



ECONOMIC VIEWPOINT

Notes by Danny Leipziger, Professor of International Business

The Competition Between Western Capitalism and State Capitalism

State capitalism is capturing a great deal of attention as state-dominated East Asian economies outperform Western economies. A surprising number of the world's largest corporations are now state-owned and many have strategic market objectives that are actively assisted by the power of the state. Of course, the strong points of East Asian development have long been recognized: high savings rates, hyper-investment in education and infrastructure, and a strong planning role for the state. Many commentators extol the virtues of Asian capitalism and predict the demise of alternatives. Does this portend the demise of the West? Frankly, it is premature to dismiss the future of Western capitalist economies despite their current travails.

The future of the Western capitalist model requires resolving three critical questions: 1) who bears business risks and who reaps the return; 2) how do societies decide on the balance between consumption today and tomorrow; and 3) how should governments and firms handle the trade-offs between national interest, private gain and global commitments? State capitalists seem rather clear in their views on these issues; market-led societies seem confused and conflicted.

1. There is considerable focus on 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. Whereas the statist model has government on both sides of the risk-return ledger, the market model is asymmetric, with the private sector reaping the gains of successful risk-taking and the government covering major risk-taking losses. This, combined with poor oversight, is deadly.

Western governments should rethink their role in risk-bearing. The quickly repaid government bailouts demonstrate the inherent flaws in their approach – public provision of distress financing should be rewarded and properly priced. Governments in the state-led systems would be benefiting from the “upside” of lending – not so in the West.

2. Can the Western market model be altered so that investing for the future is given greater weight than short-term profits and current consumption? Creating altered incentives such as deferred-compensation packages according to some national norm combined with tax reforms favoring investment of earnings over dividends would be useful first steps. It should be possible to mimic the strategic objectives of Asian state capitalism with corporate boards that are more

farsighted, particularly in the management of advanced technologies. This would require boards to be both more strategic and more independent and to weigh a set of national economic objectives.

Enlarging the role of bipartisan or independent commissions in deciding on investment levels, pension benefits and sustainable budgets is another worthwhile approach to more effective planning for the future. Europe has done better than the United States in resisting some short-term political pressures, as have other market-capitalist economies 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 to make difficult intertemporal trade-offs.

3. It may be argued that pursuit of 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. Germany seems to have achieved this consensus, for example, within the capitalist model, and countries like Singapore have been steadfast in ensuring that economic redistribution occurs, thus combining their hybrid statist-market model with social justice.

In the United States, the housing fiasco involving quasi-government corporations has cast a pall on further government involvement in public-private investments, but the needed “rethink” of government's role should be pragmatic rather than ideological. Government should back key strategic investments – such as a national infrastructure bank – since these are risks worth taking for the generation of future economic growth. The valuable lesson from Asian economies is not for governments to limit their roles, but rather to exercise them well.

The competition is reaching a decisive stage. The state capitalists are growing faster, investing more and following a clear strategy, leading to a larger share of world output and income. The Western democracies are mired in short-term difficulties, distracting them from urgent and necessary systemic reforms that would enable them to compete more effectively. State-led capitalism has an Achilles' heel, of course, in that it often coincides with a lack of political freedoms. In this circumstance, entrepreneurs are less likely in the absence of controls to invest their creativity in new businesses. The Western model has the edge in innovation, for example – if it can align its incentives correctly. It is not too late to fix the Western capitalist model, but soon it will be. ■