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# The Competition between Western Capitalism and State Capitalism as Drivers of Economic Growth

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POLICY BRIEF

State capitalism is capturing a great deal of attention. There is particular focus on East Asian economies, in which state plays a dominant role, and which are seen to be outperforming Western economies. Many commentators are extolling the virtues of Asian capitalism and predicting the demise of alternatives. Of course, the strong points of East Asian development have long been recognized, beginning with the high savings rates, hyperinvestment in education and infrastructure, and a strong planning role for the state. There are also examples of state capitalism in other parts of the world that are less laudable. Nevertheless, a surprising number of the world's largest corporations are now state owned. Does this portend the demise of the West? Frankly, it may be premature to dismiss the future of Western capitalist economies, despite their current travails.

It is important to note that the agents of state capitalism differ greatly. There are sovereign wealth funds (SWFs) whose goals are to preserve living standards of the population for future generations. Some are based on exploitable resource revenue (as in Norway) or revenues derived from state-led government corporations (as in Singapore). Other state capitalists include state-led corporations in the Russian Federation or China that have strategic market objectives and are able to use the powers of the state to advance their commercial interests. These state-owned enterprises (SOEs) are not only large but of increasing global significance. Still other variants involve private corporations that retain government support to advance national goals, such as the "chaebol" of the Republic of Korea, or more recently the promotion of national champions in France. One conclusion is clear, however: although government-firm interactions are unique to country circumstances, the nature of that interaction will help define the future of capitalist economies.

Correctly, many are highlighting the failures of western capitalism in light of the financial crisis, its origins in under-regulation, and its aftermath in public bailouts that rewarded excessive risk-taking. Indeed, one of the major differences between state-led and market-led capitalism is the way risk-taking is managed. Importantly, whereas the statist model has government on both sides of the risk-return ledger, the market model has the asymmetric characteristic of the private sector reaping the gains of successful risk-taking and the government covering major risk-taking losses. Can this

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be reformed or is the alternative model of strong state control the only alternative? This lies at the core of the debate between state-led and state-regulated capitalism.

I pose three questions: (i) who bears business risks and who reaps the return; (ii) how do societies decide on the balance between consumption today and tomorrow; and (iii) how should governments and firms handle the tradeoffs between national interest, private gain, and global commitments? State capitalists seem rather clear in their views on these issues, whereas market-led societies seem confused and conflicted. It is my view that resolution of these questions is indispensable for the Western capitalist model to continue to be successful.

How can the Western market model be changed so that the asymmetric risk-return balance is redressed? The quintessential example of this market failure is the financial sector, where government foots the bills for poor decisions but profits are pocketed by the risk-takers. Remedies may need to include a re-introduction of a Glass-Steagall separation of commercial and investment banking functions in the United States. Depositors in Citibank should not be financing highly leveraged hedge funds; the fact that depositors don't flee is based both on poor information and government insurance. The much-debated Volcker Rule is one such step. Furthermore, rather than imposing global taxes on financial transactions that will neither thwart bad behavior nor fund the costs of future bailouts, Western governments should rethink their role in risk bearing. A prime example of misguided principle was the government bailouts that were easily and quickly repaid. Distress financing should reward the government (and the public) and in the United States as well as Europe financial bailouts have been underpriced. Governments in the state-led system would be benefiting from the "upside;" not so in the West!

Some Western democracies are turning to SWF creation to advance the national interest. What would have happened had the U.S. government put shares of General Motors and Citibank in trust for future generations? What would happen if firms using space technology had agreed to pay with shares given to a " National Futures Fund?" The illusion of separation between government and private firms would be shattered, but it would better reflect the extent to which the government bears risks and gets too little return for these investments. Moreover, at least in the United States, the housing fiasco involving quasi-government corporations has cast a pall on any further government involvement in future public-private investments. This is a grave error. The government should back infrastructure investments through a national infrastructure bank, and these are risks worth taking for the generation of future economic growth. The needed "rethink" of government's role should be pragmatic rather than ideological. That is a valuable lesson from Asian economies.

How can the Western market model be altered so that investing for the future is given greater weight in comparison to short-term profits and current consumption? Is this an alien objective that can only be pursued by government or can it be linked to long-run corporate and household strategies? In the first case, I believe the problem can be dealt with but only if we see substantial reforms in the weak role played by corporate governance in most corporations. Share price maximization is the goal of most CEOs. Altered incentives would be a useful first step, such as deferred compensation packages according to some national norm, combined with tax reforms that favor investment of earnings over dividends. It should be possible to mimic the strategic objectives of Asian state capitalism, which drives large and powerful SOEs in China with corporate boards that are more far-sighted in the management of their advanced technologies, for example. This would require national corporate governance boards that are strategic, independent, and empowered.

Another avenue worth pursuing to plan more effectively for the future is to enlarge the role of bipartisan or independent commissions to decide on investment levels, pension benefits, and sustainable budgets. These can be effective in guiding household decision making. Europe has done better than the United States in resisting some short-term political pressures, as have other non-state-led capitalists such as Australia, Canada, and New Zealand. Some national decisions require guidance, and if governments are too politicized to act in the long-term interest, then other institutions may be needed. Clearly in the case of health care, pensions, and other long-term decisions, demographics dominate and government has to play a major role in guiding decisions via smart incentives.

How can the Western market model be amended to restore a sense of national purpose in a world without borders, while neither sacrificing principles of open trade, nor encouraging narrowly nationalistic policies? This is at the core of Dani Rodrik's "impossible trilemma" argument, wherein he holds that governments cannot be fully democratic, further national goals, and also adhere to difficult international commitments (Rodrick 2011). Is it reasonable for a fiscally strapped nation like the United States to lose all tax revenue from major corporations that park profits offshore? Can a nation like the United States that competes with China allow its advanced technologies to be shared by corporations seeking short-term profits, especially if some technologies were publicly financed in the first place? A strong argument can be put forward that if nations are able to successfully pursue some national economic goals, only then will they be able to exercise strong global leadership. Since the state-led capitalist model is quite clearly pursuing national aims, it behooves the market-driven capitalists to come to grips with these kinds of difficult political issues. Without resolution, they damage chances that the non-state-led model will prevail.

It has been argued that state capitalism has a corporate vision and that all aspects of state policy are brought to bear to ensure success. The weaker variant in the non-state model is coordination of policies and dialogue. The latter option is seen at work in Korea, where SOEs are now the exception, but where policy coordination works to optimize the export-based production model. The latter approach is also seen in Germany, where business, labor, and government work together to ensure competitiveness of industry. In the United States, the lack of planning and coordination is seen in an immigration policy at odds with higher education policy, incentives that favor yesterday's industries rather than tomorrow's, and a singular lack of dialogue among economic agents. Some Western democracies need therefore to learn best practices from one another in order to compete.

It may well be argued that pursuit of the national economic interests requires a basic understanding between business, labor, and government. Such a social compact is difficult to manage when wealth and income become highly skewed. Countries like Singapore have been steadfast in ensuring that economic redistribution occurs and have been able to combine the statist market model with sharing by government of the benefits with the disadvantaged portion of the population. A laissez-faire approach to distributional issues is at odds with the social dialogue needed to effectively compete in the global economy where state capitalism is prevalent. First pointed to by Joseph Stiglitz (2002) in *Globalization and Its Discontents*, the issue of how benefits of the Western system are shared among various segments of society is at the core of the longevity of that system. According to Sylvia Nasar (2011), the demise of alternatives to capitalism was based on the rapid productivity gains of industrialization that benefited larger and larger groups in societies.

With the global economic convergence that Michael Spence (2011) and others have highlighted, the growth in the pie is slowing in parts of the advanced economies and the existing fruits of capitalism are becoming more skewed. This bodes badly for Western capitalism unless major reforms are undertaken. The mechanics of those reforms are not insurmountable; however, the political consensus needed to deal with redistribution within the United States or the Euro area is difficult to achieve. It may be argued that the market that Alan Greenspan extolled has spun out of control and that vested interests cannot be persuaded to divert some of their market-derived gains to reinvest in a more stable system. This is a problem of democracies, especially those flawed by the exercise of political influence where government is less able to exercise a nonpartisan role of arbiter and futurologist.

State-led capitalism has one Achilles heel, of course, in that it most often coincides with a lack of political freedoms. In this circumstance, entrepreneurs are unlikely in the absence of controls to invest their creativity in new businesses. It is therefore in the area of innovation that the Western model has an edge, if it can align its incentives correctly. This means using its education advantage along with the legitimate use of risk capital to encourage entrepreneurship. With innovation can come new jobs and profit. Naturally, the returns will need to be secured, and the intellectual property system respected. State capitalists tend often not to play by the same set of rules, and short-sighted Western governments have mistakenly thought that better adherence to global norms would eventually emerge. This is a mistake, as Carl Dahlman (2011) has pointed out in his new book, *The World Under Pressure*, since the time to manage adherence to global rules is earlier rather later. I have argued elsewhere that the advanced economies, the traditional custodians of the international system, are struggling and cannot provide the necessary leadership, while the newly powerful economies are not yet willing to take up the gauntlet of global responsibility. Under these circumstances, multilateralism will be under increasing stress (Leipziger 2011).

The competition between state-led capitalism and market-dominated capitalism is reaching a decisive stage. The state capitalists are growing faster, investing more, and following a clear strategy that is leading to a larger share of world output and income. With that increase in economic power will come other political aims of statism. Furthermore, as Henry Kissinger (2012) has argued, military objectives are often seen as corollaries of economic power. The Western democracies are mired in short-term difficulties, distracting them from the urgent and necessary reforms to the system that would enable them to compete. It is not too late to fix the Western capitalism model, but soon it will be.

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