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GLOBAL COMPETITION, INSTITUTIONS, AND THE EAST-ASIAN ASCENDANCY

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PREFACE

We are pleased to publish *Global Competition, Institutions, and the East-Asian Ascendancy* as the fiftieth in our series of Occasional Papers, which feature reflections on broad policy issues by noted scholars and policy makers.

In this paper Dr. Wolfgang Kasper focuses on international factor mobility as a key ingredient in the phenomenal social and economic transformation of the countries of East Asia and in the creation of domestic institutions and conditions that favor growth.

The countries of East Asia began their takeoff when they were on the periphery of the global economic system. They needed to sell their products in the central markets of the world economy. In order to compete successfully in these markets, they had to attract mobile enterprises, capital, and technical, organizational, and marketing skills. A growing openness to world trade was critical to their success; Kasper believes a less widely acknowledged element was the opening of factor markets and the creation of stable and attractive conditions in which foreign capital, know-how, and firms could thrive.

Kasper summarizes a number of lessons which the East-Asian ascendancy offers countries wishing to emulate those successes. Close economic interaction with the central, advanced economies is essential. To attract investment at the beginning, wage rates, taxes, and land costs should be kept low initially, and political, macroeconomic, and business conditions should be kept steady. Improvement of international transport and communication linkages will pay off handsomely. Government should streamline administrative procedures and guarantee private property and freedom of contract under an impartial legal system. It is

easier to resist rent-seeking in the absence of import substitution, which only entrenches industrial and union lobby groups.

East Asia heeded these lessons by and large. This served to neutralize the initially high fixed costs that businesses face when they move to new countries. Of course, implicit in this strategy is the concept of government as the partner of business in the job of attracting productivity-enhancing mobile resources.

Kasper's analysis of the openness to the world economy and the competition-supporting institutions that accelerated economic growth in one East-Asian country after another will provide a useful model for nations hoping to join the ranks of the new industrialized countries.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

Panama City, Panama
March 1994

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Wolfgang Kasper is professor of economics in the Department of Economics and Management, University College (Australian Defence Force Academy), University of New South Wales in Canberra, Australia. He grew up in postwar Germany and Switzerland and studied modern languages and economics in Germany, France, England, and Spain. He worked as a senior staffer with the (West) German Council of Economic Advisers and earned a Ph.D. in economics while on the staff of the Kiel Institute of World Economics in the 1960s. In 1971–1973, he served as an economic adviser to the Malaysian Minister of Finance under the auspices of Harvard University's Development Advisory Service, and in 1973, he joined the Australian National University in Canberra. In 1977, he accepted a chair in economics at the University of New South Wales.

In between these major assignments, he was a member of the Bürgenstock Group, which analyzed the implications of greater exchange-rate flexibility in the late 1960s, headed the research staff of the International Division of the Reserve Bank of Australia, and worked on structural change and economic growth at the OECD Secretariat in Paris. He lectured as a visiting scholar in the Academy of Social Sciences of China and was an Asia Society Visiting Scholar at the Federal Reserve Bank of San Francisco. He has firsthand knowledge of most East-Asian countries.

His research interests are in economic growth, competition, and international affairs, and he has written a number of policy-oriented monographs, as well as many articles on Australian economic growth; on international trade, migration, and investment; on the economies of Malaysia and Fiji; and on growth and industrialization in East Asia. He serves on the boards of several Australian think tanks.

WOLFGANG KASPER

Global Competition, Institutions, and the East-Asian Ascendancy

The inflow of scarce production factors—such as know-how, capital and entire enterprises—from abroad has played an important role in the fast growth of the East-Asian economies. The openness of factor markets has been at least as important as the openness to international trade, not only because factor mobility added scarce resources to the growth process, but also because the attempt to attract mobile resources shaped domestic institutional developments in favor of growth. In the first part of this essay, we shall discuss the elements that matter in the international competition for mobile production factors; in the second part, we will try to find some evidence on the extent to which the East-Asian countries pursued the right policies to attract growth resources from elsewhere.

Accelerated growth. Since the 1960s, most East-Asian economies have consistently been among the top growth performers. As of the early 1990s, the city states of Hong Kong, Singapore, and Brunei are members of the small club of high-income countries. Taiwan and South Korea have reached per capita income levels that would now qualify them for membership in the Organization for Economic Cooperation and Development (OECD) (Table 1). Malaysia and Thailand are poised to become the next ''growth tigers,'' as are parts of the big, amorphous economies of China and Indonesia. East Asia's income gap with the rich OECD countries is closing. East Asia's share in world exports has passed the 20 percent mark and the share of East Asia in world production has risen from 11 percent in the early 1960s to over 18 percent in the early 1990s. In short, a whole new class of advanced industrial and trading countries has graduated, or will be graduating shortly. The

bipolar world economy, centered on both sides of the North Atlantic, has become a tripolar system, with the biggest and most dynamic pole on the western shore of the Pacific.

This constellation has been called the "East-Asian ascendancy." As is well known, it has been propelled by rapid industrialization, a high export share (relative to each country's size), and very high rates of capital formation (Table 1).

The "East-Asian development model" has, however, not been followed universally throughout the region. For a considerable time, Indonesia pursued *dirigiste,* inward-looking policies, and attained poor growth until it switched to more economic-rationalist policies in the 1970s. The Philippines and the Indochinese countries are still lagging far behind in investment, exports, and income growth.

Contending explanations for East-Asian growth. Since "success always has many fathers," the East-Asian ascendancy has been claimed as evidence for many differing theories of economic growth. Most economists claim that economic growth in East Asia can be explained by high capital formation and gains from trade along the lines of neoclassical growth theory (see, for example, Harberger 1984). Others have claimed that fast growth was caused by enlightened governments who ruled the markets by selective interventions and identified winners in industry and trade (Johnson 1982; Wade 1990).

Rather than directly addressing this long-standing controversy head-on, we want to draw attention to the role of international inflows of capital, knowledge and enterprise and the role of the competitive climate in attracting inflows of productive resources from abroad, as well as in mobilizing domestic production factors. The evidence (Kasper 1992) suggests the hypothesis that by trying to create an attractive, hospitable climate for internationally mobile production factors, the growth economies of East Asia have done much to create domestic institutions and other domestic conditions that favor growth. The openness of factor markets—along with a growing openness to international trade—prevented entrenched rent-seeking, promoted competition, and favored the evolution of transparent, nonarbitrary rules that foster competitive enterprise. Our hypothesis is that factor mobility was a key ingredient in the successful process of social, institutional, and eco-

TABLE 1 Income and Growth in East Asia

	Income level, 1991 GNP per capita (US-$)	GNP growth, 1965–91 (% p.a.)	Export share in GNP (%), 1991	Investment share in GDP (%), 1991	Industry growth 1965–90 (% p.a.)	Population (million) 1991
Japan	26,920	4.1	11	33	6.1	124.0
Brunei	17,000*	n.a.	n.a.	n.a.	n.a.	0.3
Hong Kong	13,200	6.5	141	29	n.a.	6.9
Singapore	12,890	6.8	185	37	9.3	3.1
Taiwan	8,450	7.4	48	22	11.5	20.5
S. Korea	6,340	7.5	29	39	14.7	43.2
Malaysia	2,490	4.1	81	36	7.1	18.3
Thailand	1,580	4.7	38	39	9.3	56.7
Philippines	740	1.3	8	16	4.3	62.7
Indonesia	610	4.7	27	35	9.4	181.4
China, P.R.	370	5.6	20	36	11.0	1150.1
Vietnam	ca. 225*	from 1984: +4.2*	n.a.	14	n.a.	67.8
Laos	ca. 195*	from 1982: +2.2*	10	13	n.a.	4.3
Cambodia	ca. 120*	n.a.	n.a.	n.a.	n.a.	8.7
For comparison:						
USA	22,560	1.8	10	16	2.7	252.0

*Own estimates on the basis of publications by the Asian Development Bank.

SOURCES: World Bank. 1992. *World Bank Atlas.* Washington, D.C.: World Bank. *World Development Report* 1993. New York: Oxford University Press. Asian Development Bank. *Passim. Asian Development Report.* Manila: ADB. Council of Economic Planning and Development. 1992. *Taiwan Statistical Data Book.* Taipei: Council of Economic Planning and Development.

nomic transformation in East Asia and in repositioning the entire constellation of domestic conditions in a more growth-prone direction.

Toward a Theory of International Systems Competition

Globalization. As of the 1990s, the owners of technical and managerial knowledge, capital, and many enterprises tend to think increasingly in global dimensions. They evaluate alternative locations around the world to determine what rates of return and what risks different locations are promising. They then tend to supply global markets from the preferred locations. This is the phenomenon of "globalization," which is in essence the phenomenon of increased international factor mobility. Globalization would not have occurred without long-lasting peace among the core countries of the world economy and continued reductions in transport and communications costs. The cost of sea freight has, for example, dropped by about 0.4 percent *per annum* over the past forty years, passenger air transport by 2.5 percent and trans-Atlantic telephone calls by 6.7 percent annually. Transport and communications have also become more user-friendly, allowing many producers, who previously had to stay close to their markets, to become increasingly footloose (Kasper 1993, 84). At the same time, the fixed, sunk costs of product and process innovations have risen steeply in many manufacturing and service industries and the time in which to recoup these costs has often shrunk, so that many companies now have a motive to market their innovative products immediately on a worldwide scale (Ohmae 1990).

These developments have greatly favored the growth of the world-market oriented economies of East Asia because producers and governments in these countries have been agile in exploiting the emerging trends toward globalization and transforming themselves from peripheral players to increasingly integrated participants in the core of the world economic system.

Transport costs, transaction costs, and competition. When discussing globalization and the ascendancy of the originally peripheral East-Asian economies, one must begin with an explicit recognition of

space and ''space-bridging costs'' in trade, as well as in the relocation of production facilities. East Asia began its economic ascendancy in the 1960s against the handicap of being located far from the centers of the global economic system. High transport costs to and communication costs with the major markets in North America and Europe forced prospective East-Asian producers to be highly cost competitive. They had to overcome the obstacles of distance in the global trade system by making themselves highly attractive to potential foreign investors, technology and managerial expertise.

Aiming for a high degree of cost competitiveness required institutional reforms to cut the costs of doing business. If we want to understand what happened in East Asia, we must explicitly acknowledge transaction costs and the institutions that influence them. Just as good roads, ports, telecommunications, and other elements of the hard infrastructure reduce transport costs, appropriate institutions form a ''soft infrastructure'' that reduces transaction costs. Both hard and soft infrastructures are essential if one wants to compete successfully in global markets.

Neither space-bridging costs nor transaction costs are normally incorporated in standard economic price and trade theory. These costs tend to be assumed away as a complication in the way of elegant model building. Yet, in modern economies with an advanced division of labor and trade over vast distances, transport and transaction costs tend to make up at least 40 percent of producing the national product (North 1992). The competitive edge of many businesses depends frequently on how well they cope with these costs and how well the society in which they operate manages to reduce these costs.

A realistic model to explain the East-Asian ascendancy must also leave room for production factors with differing degrees of mobility. These range from highly mobile resources, such as disembodied knowledge or finance capital that may be sent around the world instantaneously for the price of a fax, to rather less mobile resources, such as skilled people, who need fairly high and durable inducements to move internationally, and to immobile production factors, such as land, unskilled labor[1], and government administration. As will be discussed in some detail later, government (and the informal institutions in society) should in this context be treated as a production factor, because the

quality of government has a major influence on the productivity of all other production factors.

Government and the institutional rules of society also influence the incentives for innovation, which is central to industrial take-off. Productive knowledge is specific to place and time and the "traffic in knowledge" is greatly influenced by the institutional "traffic rules." A model to explain the East-Asian development phenomenon must therefore incorporate a realistic notion of space and evolution, of history and geography.

Once one accepts that—different from the frictionless world of neoclassical economic theory—there are costs of space-bridging and transaction, one also has to accept that competition is hardly ever atomistic. A more realistic model of competition in space and with transaction costs is the model of oligopolistic rivalry for market shares in which competitors enjoy (often temporary) market niches. Because standard economic theory does not cover these elements, we will sketch a reference system for analyzing the East-Asian experience which explicitly includes (1) space, transport and communications costs, and international factor mobility, (2) the information, transaction, and organization costs of doing business and the role of institutions in economizing on these costs, and (3) a theory of oligopolistic competition and competitive evolution.

These elements are sketched in the remainder of this essay's first part.

A theory of space and factor mobility. A good departure point for a theory that explains competition in the global economic space is the still much admired work of Johann Heinrich von Thünen (1783–1850), the German economist who began in 1826 to publish his pathbreaking analysis of resource allocation, income distribution, and location, and who has become the "patron saint" of location theory (Thünen 1955; Schumpeter 1955; and Giersch 1979, 1993). Thünen marks the starting point of a tradition in economics which explicitly recognizes space. This tradition never gained much of a foothold in mainstream Anglo-Saxon theory (Blaug 1985, 614–24), but it can easily be integrated into traditional mainstream economics.

A model based on the Thünen tradition can show how production

factors that are unable to move in space (namely land, low-skilled labor, and government administrations) are combined with mobile production factors (such as capital, skills, and enterprise). It permits one to again ask the main question that Thünen asked 150 years ago: what spatial pattern of economic activity results from profit maximization by the owners of mobile and immobile production factors when they compete within a uniform space—a plane of uniform fertility, in the midst of which one can envision a central market place, a city? One can also ask: What are the forces that attract mobile factors to different locations?

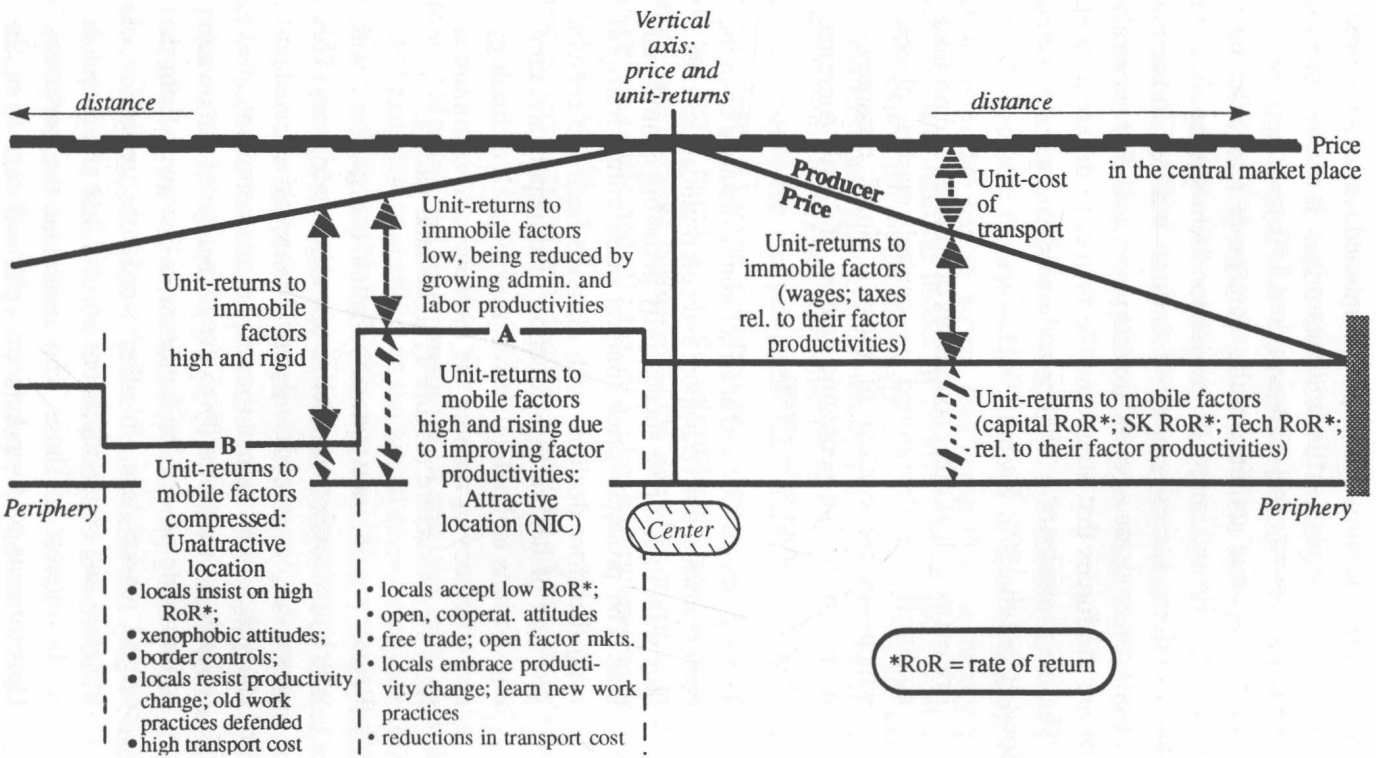
The main results of a Thünen-style analysis may be sketched as follows (Giersch 1993; Kasper 1991):

1. Prices (as well as other conditions of contract and product qualities) are determined in central market places, which—in the context of today's global economy—means in the big economic centers of North America, Western Europe and Japan.

2. Those producers located at an economic distance from the centers must absorb transport and communications cost if they want to compete successfully in the big central markets. The producer price (market price minus transport cost) therefore declines with distance from the centers. The rate of decline is a function of transport-and-communications technology, investment in such technology, and efficiency in running the transport and communications infrastructure (Figure 1, right-hand panel).

3. Reductions in transport cost flatten the gradient with which producer prices decline toward the periphery. This means that better roads and ports, lower road tolls and port charges, as well as better transport and communications technology are primarily to the advantage of the owners of immobile production factors who live away from the central marketplace. In other words, the reduction of transport and communications costs is first and foremost in the interest of those who reside on the periphery. Governments and workers in regions distant from the

FIGURE 1 Economic Activity in Space: How to Attract Mobile Factors of Production?



major markets (such as the East-Asian region in the 1960s) therefore should pursue policies that reduce the unit-cost of transport to the major overseas markets.[2]

4. As Thünen was the first to show, the producer price, or unit-return, is distributed among the owners of mobile and immobile production factors in the following way: The "law of one price" applies to mobile factors because they are able to conduct arbitrage in space. It is therefore the immobile factors that are able to capture the entire rent of being near the central market, or that have to bear the cost of "space bridging" if located towards the periphery (Figure 1, right-hand side). Their rate of return varies with distance from the center.[3] Entrepreneurs will of course adjust factor intensities and technology to maximize their own income wherever they are located. Thus, they will opt for a high intensity in using capital and other mobile factors if they operate near the center, saving on the high cost of land and other immobile inputs. This is evident in the high usage of physical and human capital in the three central poles of the global economic system. And they will make a highly intensive use of immobile factors if they produce on the periphery, which is evident in peripheral locations where ample use is made of land, labor, and other immobile factors that tend to be cheap there.

5. Moving production factors internationally is not without considerable costs and risks. In particular, high information costs must be incurred when production facilities are moved to untested locations. In order to attract mobile factors, labor and governments that are located at a distance from the central markets and in not-yet-established locations therefore have to overcome these frictions by offering higher than uniform rates of return to attract mobile factors (case A on the left-hand side of Figure 1).

6. What matters in the modern, dynamic economy is of course not simply the factor price (for example, the wage,

the land rental price, the tax), but the price of a production factor *relative to its productivity* (for instance, unit-costs of labor and land, the tax cost of government relative to the infrastructure and the quality of government services). Over time, productivity improvements will lower the unit-costs of production measured in international currency.[4] The inflow of know-how and capital from abroad is likely to enhance productivity all around. Therefore, the "sacrifice" of a low unit-price demanded by the local production factors (low tax rates, low land/natural resource prices, or low wages) tends to be temporary. If a peripheral location manages to attract mobile resources, the productivity benefits are not once-off, but extend to the dynamics of sustained ongoing efficiency and income growth. This is so because after some time and in the absence of artificial impediments, capital owners and firms learn how to produce more effectively in new industrial locations; local workers begin to acquire useful skills that raise their productivity; local educators learn to shape the curriculum to promote future labor productivity; local governments and communities learn to deal with industry and global companies and begin to provide suitable infrastructures and organizational backup for such industries; and the overall social climate becomes more businesslike. After some time, new industrial countries manage to remain attractive even when local wages and tax rates rise.

7. Some noncentral locations may try to avoid bearing the transport-cost handicap when selling in world markets. Labor in such countries may insist on wage rates equal to or higher than those prevailing in the metropolis; and governments may impose the same tax and regulatory costs on producers that are customary in the high-income centers (Case B in Figure 1). Such a high-cost strategy of course triggers an exodus of mobile capital, talent, and firms and soon requires barriers to international trade and investment in order to protect the high returns charged by

> the local production factors. For a while, such a policy (and an abundance of cheap natural resources) may compensate mobile factors for the high cost of labor and government. However, over time, the interference in trade and capital flows creates rent-seeking lobbies and a cost-plus mentality which erode the incentive to raise productivity. Because of high wages and lagging productivity, world market shares are then lost and overall growth slows down.[5]

One may generalize that trade and factor mobility determine the distribution of factor incomes in space. The more internationally mobile a production factor, the more even are the returns it earns in different countries. The less mobile, the steeper is the decline in its location-specific returns (its ''locational rents'') as one moves toward the periphery. This is not a static pattern, however. As productivity grows thanks to factor inflows, the locational handicap of peripheral, new industrial locations erodes naturally. And as trade grows, peripheral locations may even become new centers in the global economy.

The basic policy lesson for remote and new industrial countries is that the burden to be competitive in trade and to be attractive to mobile production factors falls squarely on the immobile factors. Land owners, workers, and government administrations have to absorb the higher transport costs if they want their industry to compete in the global marketplaces and to attract mobile resources for growth.

Transaction costs, and administration as a production factor. We have said that government administration is a production factor, since good government is an ingredient in production, raises the productivity of all the other production factors, and enhances a country's attractiveness to mobile production factors.

To gain a proper understanding of the role of government in achieving productivity growth, we must review the key elements of the rapidly growing ''new institutional economics,'' which is based on the following premises:

- People do not have perfect information. Rather, competitors are forced by limited time and resources to