state’s abstaining from social welfare are thus difficult to implement by politicians. If political leaders want to pursue a successful long-term industrial policy, they have to depoliticize in part their key economic decisions. Hence, in the developmental states, a nonpolitical elite was appointed which was to some degree sheltered from direct political pressures.

Depoliticization was achieved through an implicit division of labor within the polity: "The politicians reign and bureaucrats rule." In the East Asian developmental states, the politicians set broad goals and provided the space and power for the bureaucrats. They legitimated and ratified the decisions taken by the bureaucrats. In addition, they took the heat when corruption scandals were uncovered (according to Johnson, "such scandals are unavoidable when government plays any role in economic affairs"). It was the official bureaucracy that did the actual planning,

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91 These proximate causes were the result of the government's deliberate economic policies of market guidance which in their turn, were supported by authoritarian and corporatist arrangements. Refer to Wade (1990), p. 26.
92 Refer to Buchanan and Tullock (1962), Olson (1965) and Downs (1957).
93 Refer to Johnson (1987), pp. 151-152.
94 Refer to Johnson (1982), p. 316.
95 Refer to Johnson (1987), p. 152.
intervention and guiding of the economy. Only by this separation, could "a political system in which the bureaucracy is given sufficient scope to take initiatives and operate effectively" be provided.\textsuperscript{96}

The role performed by the executive or the political elites in the context of postwar Japan was similar to the task performed by the military in Korea and Taiwan. The (military) elites were committed to developmental goals as an instrument of securing national survival and independence.\textsuperscript{97} This was a key factor in ensuring the effective deployment of bureaucratic power.

### 2.3.2 Cohesiveness and autonomy of the elite bureaucracy

A prerequisite for successful economic transformation is an elite bureaucracy which is able to produce sizeable effects on the economy and control the direction of the effects.\textsuperscript{98} According to Weber, the bureaucracy needs to be able to act as a corporate entity with broadly collective goals, rather than as the sum of the individual strategies of the functionaries. They are thus able to support markets and capitalist accumulation and promote development. This internal cohesiveness secures the state's capacity to carry out stringent policies, and is therefore a crucial precondition for successful industrial transformation.\textsuperscript{99}

Furthermore, the bureaucracy needs to follow the goal of economic transformation rather than personal gain. The politicians, even when they are public-minded, have no more power than to monitor the bureaucracy according to the criterion that the total costs of state expenditure should not exceed total benefits. Bureaucrats, however, might act as selfish agents.\textsuperscript{100} Generally, the theory of self-seeking bureaucrats is based on the postulate that bureaucrats are in no sense different from other individuals in pursuing their own interests. It is assumed that bureaucrats are budget-maximizers, following Niskanen's (1971) argument that

"[A]mong the several variables that may enter the bureaucrat's utility function are the following: salary, perquisites of the office, public reputation, power, patronage, output of the bureau, ease of making changes and ease of managing the bureau. All except the last two [...] are a positive monotonic function of the total budget of the bureau during the bureaucrat's tenure in office."\textsuperscript{101}

\textsuperscript{96} Refer to Johnson (1982), p. 315.
\textsuperscript{97} Refer to Önís (1991), p. 115.
\textsuperscript{98} Refer to Wade (1990), p. 343. For further information refer to Tullock (1985).
\textsuperscript{99} For further information refer to Weber (1911).
\textsuperscript{100} Refer to Cullis and Jones (1987), p. 127.
\textsuperscript{101} Refer to Niskanen (1971), p. 38. For further information also refer to Niskanen (1973).
In the three developmental states, norms of comportment for state functionaries and structural organization ensured state cohesiveness and a reputable, rule-committed civil service:

- **Rules**: The bureaucracy and its functionaries had to follow clearly specified rules. The institutional framework of the bureaucracy ensured that the functionaries’ decisions were guided by such rules instead of individualistic and predatory interests.\(^{102}\)

- **Merit-based recruitment**: The commitment to rule-following was compounded by a mechanism crucial for state cohesiveness, namely, the adherence to precise norms of recruitment. Functionaries thus pursued their work duties rather than personal gain. Bureaucrats recruited according to meritocratic criteria generated a kind of “esprit de corps” within the bureaucracy. The knowledge that they belonged to a highly selected “club”, with similar qualifications and rare skills, created a corporate culture among functionaries. This in turn ensured state cohesiveness which would not be possible through meritocracy alone.\(^{103}\) Common educational backgrounds of the bureaucratic and business elites and their significant cross penetration played a key role in generating extraordinary degrees of elite unity.\(^ {104}\)

- **Career prospects**: One requirement for a successful bureaucracy is a well-defined, competitive career path with a substantial prize for those who make it to the top.\(^ {105}\) In the East Asian developmental states, the top decision-makers in industrial policy generally reached their positions after they had gained work experience from several agencies or public enterprises. In these years, they also built close working relationships with a stable core of colleagues.\(^ {106}\) In Japan, retirement comes early, and the rewards to a successful bureaucrat are substantial, extending beyond the pay, perks, and prestige.\(^ {107}\)

- **Remuneration**: The institutionalization of meritocratic recruitment patterns and predictable career paths was accompanied by the provision of sufficient resources, such as remuneration, to make careers in the state competitive with careers in the private sector.\(^ {106}\) In general, the more favorably the total public sector compensation package compares with compensation in the private sector, the better the quality of the bureaucracy. In economies where public sector wages are at least decent, prestige, job security and other

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\(^{102}\) The predatory state is a state in which the bureaucracy is not immune to rent-seeking and state-society relations do not happen between organized groups and the state as an institution, but between individuals. There is no functioning bureaucracy in a Weberian sense. Refer to Evans (1995), pp. 29-30 and 48-49.

\(^{103}\) Refer to Evans (1995), p. 49.

\(^{104}\) Refer to Önis (1991), p. 115.

\(^{105}\) Refer to World Bank (1993), p. 178.

\(^{106}\) Refer to Wade (1990), pp. 224-225.

\(^{107}\) Refer to World Bank (1993), p. 178.

\(^{108}\) Refer to Evans (1989), p. 582.
advantages of public employment will persuade some talented individuals to forgo higher earnings in the private sector. By the beginning of the 1990s, the World Bank (1995) also acknowledged that high-performing East Asian economies (in contrast to the Philippines, Uruguay, Argentina and Somalia) all provided their bureaucrats with wages comparable to those in the private sector. The World Bank analysis showed that bureaucratic salaries in the state sector in East Asia were as high as, or even higher than, in the private business sector, particularly at the senior level. Lower salaries in the bureaucrat sector than in the private sector aggravate the danger of rent-seeking in states, where salaries cannot prevent bureaucrats from predatory behavior.

- **Size of the bureaucratic apparatus:** As in the developmental states, the functions of the elite bureaucracy were carried out by only a small economic general staff. There is no obvious correspondence between effective market-augmenting state intervention, on the one hand, and the size of the bureaucratic apparatus or the public sector on the other. The East Asian developmental states testified that highly effective forms of market-augmenting intervention could be consistent with relatively small bureaucratic structures and public sectors. Small public sectors had nevertheless embodied highly productive and profitable public enterprise sectors. Economic policy-making in Taiwan was dominated by scarcely more than a dozen people.110

Economic policy-making in Taiwan was intensely centripetal, carried out entirely in Taipei within the executive branch. Only some input from the top of the party occurred. Few individuals dominated this process of economic policy-making. They ranged from the president, to a number of relevant cabinet ministers, to senior people in several government ministries or commissions, to managers of the largest public enterprises, to a few private businessmen who were well connected to the party. Indeed, from the early 1960s to the mid-1980s, just five men had a preponderant voice in economic policy, including monetary, fiscal, industrial and trade policy. Most of the personnel graduated from the same two or three elite universities, mostly Taiwan National University in Taipei. Almost all belonged to the Nationalist Party and many held concurrent party posts. Mostly, they held the latter because of their positions in the economic hierarchy. The combination of party ties, common educational background and, most importantly, long-standing working relationships with colleagues, resulted in high personal and professional empathy among top

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111 Refer to Wade (1990), p. 195.
113 An examination of personnel records suggests that at the "lowest" ranks (not further defined) of the Ministry of Economic Affairs about 40 percent are graduates of Taiwan National University. About 80 percent of Japan's higher-level civil service in the 1960s graduated from Tokyo University. Refer to Wade (1990), p. 217.
The East Asian developmental states

officials. This helped to create a broad consensus among them on the general growth-oriented goals of Taiwan's economic policies. A highly competitive examination had to be passed for recruitment to the economic bureaucracy. A sizeable proportion of the graduates who passed the government examination actually joined the government or public enterprises. Government service attracted a substantially higher proportion of university graduates than college graduates. As Taiwan's educational system was intensely meritocratic, this implied a higher proportion of the more able students.114

Overall, in the developmental states, startling post-war economic growth occurred with the help of this powerful, talented and prestige-laden economic bureaucracy. However, none of the East Asian developmental states was immune to clientelism and corruption. Bureaucrats used some of the social surplus for the benefit of incumbents and their friends rather than those of the citizenry as a whole. In certain periods, their regimes appeared more rapacious than developmental (e.g. the KMT in Taiwan, the Rhee regime in Korea). The exploitation of personal gain by state functionaries, however, happened less than in other transformation states. In addition, the consequences of their actions promoted rather than impeded transformation. This was essential to the bureaucracy's effectiveness.115

2.3.3 The pilot agency

Within the bureaucracy of the East Asian developmental states, "pilot agencies" played a key role in policy formulation and implementation. For Johnson (1982), the pilot agency was the "greatest concentration of brain power".116 It was a powerful and autonomous agency able to solely formulate industrial policy and coordinate economic development. The authoritative pilot agencies were charged with the task of planning, guiding and coordinating industrial policies.

The most well known government institution of this kind is Japan's Ministry of International Trade and Industry (MITI). MITI is the classic example of a pilot agency functioning like a superministry.117 Evans (1989) acknowledges MITI and its policies by contending that "the administrative apparatus that oversaw Japan's industrial transformation was as impressive as the transformation itself".118

MITI held several functions to promote the industrial structure and enhance the nation's international competitiveness. It performed think-tank functions, decided over strategic industries and high-priority sectors and prepared the environment for

117 Compared with the pilot agencies of Taiwan and Korea, MITI has been the most powerful and the Taiwanese counterparts the least so. Refer to Chan (1990), p. 49.
economic development.\textsuperscript{119} It obtained a consensus for its plans from the private sector, acted as a "gatekeeper" for contacts with foreign markets and investors and provided positive government support for private economic initiatives.\textsuperscript{120}

Korea's Economic Planning Board and Taiwan's Council for Economic Planning and Development followed Japan's blueprint of a pilot agency.\textsuperscript{121} Before its restructuring in 1994, the Korean Economic Planning Board had planning, budgetary and economic management functions. The Economic Planning Board was able to provide a strong coordinating role, as it stood outside and astride the individual ministries. Individual economic ministers were required to consult with the head of the Economic Planning Board, the deputy prime minister, before they could initiate major policies. The Economic Planning Board resisted having close identification with any particular sector or group and thus protected its institutional insulation and its broad political mandate. During its 33 years of existence, it never had direct relationship with the private sector. However, conflict and confusion over the structure and role of Korea's system of national economic management within the bureaucracy emerged which finally led to the dismantling of Korea's key pilot agency in late 1994.\textsuperscript{122} This subsequently comprised the state's transformative capacity.

The Council for Economic Planning and Development in Taiwan also operated independently of the ministerial bureaucracy and similarly had its own planning and budgetary functions. The Council for Economic Planning and Development integrated the leadership of the individual ministries. In this way, they were forced to act as a unit rather than to represent client interests. The Council for Economic Planning and Development acted relatively insulated from special interests and fulfilled its coordinating role. Although its importance as center of economic decision-making was unquestioned, its power relative to that of particular ministries varied over time and across issue areas.\textsuperscript{123}

2.4 State-led economic growth

The developmental states have been doing more than the neoclassical accounts recognize to increase supply responsiveness and steer the direction of industrial growth. State-led economic growth includes strategic industrial policy to promote "winner industries", a dualistic trade policy that protects certain infant industries and encourages domestic companies to export on a large scale, as well as the controlled inflow of foreign investment.

\begin{itemize}
\item \textsuperscript{119} Refer to Johnson (1982), p. 19.
\item \textsuperscript{120} Refer to Wade (1990), p. 195.
\item \textsuperscript{121} Of these, MITI has been the most powerful and the Taiwanese counterparts the least so.
\item \textsuperscript{122} At this time, bureaucrats were often trained in a neoclassical perception in the US.
\item \textsuperscript{123} Refer to Weiss (1998), p. 53.
\end{itemize}
2.4.1 East Asian industrial policy

Like most developing countries, the East Asian developmental states had multiyear development plans. In Taiwan, the first plan, covering four years from the beginning of 1953 was called “The Plan for Economic Rehabilitation”. \(^{124}\) Industrial policy in the East Asian developmental states has been strategically targeted towards the long-term development of selected industries. These have enjoyed competitive advantage through state support.

*Industrial policy directed towards long-term development goals:*

According to the developmental statists, the elite bureaucrats in the pilot agencies can have an advantage over the private sector when it comes to information and data-gathering due to excessive resources such as personnel and money to conduct research on market development. \(^{125}\) Subsequently, they might have good overall and long-term views of the economy. Furthermore, as governments pool and disseminate technical, commercial and market information, they can help to improve private sector decision-making and minimize their investment risks. \(^{126}\) Scholars, however, have applied relatively little research to the question of how individual sectors are chosen for high-priority treatment in particular countries and times. \(^{127}\) Consequently, there is only a little information available. In Taiwan, domestic and international research institutes and consultancy firms have worked on identifying sectors and products of interest for foreign investors. \(^{128}\) Moreover, particular industries were chosen for special attention by looking at outside reference economies. Japan looked to the USA and Europe, Korea and Taiwan to Japan and to each other. \(^{129}\) Sometimes policies were even copied in detail.

Generally, in the developmental states, the basic criteria for the choice of strategic industries involved high income elasticity of demand in world markets and the potential for rapid technological progress and labor productivity growth. Sectoral industrial policy was adjusted to the long-term goal of industrialization rather than short-term profit maximization on the basis of current comparative advantage. \(^{130}\) The

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124 Refer to Wade (1990), p. 81.
125 Hayek, however, argued that planners will never have enough information to carry out allocation of resources reliably. The efficient exchange and use of resources, Hayek claimed, can be maintained only through the price mechanism in free markets. For further information refer to Hayek (1945).
126 Refer to Yue (1995), p. 86.
127 This aspect is further elaborated in Chapter 2.7.1.
129 Refer to Wade (1990), p. 334.
130 The essence of Japan’s, Taiwan’s and Korea’s industrial policy was that they all were cases of a guided market economy in which market rationality has been constrained by the priorities of industrialization.
economic bureaucrats acted in anticipation of future comparative advantages rather than in accordance with them. Thus, the governments of the developmental states have "made the winners".131

Japan’s MITI shifted from labor intensive light (textile) to capital intensive heavy industry (steel works, harbors, dockyards, airports, autos etc.) already in the early 1950s, although this was contrary to their comparative advantage, cheap labor, at that time.132 This may be considered as one of MITI’s most important decisions. MITI officials believed that products with higher income elasticities of demand like appliances and electronics offered a way out for Japan from its position of dependency. In the 1960s, before the period of liberalization, synthetic textiles, plastics, petrochemicals, autos and electronics were nurtured and supported.133 Even after the economy had been liberalized, the economic officials continued to identify such new strategic industries as semiconductors, numerically controlled machine tools and advanced consumer goods like videotape recorders and computers.134

In this way, Japanese firms were encouraged to move up the ladder of technology and pass the less desirable industries where their international competitiveness was already declining (those with low technology content, high labor intensity, environmental pollution hazards) to follower nations such as Taiwan and Korea.135 As Japan’s economy was strongly dependent on exports, these steps were clearly designed to encourage continuous industrial adjustment and to stimulate dynamic trade competitiveness. In this respect, MITI controlled not only foreigners’ access to the Japanese economy, but also Japanese producers’ access to foreign markets.136

*Preferential treatment only for selected industries:*

Strategic industrial policy implied that preferential treatment of enterprises was channeled on a selective basis according to the state’s long-term development plan. Only certain enterprises of “upstream” industries with the most favorable environment for growth were targeted. Protection and assistance such as preferential allocation of key production inputs and bureaucratic support for promotion, were given primarily to

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131 For information on Taiwan’s promotion of the heavy and chemical industries during the 1960s and 1970s, refer to Wade (1990), p. 110 and p. 334.


134 With regard to MITI refer to Johnson (1982), p. 302.

135 Taiwan’s development path looks very similar, moving up from light to heavy and chemical industry. In the early stage, textiles, plastics and the synthetic fiber industry were treated. Preferential treatment was later given to petrochemicals, machinery, computer terminals, machine tools, semiconductors, computers, telecommunications, robotics and biotech. Refer to Wade (1990), pp. 90-99. Korea followed suit with a big push in heavy machinery and chemicals in the late 1970s, and targeted, among others, the electronics and the auto industries. Refer to Amsden (1989), p. 81.

136 Refer to Chan (1990), p. 50.
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infant industries and to those industries perceived to be "sunrise industries" with potential future competitiveness. Downstream or "sunset" industries have been left much freer.\textsuperscript{137} This was contrary to the general policies of mercantilism where the domestic industry as a whole was protected.

The Japanese state, after experimentation with direct and detailed intervention in the pre-World War II period, limited itself to strategically selected economic involvement. The industries apart from the priority sectors experienced policy intervention only from time to time, while the remaining industries were exposed unaided to the rigors of market competition. Subsequently, the centerpiece of industrial policy was a high degree of selectivity.\textsuperscript{138}

\textit{Instruments of the pilot agency:}

The policy tools the pilot agency's bureaucrats used were manifold: tax incentives and breaks, subsidies, preferential bank loans and selective credit allocations, tariffs on imported goods, foreign investment screening, foreign technology licensing as well as government sponsored research and development (R&D).\textsuperscript{139} In addition, the pilot agencies provided administrative guidance that regulated competition in an industry.\textsuperscript{140} Control of foreign exchange together with export incentives were the link between industrial policy and international trade.\textsuperscript{141} The use of selective subsidies based on performance was probably the most important of the different policy tools MITI had. In this line, in accordance to the neoclassical approach, MITI encouraged specialization according to Japan's comparative advantage. At the same time, it tried to minimize the country's dependence on, and therefore vulnerability to, external suppliers (as advised by the dependency theorists) by import substitution of certain products. Besides regulating imports and allocating export quotas, MITI officials influenced the geographic location of particular plants. They also issued advisory directives ("administrative guidance") that attempted to steer firms toward, and to prepare them for, future "sunrise" industries like electronics or information systems, and to persuade them to abandon unprofitable "sunset" industries like textiles or petrochemicals.\textsuperscript{142}

Through all these measures, the developmental states sought, not always successfully however, to bring about mergers or collaboration among firms in order to

\textsuperscript{137} Refer to Wade (1990), p. 73.
\textsuperscript{138} Among others, refer to Amsden (1989), p. 243 ff.
\textsuperscript{139} In Taiwan for reference, in the 1960s, in order to promote technological and managerial upgrading in industry additionally to those established in the 1950s, the government established several more research and service organizations. For an analysis of these institutions refer to Wade (1990), p. 95.
\textsuperscript{140} Refer to Edin (2000), pp. 26-27.
\textsuperscript{141} MITI in 1952 informally advised ten large cotton spinners to reduce production by 40 percent and those who did not heed this advice were told that foreign currency for the following months supply of raw cotton might not be available. Refer to Johnson (1982), pp. 224-225.
\textsuperscript{142} Refer to Chan (1990), p. 49.
profit from economies of scale and pool resources. In this way, the pilot agencies aimed to enhance the international competitiveness of selected industrial sectors in order to spur the state's economic transformation.

Overall, the difference between what happened in East Asia and elsewhere cannot be ascribed to industrial policy instruments not known elsewhere. Many other developing nations have at one time or another tried most of the policy tools used in East Asia. What differentiates their efforts, above all, are the pilot agency's consistent and coordinated attentiveness to the problems and opportunities of particular industries in the context of a long-term perspective of the economy's evolution. Another key message is that a powerful pilot agency such as MITI provided important strategic guidance in the selection of key industries to be encouraged and also in the provision of a stable and predictable environment for private investors to undertake risky, long-term investment projects. Hence, sector-specific forms of indicative planning can be an essential complement of market-oriented growth in the initial phase of transformation.

2.4.2 Trade policy – import substitution and export promotion

The developmental states protected strategic infant industries from international competition. Pursuing this goal, the Japanese government attracted only specific imports like production ingredients that Japan either lacked or did not have in sufficient quantity or quality. Specifically, these were raw materials and certain advanced technology from external markets such as in the aerospace and computer sectors. Simultaneously, the government hindered the import of e.g. foreign capital. The goal was to encourage national autonomy in strategic industries such as computer, telecommunications steel and energy. At the same time, foreign penetration and domination of these sensitive sectors was to be avoided.

The initial phase of build-up protection in the East Asian developmental states was combined with an export-oriented free trade regime which initially paralleled and later displaced the previous import substitution policy. The developmental states have exposed national companies to international competition by encouraging them to export. In general, export-promotion was based on the following arguments:

- Continued import substitution in the form of protectionism in narrow domestic markets requires the production of commodities that involve higher domestic costs per unit of foreign exchange saved. Exporting, by contrast, involves the

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143 Refer to Wade (1990), p. 343.
144 Refer to Onis (1991), p. 122.
145 Refer to Chan (1990), p. 49.
production of commodities in which the country has a comparative advantage. This implies low domestic resource costs per unit of foreign exchange.

- Exports enable fuller capacity utilization and allow reduction in unit costs through the exploitation of economies of scale contributing thereby to efficient import substitution.
- Export orientation not only provides an engine of growth, it also encourages domestic industries to become and remain internationally competitive. By exporting, enterprises are disciplined because they have to fulfill standards set by export markets in order to be internationally competitive. Exposure to foreign competition is decisive as it provides the stimulus needed for technological change.\(^\text{146}\)

The protection of infant industries in the East Asian developmental states was unlike the policy approaches of other late developers such as Latin America. In East Asia, the period of "pure" import substitution industrialization (that is without a significant manufactured goods export drive) was generally shorter: in Korea only for a short spell in the 1950s and in Taiwan only between 1953 and 1957. Korea and Taiwan adopted an outward-oriented strategy in the early sixties, emulating the industrial strategy of Japan.\(^\text{147}\)

Akamatsu's (1962) "flying geese pattern" implies that there is a broad similarity in the types of export industries in which countries specialize in comparable development stages.\(^\text{148}\) All developmental states started with a focus on technologically simple labor-intensive goods such as clothing, toys, processed foods and so forth, and advanced to exports of more capital-intensive, technologically sophisticated items.\(^\text{149}\) Obviously, the speed of graduation has varied; however, the moves have been the same.\(^\text{150}\)

\(^\text{146}\) A number of indirect, but positive effects also result from export promotion. Export expansion will ease the foreign exchange constraint, thereby permitting increases of materials and machinery imports. For further positive indirect effects refer to Balassa (1981a), p. 15.

\(^\text{147}\) In Korea, the share of exports in manufactured output rose from 1 percent in 1960 to 41 percent in 1973. In Taiwan, the share of exports rose from 9 percent in 1960 to 50 percent in 1973. Despite their poor natural resource endowment, the East Asian countries had the highest growth rates of primary exports and thus of total exports, compared to the developing Latin American countries, which had mostly chosen an import-substitution strategy of development. Refer to Balassa (1981a), pp. 14-15.

\(^\text{148}\) The center of gravity of industries shifts from first movers of industrialization to the second-tier group, and then to a third group of countries. Refer to Akamatsu (1962), pp. 3-25.

\(^\text{149}\) Refer to Weiss (2005), p. 3 and Ito (2001), p. 61.

\(^\text{150}\) The move of the ladder of comparative advantage can be illustrated with data from Korea. In 1961, the single largest export item was iron ore (13 percent of total exports), in 1980 it was textiles and garments (29 percent of the total) and in 1989 it was electronics (also 29 percent). Refer to Weiss (2005), p. 3.
Since the 1990s, there has been much less emphasis on increasing and coordinating investment for the purpose of export promotion and industry creation in Japan, Korea and Taiwan. Instead, stress has been laid on developing and disseminating new products and technologies. The developmental states have focused on the R&D side of industry policy, namely the promotion and diffusion of technologies instead of sectoral promotion of export via investment allocation.\textsuperscript{151} In this line, trade policy in Korea has shifted from import substitution (prevalent in the 1950s) towards export promotion (starting in the 1960s) and high-tech industrialization (since the late 1980s). At the same time, policy instruments have changed from import protection, export subsidization and policy loans to investment incentives for R&D and eventual financial sector liberalization (refer to Table 1).

Table 1: Timing of shifts in Korea’s trade policy.

<table>
<thead>
<tr>
<th>Period</th>
<th>Priority activities</th>
<th>Main Instruments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960-1973</td>
<td>Initial export take-off: Promotion of exports in general - key sectors labor-intensive manufacturers.</td>
<td>Import protection, export subsidies including duty drawbacks, subsidized credit allocation, export targeting.</td>
</tr>
<tr>
<td>1973-1980</td>
<td>Heavy and chemical industry drive: selective promotion - priority sectors steel, petrochemicals, non-ferrous metals, shipbuilding, electronics and machinery; priority firms selected large enterprises.</td>
<td>Import protection, export subsidies including duty drawbacks, subsidized credit allocation, export targeting. Widespread use of policy loans to channel funds to priority firms and sectors. Investment incentives through tax credits.</td>
</tr>
<tr>
<td>1980-1990</td>
<td>Gradual trade liberalization and move to less selectivity. Priority on high technology activities.</td>
<td>Phased import liberalization, ending of policy loans. Still government influence over allocation of credit. Investment incentives for R&amp;D. Easing of restrictions on FDI.</td>
</tr>
</tbody>
</table>

Source: Refer to World Bank (1993), p. 124 and Weiss (2005), pp. 3-4 and p. 19.\textsuperscript{152}

In the East Asian developmental states exports generated “learning-by-doing”. Exports also improved the quality of capital stock because of the need for products to compete in export markets. This in turn raised overall productivity, which then led to an increase in average profit rates across the whole economy (not just in exports). Real wages could thus rise without inflation.\textsuperscript{153} The developmental states used various measures in order to stimulate exports.\textsuperscript{154} Among those have been export promotion schemes, performance tracking as well as the devaluation of the developmental states' currencies.\textsuperscript{155}

\textsuperscript{151} Refer to Weiss (1998), p. 33.
\textsuperscript{152} For further information refer to Kim and Leipziger (2000).
\textsuperscript{153} Refer to Wade (2004), p. 10.
\textsuperscript{154} The policy instruments used certainly changed over different periods.
\textsuperscript{155} For further information on export incentives refer to Wade (1990), p. 119.
Export promotion schemes:

In order to give positive discrimination in favor of export sales, several export promotion schemes were introduced in the East Asian developmental states. Exporting enterprises were free to choose between domestic and imported inputs. Exporting enterprises, as well as the producers of domestic inputs used in export production, were granted several privileges, such as exemption from indirect taxes on their output and in inputs, they were not obliged to pay duty on imported inputs, and were entitled to retain a large proportion of their foreign exchange. Moreover, the broadest functional targeting of credit in the developmental states has been to exporters. Taiwan introduced fiscal incentives, such as a five-year tax exemption for a wide range of industrial goods. The state granted tax reliefs only if companies' exports equaled 50 percent or more of production. Furthermore, only a small percentage of a firm's export earnings was made tax exempt. The state granted these privileges to all enterprises, as a differentiation among individual export commodities did not take place. Altogether, subsidies in the form of tax exemptions and credits at low

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156 One of the most influential models of strategic export policy is the Brander - Spencer model, in which it is shown that the home government has a unilateral interest in adopting an export subsidy policy if the home firm competes with a foreign firm in quantities (they refer to the example of the American and European aircraft manufacturers Boeing and Airbus). The central motive for these types of strategic policies is to shift profits from foreign firms to the home country. Refer to Brander and Spencer (1985).


158 The East Asian developmental states had different characteristics of export credit schemes.

Japan: Between 1946 and 1972, the Bank of Japan rediscounted export bills at low rates of interest (1 to 2 percentage points lower than that applicable to general trade bills). During this period, the Bank of Japan directed 10 percent of its loans to export finance (which financed 50 percent of total export-related bank lending).

Korea: The Korean Export-Import Bank offered concessional rediscounting of preshipment credit based on letters of credit. The differential between loan rates of this export credit and general loan rates was between 3 and 20 percentage points until 1982, when this difference was eliminated. In 1984, the differential was restored at 1.5 percentage points. The Korean Export Import Bank also provided longer-term post-shipment finance and export credit insurance.

Taiwan: Banks offered firms short-term preshipment loans based on letters of credit. After products were shipped, firms were eligible for loans based on letters of credit, documents against acceptance of payment, and shipment documents. In addition, the Central Bank provided a special discount rate to designated domestic banks for export loans, usually at 1 percentage point lower than the usual discount rate. The export loan rate was about 3 to 5 percentage points below the minimum interest rate for secured loans between 1970 and 1980, and it dropped to 1 to 2 percentage points after 1980. Refer to World Bank (1993), p. 281.

159 Refer to Wade (1990), p. 119.

160 There is evidence that the system of incentives applied affects the country's export performance. Econometric estimates made for a number of countries show that increase in export prices due to export incentives are associated with a rise in the volume of exports. In addition, export incentives positively correlate with the share of exports in domestic output and with the contribution of exports to increases in output in an inter-industry framework. Refer to Balassa (1981a), pp. 13-14. For further information refer to Balassa (1981b).
interest rates were one of the main incentives the developmental states offered their exporting firms. Thus, the disadvantage faced by national firms in international competition was offset, and the industrial structure moved up the value-chain toward more technology-intensive activities.

The Korean textile industry gave the national economy its initial push to significant growth and it largely accounted for the country’s impressive export performance. In the late 1960s, subsidies, at that time a new policy instrument, were implemented to guide the textile industry. Subsidies were introduced because the cost position of Korean manufacturers of cotton textiles was less favorable than that of their Japanese counterparts although the income level in Korea was lower. Amsden (1989) observed,

“Subsidies in Korea were necessary not because of ‘distortions’ [in particular, the exchange rate was not much distorted] but because the Koreans could not, initially, compete against the Japanese, even in industries such as cotton spinning and weaving in which the least developed, most labor-intensive countries supposedly have a comparative advantage”.

Only with the state's subsidies, could the Korean textile industry enter export markets on a sizable scale. Subsidized credit for working capital was available to any exporter, but long-term capital at favorable interest rates was allocated only to targeted firms and industries. At the same time, import restrictions were applied by the government in order to exclude foreign competition. The state also initiated mergers of small firms to encourage productive manufacturing and improve competitiveness. Drastic growth of exports followed only after the May 1961 military coup, and was hence a direct consequence of the new military regime’s policies. The share of textile and clothing exports in Korea's gross national product rose from 1.8 percent in the mid-1950s to 7.7 percent in the early 1970s. The share of textiles in manufacturing exports grew from less than 5 percent in 1963 to more than 47 percent in 1973. At that time, the cotton textile industry had become internationally competitive in a system of free trade and could be weaned off subsidies.

Performance tracking:

In addition to the government's support for exporting companies, it exerted strong discipline on businesses to which it granted subsidies. Firms had to fulfill certain performance standards in exchange for subsidies. The performance had to be

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161 Refer to Levi-Faur (1998), pp. 77-78.
164 For examples refer to Amsden (1989), p. 73.
166 Refer to Wade (1992), p. 287.
accomplished whether the targeted enterprises were public or private.\textsuperscript{168} The businesses in the developmental states that used subsidies "well" were rewarded with further help, and support was withdrawn from those that did not.\textsuperscript{169} This suggests a reciprocal relationship between governments and firms. The conditional performance which was imposed on firms located in strategic sectors and the discipline exercised by them led to price distortions, such as heavily subsidized rates of interest on long-term credits. However, resources were not wasted as in the case of many other middle income economies which made extensive use of subsidies to declining firms or industries experiencing financial difficulties. As subsidization was not dependent on business performance in those countries, subsidies emerged as a major avenue for rent-seeking.\textsuperscript{170} In the developmental states, the government has deliberately refrained from bailing out firms which were badly managed.

In order to hold enterprises accountable for achievements, the developmental states formulated performance criteria. In line with the outward-oriented development strategy of the developmental states, success in export markets became the main criterion of good use of subsidies, and of the distribution of further subsidies. In Taiwan, a firm was entitled to concessional credit on the basis of the previous year's export performance and the planned exports for the current year.\textsuperscript{171} In similar ways protection was made conditional. In 1982, an import ban on videocassette recorders was granted by the Taiwanese government in order to assist two domestic electronics companies to build up their capacity. Eventually, after eighteen months, as their prices were still substantially above those of Japan, the ban was lifted.\textsuperscript{172} At this time the government announced that it was allowing Sony to form a joint venture (JV) with a local firm (not one of the two which had already started). The only condition was that 50 percent of production should be exported after three years.\textsuperscript{173}

\textsuperscript{168} The distinction between public and private ownership is of subordinate importance, as ownership structure has varied from country to country in East Asia. Governments chose which type of enterprises they use to implement their economic policies. Taiwan has seen one of the largest public enterprise sectors outside the communist bloc, complemented by a large number of small family firms. In comparison, most of the enterprise conglomerates, \textit{zaibatsu} in Japan and \textit{chaebol} in Korea, are private businesses.


\textsuperscript{171} Refer to Wade (1990), p. 142.

\textsuperscript{172} Sony was subsequently allowed to form a JV with another domestic firm on condition that, after a 3 year period, 50 percent of production was exported. Refer to Wade (1990), pp. 132-133.

\textsuperscript{173} Refer to Wade (1990), p. 133. With regard to the Korean developmental state, Amsden delivers insight from fairly detailed case studies of approximately thirty-five Korean enterprises not only in the textile industry, but also in the cement, paper, steel, shipbuilding, general machinery, auto and construction industries. Several subsidiaries within a business group were studied (five in the case of Hyundai, three in the case of Samsung) to analyze, among other issues, whether repeated patronage by the government was justified on efficiency grounds. Refer to Amsden (1989a), p. 16.
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**Exchange rate devaluation:**

The East Asian developmental states also maintained an undervalued and thereby "distorted" exchange rate against the currency of the main export market, mostly the USD.\(^{174}\) This undervaluation, combined with export-exhorting national campaigns and competitions like "Japan's Trade Promotion Monthly", provided incentives to seek out export markets. The undervalued exchange rate not only provided a general incentive to exports, but also provided a measure of protection against imports. In the East Asian developmental states, despite the resulting increase of economic growth, the undervalued exchange rate remained credible, because it was linked to fiscal conservatism. Latin American states, in contrast, often pegged exchange rates, which became overvalued through domestic inflation. The loss in credibility then resulted in a financial crisis. In East Asia, the profitability of the companies, rising real wages and the credibility of the currency peg, attracted additional domestic savings and more foreign investments. The quality of capital stock and labor stock rose again, due to high rates of investment and re-investment.\(^{175}\)

Altogether, while encouraging exports and simultaneously protecting key infant industries, the developmental states strategically pursued a dualistic approach of regulating international competition according to its needs. The central role of the government's guiding hand is obvious. According to Haggard (1990), export promotion is one decisive factor which explains the accomplishments of Asia-Pacific industrialization compared with less successful transformation states.\(^{176}\) A short period of import substitution led to a less intensive development of industrial-societal forces, which demanded protection of the domestic industry in the East Asian developmental states. Unlike the East Asian developmental states, in Latin America, a long period of import substitution industrialization allowed a strong lobby for inefficient firms to develop.\(^{177}\)

### 2.4.3 Foreign capital

One element within the development approaches of the East Asian states appears to be contradictory. Japan has been "close to paranoid on the subject of the dangers of an invasion of foreign capital"\(^{178}\) and has eagerly tried to prevent foreign participation in its economy. Unlike the Japanese approach, Korean and Taiwanese bureaucrats have used foreign and multinational capital extensively. Yet, what is important is that they attracted the needed foreign capital without at the same time becoming obsequious to it.

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\(^{174}\) On exchange rate regimes in East Asia, refer to Collignon et al. (1999).

\(^{175}\) Refer to Wade (2004), pp. 9-10.

\(^{176}\) Refer to Haggard (1990).

\(^{177}\) Refer to Thompson (1996), p. 631.

Postwar Japan did not totally exclude foreign investment or foreign borrowings. It imported loans from the World Bank and from American commercial banks during the 1950s, and made use of American offshore procurement contracts and military expenditures. It was concerned to separate foreign money and technology, both of which it needed from foreign ownership-rights and manufacturing facilities, because it aimed to preserve its large domestic market for its new industries. The Japanese state aimed to restrict foreign investment. Due to its larger size (in comparison with Korea and Taiwan) the domestic market was used for national companies to prove their competitiveness, and then successfully export in international markets. Thus, high economic growth could be achieved.

The domestic markets of Korea and Taiwan were too small to generate enough domestic savings needed for fast industrialization. Subsequently, they had to attract foreign capital extensively. While in Korea and Taiwan, firms exported and developed overseas markets, bureaucrats additionally aimed at attracting foreign firms. Foreign firms investing in Korea and Taiwan were largely producing for export. At the same time, however, Korea and Taiwan exercised broad controls over foreign investments (such as "unrealistically" high local content requirements) which were decisive in avoiding domination of more powerful countries. Essentially, despite different strategies of letting foreign capital participate in its economies, none of the East Asian developmental states has become "subservient" to it, as the inflow of capital has been intensively controlled by the state.

2.5 Financial system

The governments of the developmental states were able to wield instruments capable of discriminating between industrial sectors in order to lead industrial restructuring. One instrument has been the financial sector.

Generally, financial systems may be capital market-based or credit-based. Each has different implications for the influence of governments and banks on business. In a capital market system such as the American and British financial systems, securities (stocks and bonds) are the main source of long-term business finance. There is a wide range of capital and money-market instruments. Furthermore, a large number of specialized financial institutions compete strongly in terms of price and service, and actively contribute to the financing of particular firms. In a credit-based system, the capital market is usually weak. Thus, besides retained earnings, firms heavily depend on credit. The allocation of credit can be actively controlled either by relatively autonomous banks, as in Germany or by banks dependent on the government.

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179 Refer to Johnson (1987), p. 163.
The East Asian developmental states had bank- and credit-based financial systems, and the banks were virtually all owned or controlled by the government throughout their transition periods. In the developmental states, the financial authorities adopted a grading system to ensure that money was directed to productive investments. Bank loans were approved for business plans in priority sectors (e.g. producing textiles for export markets) and were hindered for businesses in low priority sectors (e.g. noodle production for domestic consumption). In this, the attention of the business groups was diverted towards capital accumulation.

As governments in the developmental states Japan, Korea and Taiwan had control over the financial system, they were able to allocate credit at low interest rates to strategic industries. The three developing countries, however, had different institutional roots and forms of how to mobilize capital:

- In Japan, the banks were mostly privately owned. However, in order to expand their lending, they depended on the central bank for access to supplementary deposits. The central bank, the Bank of Japan, has been controlled by the government's Ministry of Finance, and the public postal savings system has been a key component of the entire system. Subsequently, until the 1970s, MITI and the Ministry of Finance were able to re-cycle Japan's high levels of domestic savings to targeted domestic industrial sectors and businesses. Selected businesses received capital at "artificially" low interest rates. This gave them an advantage over established rivals elsewhere. Already in 1982, the Japanese postal savings system controlled more assets than the Bank of America, which was the world's largest commercial bank at that time. The sources of funds for large Japanese companies showed almost

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182 Refer to Whitley (1999), pp. 159 and 171.
183 In Korea, one of the first acts of the government of Park Chung Hee (since 1961) was to nationalize the banking system. (The government of Syngman Rhee had to denationalize it a decade earlier to appease American pressures.) Although pressures to liberalize in the 1980s led the government to privatize commercial banks, thereby strengthening aggregate economic concentration and income inequality, the government maintained its control over commercial banking. However, the government still reaches far down into the officially denationalized banks in terms of personnel policies, appointment of senior managers, range of services and the like. Refer among others to Amsden (1989), p. 16 and Wade (1988a), p. 133.
185 Refer to Pempel (1999), p. 149.
186 Refer to Wade (1988a), p. 133.
187 Refer to Pempel (1999), pp. 149-150. For further information on the postal savings system refer to Amyx (2005), ‘Reforming Government-Backed Financial Institutions, Internet Edition, reviewed 01.05.2007.
189 In 2001, the Japanese postal savings system accounted for 34 percent of household deposits and held about USD 2.2 trillion in deposits. Still in 2005, it is the largest financial institution in the world. Of course, the Japanese save so heavily in postal savings accounts, because, by law, these accounts offer the highest rate of interest available to small savers. Refer to FRBSF Economic Letter (2001), "Japan’s New Prime Minister and the Postal Savings System", p. 1, Internet Edition, reviewed 22.10.2006 and Frankfurter Allgemeine Sonntagszeitung (2005), p. 11.
no change during the period 1972-1981. In 1972, companies obtained 75 percent of their funds through loans from banks, and only 19 percent from shares, and the figures for 1981 were 68 percent and 21 percent.\textsuperscript{190} Government control of the domestic banking system ensured that indigenous financial institutions cooperated in providing funds to industry. This in turn helped to consolidate the close ties between industrial and financial capital that was characteristic of Japan during the boom years.\textsuperscript{191} Although some measures of financial "internationalization" have taken place, the government's postal savings system is still intact and functioning as one of Japan's most important institutional inventions.

- In Taiwan, only 5 percent of deposits as well as the branches of all commercial banks were under private ownership in 1980. Moreover, banks' chairmen were either former Ministry of Finance employees or central bank officials appointed by the government. Bank boards had little autonomy: all transactions had to be reported once a week to the central bank, and all foreign exchange transactions had to be reported daily.\textsuperscript{192}

- In Korea, although almost all banking was privatized, government oversight was critical in directing capital to desired sectors.\textsuperscript{193} The Korean Economic Planning Board exerted extensive financial control. It effectively controlled Korea's banking sector and credit allocation decisions, as it had supervision over the Ministry of Finance. Its authority encompassed several different functions such as the appointment of personnel and foreign exchange allocations. Since the 1960s when the commercial banks were also nationalized, they have had to deposit their funds in the Korean Development Bank and to purchase long-term bonds issued by the Korean Development Bank. In addition, they were required to extend credit to firms with loan guarantees from the Korean Development Bank. The government used policy loans to support exports and promote the industrialization of the heavy and chemical industries in the 1970s, or to re-structure Korea's auto industry. Foreign loans were also channeled via government which implied that all firms needed approval from the Economic Planning Board in order to obtain loans from foreign banks. As foreign credit constituted an important source of capital to Korean firms, the Economic Planning Board had an important leverage over Korean firms through foreign credit control. However, as the debt/equity ratio in Korea reached 300 percent, the government's credit control was an important policy instrument for the bureaucracy.\textsuperscript{194}

\begin{flushleft}
\textsuperscript{190} Refer to Johnson (1987), p. 148.
\textsuperscript{191} Refer to Beeson (2004), p. 6.
\textsuperscript{192} Refer to Wade (1990), p. 161 and p. 264.
\textsuperscript{193} Refer to Pempel (1999), p. 150.
\textsuperscript{194} Refer to Huang (2002a), pp. 552-553.
\end{flushleft}
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The developmental states' bank- and credit-based financial system enabled policy leaders to support selected industries by credits at below market interest rates through the banking system. Japan, during its postwar reconstruction, and Korea, during the 1970s, directed large amounts of credit to specific sectors and firms, mostly in heavy and chemical industries. The Fiscal Investment and Loan Program of the Japanese government accounted for about one third of new equipment lending in the 1950s. Korea's policy loans were almost 60 percent of the total loans of its deposit money banks between 1973 and 1981. Most of Japan's priority lending through the early 1960s targeted industries associated with large optimum scales and increasing returns to scale. This is in accordance with Korea's lending behavior during the heavy and chemical industries period.

A well documented industrial policy success relates to the government-sponsored Japan Electronic Computer Company. In 1960, MITI decided that Japan should establish a domestic computer industry. Between 1961 and 1981, USD 2 billion were invested in this sector, because the Japanese government offered low-interest loans only for investments in this sector. Thus, it decisively helped create Fujitsu, as it is known today. The policy mechanisms used have their parallels in the East, but are unknown in the West.

Directed credit in the East Asian developmental states has generally gone to the private sector, unlike many other developing economies, where directed credit often went to public and quasi-public enterprises. Although the developmental states have also directed credit to state enterprises, the proportions of total credit were not persistently high, the parastatal banks tended to perform better financially, and the interest rate subsidies were not large. Korea can be regarded as an exception, because its lending to the public steel plant, POSCO, was substantial, and widely considered a success story.

The analysis revealed that in countries where capital is channeled largely through banks, the state is in a position to extend a visible and vigorous hand in the operation of the economy. The system of external indirect financing gives the state the power to ration credit to banks and channel capital to targeted sectors. This enables the state to influence the direction of industrial change. Since capital is the "lifeblood" of industrial activity, the state's capacity to set the supply and channel the flow of capital, constitutes one of the most effective tools of industrial policy.

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199 Refer to Okimoto (1989), pp. 142-143.
2.6 State-society and government-business relations

As the economic bureaucracy is itself an elite body "occupying a position of preeminence in the society", it is important to examine external ties with the rest of society. In the following, the connections of the state with the public are divided into an analysis of the state’s relations to societal groups, and government agencies' interaction with industrial capital, namely the private business sector.

2.6.1 State-society relations

The strong developmental states were characterized by authoritarian governance. An authoritarian regime can be defined by the cooptation of important interest groups ("limited pluralism"), the renunciation of militant forms of ideology and mobilization of the masses, and therefore the promotion of political apathy and passivity.

Japan was termed "soft authoritarian", meaning the prewar authoritarianism of the Meiji and early Showa eras, and the postwar pattern of the monopolization of political power by a single party. This form of organization made possible the implementation of a set of economic priorities that seemed unattainable under true political pluralism. This also applies to Taiwan and Korea in later phases of their development: Korea was ostensibly a democratic country, however, actually had a military dominated single-party regime which was close in form, if not in ideology, to Japan during the 1930s and 1940s. Taiwan differed from both Japan and Korea, as it did not even claim to be a democracy. Publicly, Taiwan justified the single-party rule of the Kuomintang in terms of the threat from communist China, the political crisis caused by its international isolation and the need to maintain stability on the island. Taiwan was the most explicitly authoritarian of the three countries.

Essentially, democratization in the East Asian developmental states has taken place only after substantial economic development was already achieved. In Korea and Taiwan, authoritarian regimes raised living standards before democratic transition took place. When both countries democratized, this political transformation had been long delayed.

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200 Refer to Wade (1990), p. 195.


204 With respect to Taiwan, Wade conceives: "... what is striking, I think, is how late this (political) softening comes – long after the regime was well formalized and institutionalized, long after the mainland receded, long after the period of economic breakthrough, long after living standards began to rise for everyone". Refer to Wade (1990), p. 254.
In the developmental states, the characteristic of authoritarianism was combined with a weak society. Thus, the authoritarian state organization enabled the ruling elite to pursue a strategy of minimizing commitments to the few existing groups and preventing counter-elites from defining their opposition in politically relevant terms. The governments prevented emerging groups from acquiring autonomy from the state and hindered the formation of independent interest aggregation. Moreover, the governments spread threats of adverse consequences should a private party refuse to conform to a “suggestion or recommendation” of the government. MITI is well-known for having accomplished this with great skill. The elite bureaucracy therefore had the necessary autonomy to define, and the power to implement, national goals. In 1993, the World Bank also stressed the importance of the bureaucracy’s insularity from society for strategic, long-term policy implementation:

“Without it [technocratic insulation], technocrats in the high-performing Asian economies would have been unable to introduce and sustain rational economic policies, and some vital wealth-sharing mechanisms would have been neutralized soon after their inception, as was land reform in the Philippines.”

In this respect, the nation-building strategies of the ruling elites in the East Asian developmental states differed from those used in Latin America. Their ruling group (from 1949 onwards for Taiwan, and from the arrival of Park Chung Hee in 1961 for Korea) had clear principles of industrialization. The process of industrialization was seen and understood in a comprehensive, rather than piecemeal, perspective from the beginning. Both countries were under threat from powerful external enemies, which made industrialization even more vital. The implementation of a comprehensive industrial policy by the elite bureaucracy was possible because the state was strong enough to turn away demands of different interest groups. Thus, these groups were not in a position to pick industrial policy to pieces.

Some bureaucratic-authoritarian regimes in Latin America strived to acquire similar autonomy, but came to power in situations where many existing groups already had

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205 In none of these countries were peasants united or politically organized, partly because smallholder agriculture predominated. In none of these countries were labor movements able to challenge state authority. Only in Korea and Singapore was labor strong enough to provoke repressive measures from the state in the early phases of export development. In addition, in neither case was labor’s resistance sustained effective. Refer to Deyo (1987), pp. 233-234.

206 According to Skocpol, the interest-group approach is about “the allocations of benefits among demanding groups”. Refer to Skocpol (1985), p. 4. The argument goes, since the most powerful groups will be most able to affect the decisions of the state, state economic policies will be inevitably biased towards them. The most representative of these theories is the “regulatory-capture” theory of the Chicago school. Refer to Stigler (1975).


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considerable autonomy from the state. The states of Latin America were confronted with bargaining and shifting alliances of strong interest groups. These groups influenced the policy process of those countries. Macroeconomic populism has become a regular part of the Latin American economic environment. Due to the missing autonomy, the state operated under constant duress.\textsuperscript{211} The Latin American states became unable to realize their long-term vision for their countries. These are examples of such political economies of the "predatory state", in which close government-society cooperation has materialized in the context of "weak" states, which lack autonomy from powerful groups in society.

The industrialized countries and the developing countries in East Asia and Latin America can be categorized according to their state's and society's strength or weakness: the industrialized countries are characterized by strong states and a strong society; the East Asian developing countries exhibit a strong state and a weak society, whereas the developing countries of Latin America represent the combination of a weak state and a strong society (refer to Figure 4).

\textit{Figure 4: A framework for state-societal interaction.}

![Figure 4: A framework for state-societal interaction.](image)


Altogether, in neither Taiwan, nor in Japan and Korea, were organized groups an important factor in shaping economic and social policy, and their disruptive potential was under control. Industrial associations were not important centers of autonomous

\textsuperscript{211} Luiz (2000), p. 239.
influence on the state. Additionally, in none of those countries was an elected legislature important in policy-making. The strong and cohesive elite bureaucracy was insulated from external demands and was not captured by their interests. Thus, the constellation of a strong state and a weak society is a crucial factor for cohesive policy-implementation by the bureaucracy.

### 2.6.2 Government-business relations

Okimoto (1989) contends that informational asymmetry between the state and other agents can be reduced through institutional design. The willingness of Japanese firms to reveal the necessary information to the state and thus reduce informational asymmetry, is often attributed to the tradition of a close government-business relationship. "Business" essentially implies the massive conglomerates in the developmental states. "Government" in this context, refers primarily to a number of key ministries in the state bureaucracy, like MITI in Japan.

Governments can improve private sector decision-making by minimizing risks as they collect, pool and disseminate technical, commercial and market information. Nevertheless, they usually do not have a comparative advantage at the micro-level. In consequence, while governments may provide special support based on the infant industry argument, they are not capable of actually picking national "winners." Therefore, close institutionalized links between the elite bureaucracy and private businesses for consultation and cooperation between government and business are decisive. It enables state actors to base long-term development goals on up-to-date information gained from direct involvement with key economic agents. Consequently, the state can obtain information on how changing economic realities affect entrepreneurial interests.

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213 Refer to Okimoto (1989), p. 156.
214 Conglomerates in Japan, prewar zaibatsu and post-war, vertical integrated keiretsu, were large corporate holding groups. The zaibatsu were closely linked with the military-bureaucratic complex of the 1920s and 1930s and were a key element in building the economy's industrial and military base. Most of the leading electronics firms in Japan, such as Nippon Electric Corporation, Fujitsu, Hitachi and Toshiba, belong to a major keiretsu. For keiretsu firms, membership actually means extensive intra-keiretsu stockholding, reliance on the main keiretsu bank for external indirect financing, and stable but by no means exclusive business transactions. For further information on the Sumitomo keiretsu which incorporates Nippon Electric Corporation, refer to Okimoto (1989), p. 133 ff.
216 Refer to Johnson (1982), p. 23.
217 Refer to Nee et al. (2005), pp. 7-8.
2.6.2.1 Information exchange

In the East Asian states, there has been far-reaching public-private cooperation. In Japan, bureaucrats regularly invited representatives from private industry to discuss policy and market trends. Private actors could exchange information with economic bureaucrats in "deliberation councils", which were attached to the respective ministries. Deliberation councils were organized either along functional or thematic lines, such as pollution and finance or according to industry, such as autos or chemicals. The councils were established by government ministries and were generally associated with a specific bureau within the ministry. The private sector was represented by people from business, labor, consumers, academia and the press. The success of MITI's policy implementation was only achieved with a consensus from the relevant deliberation council. Through discussions in the councils, economic bureaucrats obtained crucial market information from industry representatives. At the same time, economic bureaucracies had considerable in-house expertise. Thus, state officials could profit from their extensive linkages with industry, and use the knowledge and business experience from private entrepreneurs for their policy considerations. They obtained information about specific sectors and products from industry representatives. This information was then incorporated in their own research.

In Korea, from the mid-1960s to the early 1980s, government and private sector relations were close and cooperative, although some might argue that the government was too strong handed or even dictatorial. Government and business leaders met frequently although less formally than in Japan. Until the early 1980s, the most important communication channels were monthly export-promotion meetings presided over by Korea's president, at which businessmen expressed their opinions on markets, regulations and potential plans. The president then instructed the responsible ministers to attend to each important issue and present, at the next meeting, a progress report on their assigned tasks.

The Korean bureaucracy also established special intermediate organizations such as trade associations and industry promotion societies. These were responsible for fostering new industries and supporting the private sector in its development. In 1967, the government established the Korea Electronics Industry Promotion Society to promote the electronics sector. Its members were drawn from the leading electronics producers. The Korea Electronics Industry Promotion Society was authorized by the then Ministry of Trade and Industry as the exclusive body representing the interests of the industry. Thus, it became the major link between bureaucracy and firms. The Korea Electronics Industry Promotion Society interacted

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218 Refer to Johnson (1982), p. 47.
with the Economic Planning Board, the Ministry of Trade and Industry and other
government agencies through its specially constituted deliberation council. Thus, it
was best informed to fashion and implement development strategies for the sector.\textsuperscript{222}

Essentially, the councils enabled the bureaucracy to gather information about world
markets, technology trends and the impact of regulations domestically and abroad.
The government could then synthesize the information into an action plan. This plan
was communicated back to the private sector. The repeated nature of the
 collaboration restricted more or less self-interested behavior, and in part helped to
establish the bureaucrats’ credibility. Politically, these councils served as proto-
democratic institutions, because they provided direct channels for business, labor
and academia to the seat of power. Moreover, because the rules of governing
industry were established in the council, every member was assured that the rules
could not be altered arbitrarily.\textsuperscript{223}

Developmental statisticians also call attention to the construction and execution of joint
projects between the state and nascent industrial groups.\textsuperscript{224} This relationship was
beneficial to both parties, as Okazaki (1997) elaborates, referring to Japan’s
reestablishment efforts of its heavy-industry base. In the 1950s, MITI attempted to
abandon Japan’s textile industry, which was unskilled-labor-intensive and challenged
by developing countries, and move towards heavy industry.\textsuperscript{225} The Council for
Industrial Rationalization (an advisory organization for the Minister of International
Trade and Industry) was a body wherein co-operation between government and
private enterprises could create a path to escape coordination failure, which resulted
from complementarity among industries, economies of scale and incomplete
information.\textsuperscript{226} The Council developed the plans for simultaneous investment in
related industries, helped companies to raise funds, and coordinated industrial
enterprises with financial institutions. This process can be interpreted as a
coordinated experiment by the government and private enterprise, which was one of
the essential aspects of the government-firm relationship in postwar Japan.\textsuperscript{227} The
intimacy of interaction was possible in Japan for several reasons:

- MITI officials were viewed as impartial and supportive.
- There was no tradition of ideological bias against public-private interpenetration.

\textsuperscript{222} Refer to Weiss (1998), pp. 57-58.
\textsuperscript{223} Refer to World Bank (1993), p. 187.
\textsuperscript{224} The idea of “joint projects”, which is central to the visions of Gerschenkron, Hirschman, Amsden
and Wade, makes close ties of key social groups fundamental to developmental efficiency.
\textsuperscript{225} Refer to Okazaki (1997), p. 95.
\textsuperscript{226} The Council was composed of representatives from the industrial associations and leading
enterprises of each industry. Refer to Okazaki (1997), pp. 94-95.
\textsuperscript{227} Refer to Okazaki (1997), pp. 92-95.
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- Government and industry shared overriding interests.
- Most industries looked to MITI for some kind of support.
- The private sector, on balance, was satisfied with MITI's industrial policy.
- The advantages of long-term cooperation were perceived to outweigh any incentives for industry to engage in rent-seeking behavior.\(^{228}\)

In order not to fall captive to specific industrial interests, MITI officials in the vertical bureaus and divisions could not develop a strong sympathy for the interests and needs of industries under their jurisdiction. Only those businesses that would not damage higher-priority sectors and harm the economy were able to pass through MITI's policy-making channels without opposition or fundamental revision. However, because MITI's horizontal divisions had to find ways of integrating policies advocated by all units, the needs and interests of one industry had to be balanced against others. This provided built-in safeguards against responding politically to short-term industrial demands.\(^{229}\)

Overall, the analysis indicates that the industrial transformation in the developmental states was enhanced not by a strong state acting over or against capital from the business sector, but by a project-oriented state that has worked in coalition with a well-organized private sector.

2.6.2.2 Embedded autonomy

Evans (1995) also discusses how bureaucracies provide institutional channels for continual negotiation with external groups, regarding economic development goals and policies. Evans argues that states which aim to transform economically have to be sufficiently autonomous from special interests to formulate their own goals, and at the same time also adequately embedded in particular industrial networks between bureaucrats and organized business to implement them. "Embedded autonomy", as Evans conceives, "is precisely the mirror image of the incoherent absolutist domination of the predatory state."\(^{230}\) According to Evans, the logic of the developmental state rests precisely on embedded autonomy, namely of bureaucratic autonomy, with an unusual degree of embeddedness in the sense of public-private cooperation. Embeddedness links the state intimately and aggressively to particular social groups, with whom the state shares the goal of development and transformation. Thus, the success of the developmental state depends on the highly developed bureaucratic apparatus with interventive capacity that is built on historical

\(^{228}\) Refer to Okimoto (1989), pp. 156-157.
\(^{229}\) Ibidem, p. 157.
experience, and well organized private actors who can provide useful intelligence and the possibility of decentralized implementation.231

The embedded autonomy approach intends to solve the puzzle of why highly interventionist states like Korea have successfully translated their developmental goals into practice, while others like India and Brazil have been less effective in economic management.232 Evans' explanation is not based on the form of governance such as authoritarian versus democratic, but on the equal importance of embeddedness and autonomy. Either autonomy or embeddedness may produce perverse results without the other.233 According to Evans, in Korea, a strong and coherent bureaucratic apparatus and close ties to private industrial capital were an efficient combination in high technology, just as it had been in other industrial sectors. The complex ties between the Ministry of Communication, the Electronics and Telecommunications Research Institute and the chaebol were used to nurture technological entrepreneurship and epitomized embedded autonomy.234

Unlike Korea, neither the state of Brazil nor India was able to pursue economic transformation successfully, as both lacked either autonomy or embeddedness. In Brazil, despite the pervasive presence of the state, its apparatus was badly divided, and lacked the overall coherence and cohesiveness it needed. This lack of coherence made it hard to use ties with local firms effectively. In India, bureaucracy was designed to avoid the pitfalls of being too closely tied to society with its contradictory demands. Because of this, however, it was difficult to promote new industrial entrepreneurship from the private sector necessary for dynamic industrialization.235

The question remains, whether embedded autonomy is simply a property of successful late industrializers, as Evans suggested. While pre-industrial states were almost entirely disconnected from their surrounding society, embedded autonomy applies, to some degree, to most contemporary industrial states. No modern state lacks multiple linkages and connectedness with its civil society, and only few modern states are without some degree of organizational autonomy from special interests. However, only a few states have also developed these features in a form and degree of particular benefit to the industrial economy. In the developmental states, although state-economy linkages have sometimes been tight, they have always been highly selective, with structured access points for particular groups, and the exclusion of

232 For further information on Brazil refer to Evans (1979).
233 Without autonomy, embeddedness might turn into capture. However, autonomy by itself does not necessarily predict an interest in development, either in the narrow sense of economic growth or in the broader sense of improved welfare. Refer to Evans (1995), p. 59.
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others from this access. Hence, the core feature has been selective embeddedness.\(^{236}\)

Despite the fruitfulness in Evan’s work, the notion of embedded autonomy suffers from ambivalence. Evans’ empirical evidence of embedded autonomy as a prerequisite of successful industrial policy is vague, regardless of the right balance between insulation and direct intervention.\(^{237}\) The state has to be sufficiently autonomous from society in order not to be captured by rent-seeking groups and be able to coordinate development. At the same time, the state has to be sufficiently embedded in society and be able to established links and ties with social groups. Such a state would constantly be in danger of being too little insulated and too tightly embedded.\(^{238}\)

Political institution-bound factors in the East Asian region have effectively bolstered industrial growth. It is extremely difficult, though, to engineer equilibrium between the two apparently contradictory conditions of bureaucratic autonomy and public-private cooperation, and to sustain it over time. The equilibrium can easily be disturbed by the more rapid growth of private vis-à-vis public power.\(^ {239}\) Therefore, embedded autonomy, as Evans defined it, is important, but not compelling. Even Evans together with Rauch (1999) stresses in later works the bureaucracy’s characteristic of “Weberianess” for successful economic development and neglects the factor of embedded autonomy.\(^ {240}\)

The analysis showed that, in essence, effective market-augmenting forms of state intervention require both bureaucratic autonomy and close public-private cooperation. Both have to be built up gradually through a process of institutional reform. Hence, bureaucratic capacity and autonomy, as well as organized and institutionalized forms of information-sharing, and cooperation between public and private spheres for targeting and prioritizing certain sectors, are important for improving the effectiveness of state intervention in a market-oriented setting.

Political institutions are not the unique product of a particular cultural environment. Factors such as traditions of social and political hierarchy and group solidarity have played an important role in East Asian industrialization. However, the degree of social consensus and cooperation linked to the East Asian developmental state cannot be associated purely with cultural explanations. In Japan, the key institutions

\(^{236}\) Refer to Weiss (1998), p. 36.
\(^{237}\) Refer to Nee et al. (2005), p. 30.
\(^{238}\) For further information refer to Weiss and Hobson (1995).
\(^{240}\) “Weberianess” implies the bureaucracy’s characteristics as Weber defined and which were examined in the beginning of this chapter. Refer to Evans and Rauch (1999), p. 748 ff. For detailed information refer to Evans and Rauch (1999) and Evans and Rauch (2000).
underlying rapid economic growth are of relatively recent origin. Similarly, the developmental state’s characteristics of consensus and cooperation are a specific post-war phenomenon. The rejection of the culturalist explanation implies that bureaucratic capability and public-private cooperation can be built up over time through a process of institutional reform.\textsuperscript{241}

2.7 Assessment of the East Asian developmental state approach

Extracting the relevant elements of the institutional context and formulating them at a level of generality appropriate for possible transfer to societies with different cultures and histories is a formidable challenge. It has to be answered what features of the multifaceted East Asian institutional context constitute prerequisites for successful policy implementation. This, in turn, requires a characterization of the successful policies themselves and an assessment of possible short-comings of the East Asian developmental state approach.

2.7.1 Subjects unaddressed by the developmental state theory

Among the weaknesses the developmental state’s transformation approach might have, two aspects need to be pointed out: crony capitalism and the selection of priority sectors. These aspects become relevant after the initial stage of transformation and endanger the long-term strategic development approach and the future stability of the developmental state.

\textit{Crony capitalism:}

The state controlled financial system helps bureaucrats to promote the chosen priority sectors and contain the ones which are expected to have no profitable future. Yet, a state controlled financial system only has positive results if the state possesses a functioning, strict bank regulation system and full transparency of business activities. The developmental states have not always been able to do this. In Korea, high private savings (amounting to 35 percent of gross savings in the 1990s) were deposited in banks. The banks in turn lent these savings to large \textit{chaebols}. Especially to the ones which were supported by the government and thus had easy access to credits.\textsuperscript{242} While in the early periods of Korea’s development, strong discipline was exerted on cheap credits, during the 1990s the supervision diminished. Creditworthiness was not anymore determined by the soundness of firms - their books were laxly examined - but by the government’s political decision of supporting the industrial sectors in which the borrowers were active. As the \textit{chaebols}

\textsuperscript{241} Refer to Ōnis (1991), pp. 122-123.
\textsuperscript{242} Korean firms in general had been allowed to operate with 20 percent of equity borrowing at 4/1 ratio.
produced for the domestic and the international market, they borrowed heavily and used large amounts of funds in their foreign market ventures. Yet, their profitability was often low. Loans thus frequently turned into non-performing ones.\textsuperscript{243} Krugman (1998) even claimed that

\begin{quote}
"The success of too many Asian businessmen depended less on what they knew than on whom they knew" and "dubious investments [...] were cheerfully funded by local banks, as long as the borrower had the right government connections."\textsuperscript{244}
\end{quote}

Within a state-controlled banking system, the relationship between governments, banks and firms may insulate business from market forces. This can lead to an encouragement of excessive borrowing despite a weak equity basis. A wasteful use of resources is the result. Structural weaknesses such as inadequate bank regulation,\textsuperscript{245} and a lack of transparency in business, together with excessive borrowing, may turn into dead debt. Moreover, due to the bank’s soft budget constraints, the state’s deficit spending increases steadily.\textsuperscript{246}

During the Asian financial crisis in 1997, the negative consequences of dense ties between the state and private businessmen came to light. The form of Asian capitalism, namely the link between state officials and key families, the military and various individuals who have built huge conglomerates is unique. These arrangements are called "crony capitalism."\textsuperscript{247} Crony capitalism consists of close business-government networks that are based on trust and patron-client relations, which are effective in capital accumulation and development. Policy networks that existed between states and societies became a critical channel to drive various industries to an investment decision.\textsuperscript{248}

Despite powerful government institutions, the close coordination between the state and the private sectors gave rise to serious problems in corporate governance and regulatory forbearance. This experience showed that certain institutional arrangements that were effective at earlier stages of development, became destructive as market-based arrangements expanded.\textsuperscript{249} As the state’s selection and intervention in particular “sunrise” industries is decisive for the successful transformation of the developmental state in its early stages, the state depends on

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{243} Refer to Carreno (2001), p. 2.
\item \textsuperscript{244} Krugman (1998), p. 70.
\item \textsuperscript{245} Stiglitz conceives that the "The crisis was caused in part by too little government regulation (or perverse or ineffective government regulation)". Refer to Stiglitz (1998), Internet Edition, reviewed 25.5.2006.
\item \textsuperscript{246} Refer to Kornai (1992a), p. 140 ff.
\item \textsuperscript{247} Refer to Krugman (1998), p. 70.
\item \textsuperscript{248} Refer to Liao (2001), pp. 38-39 and p. 41.
\item \textsuperscript{249} Refer to Elson (2006), p. 40.
\end{itemize}
\end{footnotesize}
information sharing with private enterprises on future trends. Thus the key to successful interactive negotiation on policies and goals must be an organized and, above all, institutionalized form of cooperation that can hardly turn into the capture of the state by private businesses. In this sense, it is quite obvious that, unless “autonomy” and “cooperation” requirements are satisfied, attempts to implement developmental state style industrial policies will prove to be counterproductive: In such an environment, bureaucratic elites will lack the capability to identify dynamic industries to be targeted in the first place, and will be in a weak position in terms of monitoring and regulating the activities of firms located in strategic industries.

In the initial phase of the state’s development, a state-controlled and bank-based financial system may positively support the state’s industrial policy. Strict regulation, transparency and hard budget constraints are of importance. In the long-run, however, a private banking system needs to be implemented gradually, so that credit issuing is based on commercial criteria. In addition, cooperation and information sharing between the state and private businesses has to happen in an institutionalized manner.

**Long-term selection of priority sectors:**

The long-term selection of priority sectors is largely unaddressed in the developmental state theory. The state’s information problem (the state “does not know better” about the future course of events, and such an informational deficiency can only be corrected at a prohibitive cost) is a point that was already made by the Austrian school in the central planning debate in the 1930s. In a market economy, the profit and loss system which is based on market prices provides the necessary information, as to which industries should expand, and which should contract, in a market economy. In the developmental states, this function was largely fulfilled by the state. Thus, the question arises how the pilot agencies gained the knowledge that was assumed to be superior to the free market. Moreover, once anticipated profitable industries are selected, how are the planners’ interests to promote only those industries that best generate economic growth to be sustained?

With state industrial planning, the problem emerges that due to the synergism of state and market, the market is not replaced with complete central planning, because the state requests the information needed for an efficiently functioning economy that is guaranteed by the market. The interference with, and distortion of, price signals by selectively promoting individual industries undermines, in turn, the process by which the necessary market information is generated. In this respect, bureaucratic elites

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250 For further information refer to Lavoie (1985) for a discussion of the debate. Another important dimension of the information problem is the existence of informational asymmetry, the principal-agent problem. Refer to Stiglitz (1987).

251 Refer to Powell (2003), pp. 10-11.
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are incapable of guiding the developmental process beyond a certain critical point. As Gerschenkron (1962) conceived, in the initial phase of development, the "late developer", that has enough autonomy and capacity, can "catch up" with the existent industrial power by replicating successful strategies, borrowing key technologies and generally accelerating the course of industrialization. In the East Asian developmental states, the successful and rapid catching-up process was evidence of the effectiveness of their industrial policy approaches. At the time when countries reach the "technological frontier", and are confronted by fundamental uncertainty which characterizes the course of technological evolution, the benefits and capacities of the state-led approach diminish.\textsuperscript{252} State planners are clearly not infallible, when it comes to deciding which future industry sectors are likely to be at the technological cutting edge, and therefore worthy of government support.\textsuperscript{253}

Thus, while governments may provide special support based on the flying geese argument in the initial phase of development, they are not well equipped, and thus do not have the ability to pick national champions in the long run.\textsuperscript{254} In a later period of development, only the free powers of the market can decide on profitable investments, and only private enterprises are flexible and efficient enough to be competitive in profitable sectors.

Future stability of the developmental state:

The stability of the developmental state in the long run is questionable. The successful developmental state that accelerates income and the standard of living might be "its own gravedigger".\textsuperscript{255}

- Stronger private firms are in a position to better resist government direction. Once the private business sector has accumulated industrial capital, it becomes less dependent on resources provided by the state. The relative dominance of the state diminishes, and government industrial policies are more conditioned by negotiations with private firms and industry associations.\textsuperscript{256} In the 1980s, powerful emerging domestic forces hampered the operations of the Korean developmental state, thus threatened its state autonomy, and forced it to retreat step by step. The very success of the Korean developmental state undermined the basis of its power.\textsuperscript{257}

- The general weakness and control of civil society appears to have been a general condition for the constitution and continuity of developmental states. However, as it did in Japan in the early 1970s, the very success of Taiwan and

\textsuperscript{252} For further information refer to Fong (1998).
\textsuperscript{253} For further information refer to Callon (1995), p. 147 ff.
\textsuperscript{254} Refer to Yue (1995), p. 86.
\textsuperscript{255} The unsuccessful developmental state, the one that cannot accelerate economic growth, loses the legitimation for its authoritative ruling in the long run as well.
\textsuperscript{256} Refer to Wade (2003b), p. 343.
\textsuperscript{257} Refer to Minns (2001), p. 1031.
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Korea caused fundamental changes in the relationship of states with society. The government’s economic achievements have promoted the growth of an active civil society. Regular participation in modern economic life, rising levels of consumption, expanding education provision, the strengthening of labor and capital organizations and the functional requirements of economic growth have all been achievements of developmental states. Rising affluence and education make for large middle classes, which demand participation in the form of democracy.

- The applicability of the developmental state approach to other than authoritarian national settings is questionable. Is the East Asian developmental state approach desirable and practicable in environments where democratic values and institutions, as well as widespread political participation, have already emerged as central objectives? Indeed, in countries which have experienced a long trajectory of democratic development, it would be impossible for the state to withdraw entirely from participation and social welfare, and focus solely on growth and productivity objectives. In this respect, the question arises, whether the developmental state is compatible with emerging political liberalization and participation demands, namely a liberal western type political system, as a form of governance in the long-run. Thus, while not possible in this study, it would be interesting to examine whether, and to what extent, the institutions of the developmental state have survived and will survive in the future under conditions of popular participation and democratic governance in Japan, Taiwan and Korea.

Despite the shortcomings the developmental state theory exhibits, economists allege that only few societies in the modern world will achieve high economic growth rates and thus make successful transitions from poverty without states which approximate to the model of a developmental state. From this arises the question about the culture-free lessons to be learned from the examined developmental states.

2.7.2 The East Asian Developmental State Model

The focus of the developmental state theory has generally been on East Asia, with only few analyses concentrating on Southeast and South Asia. Some even argue that the developmental state is a product of East Asia’s unique historical

262 For further information on Southeast Asia refer to Hawes and Liu (1993) and on South Asia refer to Chibber (2003).
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circumstances. The knowledge about developmental states is based on case study research. The main objective of statists such as Johnson, Amsden and Wade was to describe the economic policies that led to success in each of the respective countries they studied. They integrated the findings of earlier studies on the active state, bureaucratic organization and state-society relations from scholars like List, Polanyi, Weber, Gerschenkron, Hirschman, Skocpol and others into their own research (refer to Figure 5).

**Figure 5: Highlighted features of developmental states by different scholars.**

![Diagram showing highlighted features of developmental states by different scholars.](image)

The analysis showed that the examined works of developmental statists not only focused on different countries, but also set different focal points. In addition, although the East Asian developmental states have all played a developmental role, there are important differences between them. Looking for shared features is the best starting point for an understanding of the state's industrial policy, and the organizational and structural characteristics that allow the state to play a developmental role. In the following, similarities between the three examined developmental states are categorized by conditions to be historically given, and measures (policy indicators and institutional setting) to be implemented by the authorities.

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(1) Conditions:
- The state's stringent developmental approach could only be implemented because of the states' authoritarian structure. Authoritarianism enabled the state to contain civil society in the form of public interest groups. Labor was disciplined and dissent quickly suppressed. Subsequently, society in the developmental states was usually weak, and did not actively participate in policy formation. The state's capacity and autonomy from strong societal groups was important to East Asia's economic development, and was often lacking in Latin America. The developmental states were able to ensure insulation of the central decision-makers from interest groups by their authoritative state structure.\(^\text{265}\)
- The developmental states' intense and almost unequivocal commitment on the part of government to build up the international competitiveness of the domestic industry arises from their economic backwardness. Japan, Korea and Taiwan were all industrial backward states (so called "late developers"). This can mostly be attributed to geopolitical pressures and national security issues.\(^\text{266}\) Thus, economic growth has been increased, yet sometimes at the expense of other objectives, like social welfare.\(^\text{267}\)

(2) Measures:

a) Bureaucracy:
- Decision-makers all pursued growth-oriented goals and had centralized structures through which to decide and coordinate relative priorities. In the various East Asian economies, there was generally close coordination between various ministries. The bureaucracy was depoliticized (separated from politicians) which enabled it to implement "unfavorable" policies.
- The decision-making process was streamlined in a leading government agency (pilot agency) which had a strong coordinating authority. The pilot agency "translated" national strategic visions of economic development into specific policy actions.\(^\text{268}\)
- Asian governments fostered the development of a professional, merit-based civil service tradition. Thus, the decision-making structure was staffed by the best administrative and managerial talents. Remuneration of management and career paths in the public sector were competitive with those offered by the private sector.

\(^{265}\) These interest groups might for example be the legislature, a farm lobby, a trade union or entrepreneurs which tried to lay pressure on the government. Refer to So (2003), p. 18, Wade (1988a), pp. 129-163 and Yue (1995), p. 81.
\(^{266}\) Refer to Weiss and Hobson (1995), p. 184.
\(^{267}\) Refer to Wade (1990), p. 7.
\(^{268}\) Refer to Elson (2006), p. 40.
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- Clearly defined norms of comportment (with regards to recruitment, career, remuneration) helped to contain rent-seeking.

- The East Asian bureaucracies were generally characterized by unity, competence and efficiency. Government interventions had a high degree of policy and implementation coherence. Interventions pulled in the same direction and had cumulative impacts.  

b) State:

- The developmental states' economic development was state-led. The bureaucracy used strategic industrial policy mechanisms to influence the economic development of particular sectors. National bureaucrats identified existing market failures, and devised appropriate policy responses.

- The state only supported selected industries. Protection and assistance were given primarily to infant industries, and to those industries perceived to be economies with potential competitiveness ("sunrise industries") rather than those which had already lost their competitiveness ("sunset industries").

- The developmental states in East Asia initiated a dualist trade regime with significant focus on exports. The outward industrialization strategy is the principal difference between the developmental states in East Asia and those in Eastern Europe and Latin America. The regimes of the developmental states "made exports a compulsion rather than a choice" for private companies. At the same time, specific nascent industries have been protected. To ensure that protected industries became competitive, the economic bureaucracy used different ways to do so. Often, exports were used as an instrument to measure performance, and bureaucrats linked subsidies to performance. Subsidies were cut down if no longer needed, or if performance expectations were not fulfilled after a certain period of time.

- Although the developmental states' approach towards foreign capital and participation differed in its intensity, FDI inflow has been limited. The state strictly controlled inflowing investments, and encouraged domestic companies

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269 Activities that received help through trade controls were also assisted through financial subsidies and fiscal incentives. Refer to Wade (1988a), p. 157 and Wade (1988b), p. 139 ff.


272 Hence, the import substitution policy was not totally abandoned. The state continuously provided financial subsidies to the private firms for the development of domestic technology to substitute for imported intermediate goods. Nevertheless, Korea and Taiwan show high levels of export dependency in their economic growth. During the 1980s the average trade dependency ratio was almost 65 percent in Korea and 83 percent in Taiwan. Putting this in perspective, it was 36 percent in France, 47 percent in Germany, and 16 percent in America. Refer to Kim (1998), p. 9.

273 The Korean government strongly encouraged infant industries to export. They were directly exposed to international competition, even when exports had to be sold at a loss. Subsequently, import substitution did not saddle Korea with inefficient and non-competitive industries.
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to compete in foreign markets and gain international expertise. None of the states has become subservient to foreign capital, and all have strictly controlled inflowing investments.

c) Financial system:

- The developmental state's financial system played an important role in the state's development process. It was largely government-controlled and bank- and credit-based.

- The financial system enabled the government to directly influence the sectoral and firm-level allocation of credit to promote strategic industries. The developmental states had state-owned banks as well as private banks. Yet, both types operated under close government-business guidance. The state used the banks as conduits for development and fiscal policies.\(^{274}\)

d) Government-business relations:

Complementing insulation, the success of the state required a high degree of public-private cooperation and information sharing. In the East Asian setting, the careful construction of policy networks, namely, the organizational and particularly institutional links between the bureaucrats of the pilot agency and major private sector firms were crucial in order to generate a consensus on goals and to exchange information; both of which constitute essential components of the process of policy formulation and implementation. Government-business cooperation was institutionalized in a variety of forms, including state-sponsored industrial associations, export cartels and policy consultation bodies. Subsequently, the key to successful cooperation was an institutionalized form of information exchange.

Altogether, policy consistency and bureaucratic autonomy in East Asian societies during their post-war development compensated for the lack of well-developed market-based institutions and legal frameworks on which economic development in the advanced countries is based.\(^{275}\) Accordingly, the East Asian developmental states had an institutional advantage at the governmental level.

According to the flying geese pattern, developing countries can catch up with advanced economies which point to the "right industries" to promote. Comparative advantages can be used and the necessary technology can be imported. Korea and Taiwan followed the pattern of Japanese industrialization, and moved up the value chain starting from light industries to heavy and chemical industries, then to electronics, and to high-tech industries. Thus, the difficulty in industrial policy of backward countries in the development stage lies not in identifying the right


\(^{275}\) Refer to Elson (2006), p. 40.
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industries to promote, but in designing a system of transformation that is less subject to moral hazard.\textsuperscript{276} This is exactly what defines the required conditions and measures of the developmental state in order to be able to conduct industrial policies which lead to internationally competitive industries and fast national economic growth (refer to Figure 6).

\textbf{Figure 6: The East Asian Developmental State Model.}

<table>
<thead>
<tr>
<th>CONDITIONS</th>
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<tbody>
<tr>
<td>Strong state and weak society (authoritarianism)</td>
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<td>Economic backwardness and developmental commitment</td>
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<table>
<thead>
<tr>
<th>Historical influence</th>
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<tbody>
<tr>
<td>Strong state and weak society (authoritarianism)</td>
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<td>Economic backwardness and developmental commitment</td>
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<table>
<thead>
<tr>
<th>Institutional setting and policy indicators</th>
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<tbody>
<tr>
<td>Bureaucracy</td>
</tr>
<tr>
<td>- Depoliticized bureaucracy</td>
</tr>
<tr>
<td>- Meritocratic recruitment and minimal rent-seeking activities</td>
</tr>
<tr>
<td>- Pilot Agency</td>
</tr>
<tr>
<td>- Strong, coherent state apparatus</td>
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<tr>
<td>State</td>
</tr>
<tr>
<td>- Industrial policy</td>
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<tr>
<td>- Promotion of selected sectors</td>
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<tr>
<td>- Marginal foreign participation</td>
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<tr>
<td>- Export-oriented industrialization</td>
</tr>
<tr>
<td>Financial System</td>
</tr>
<tr>
<td>- State-dominated, bank- and credit-based financial system</td>
</tr>
<tr>
<td>- Government influence on sectoral and firm-level allocation of credit</td>
</tr>
<tr>
<td>Gov.-Business Relations</td>
</tr>
<tr>
<td>- Institutionalized cooperation</td>
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<td>- Regular information exchange between bureaucrats and business leaders</td>
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<table>
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<tr>
<th>Performance outcome</th>
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<tr>
<td>Internationally competitive industries lead to fast economic growth</td>
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</table>

Source: Own illustration.

Developmental states vary with respect to distinct specifications of the major factors outlined above. They have in common, however, that the state is a key factor which determines economic development in the region. For a developmental state to be successful, not all of the above conditions and measures have to be adopted to an equal extent.

The central lesson that emerges from the examined literature on East Asian development is that the transfer of specific policies to new environments will be self-defeating in the absence of the political and institutional conditions and measures required for their effective implementation. Without such states, transitions may be slow, and the social costs (rent-seeking, unemployment, low education levels etc.) immense.\textsuperscript{277} The corollary of this proposition is that the same set of policies will be counterproductive, or at least ineffective, in the absence of the associated set of

\textsuperscript{276} Refer to Ito (2001), p. 63.

\textsuperscript{277} Refer to Leftwich (1995), p. 421.
institutional and political structures or contexts. Hence, the developmental state approach points towards the importance of certain interaction between government, market and society in the development process. The experiences from the growth model of the East Asian developmental states raises the question of the repeatability of the developmental state model for transforming countries.

2.7.3 Emulation of the developmental state model by other developing countries?

The last fifty years have shown both the benefits and the limitations of state actions, especially in the promotion of development. Even where governments have successfully promoted economic development in the past, the question remains whether they will be able to adapt to the demands of a globalizing world economy. Along with globalization, developing countries need to integrate their economies into the international economy. With integration into the world economy in turn, external pressure from industrialized countries arises, which urges the developmental states to open their markets to international goods and services, and to stop their “export extravaganza”. Accordingly, many of the policy instruments of the developmental states (used in the 1950s through the 1970s) such as protection, export promotion, foreign investment and exchange controls are being marginalized. Japan and Korea were welcomed as members of the General Agreement on Tariffs and Trade (GATT), although they were still violating the free trade principles of GATT at that time. In consequence, developing countries today are being increasingly constrained in their national development strategies by proliferating regulations formulated and enforced by international organizations.

From this, the question arises as to whether the less industrialized countries can mimic the developmental states and use similar policy measures to accelerate growth in a liberal economic environment under the guidance of the WTO. Is the developmental state concept an option available to other countries regardless of the integration level in the world economy?

States which are more integrated into the international economy may yet still influence the development of their domestic economies, and implement industrial policy. There continues to be considerable scope for state guidance in national economic management, and for government-business cooperation, even – or perhaps especially – as economies restructure to meet the new conditions of economic openness. In essence, the developmental states’ ability to foster

280 Refer to Wade (2003a), p. 621.
282 Refer to Pempel (1999), p. 147.
283 Refer to Weiss (2003), p. 246.
economic transformation is mostly dependent on the nature of domestic linkages and national strategies, and less on the level of economic integration. With economic integration, the tasks of developmental states have to change from export promotion and industry creation to the coordination of innovation and technology diffusion, as well as the management of trade disputes, currency realignments and economic integration. The state thereupon constantly creates new tools of industrial policy for its new tasks along with the changing domestic and international circumstances.284

Altogether, what makes for an effective state differs enormously across countries at different stages of development. Even among countries at the same level of income, differences in size, ethnic makeup, culture and political systems exist. This does not, however, imply that each transforming country has to "invent" its own development strategy.

284 Refer to Weiss (1998), pp. 7-8.