

Commander, Simon; Estrin, Saul

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Coordinating success, predicting failure? Why the market vs state debate misses the mark in Asia

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POLICY PAPER SERIES

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the Mark in Asia**

Simon Commander
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SEPTEMBER 2023

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Simon Commander

Altura Partners and IE Business School and IZA

Saul Estrin

London School of Economics and IZA

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ABSTRACT

Coordinating Success, Predicting Failure? Why the Market vs State Debate Misses the Mark in Asia*

Much of the debate about Asia's economic success has focussed on the respective roles of the market and state. It has been argued that industrial policy has helped address market failures and achieve critical coordination of development planning and process. Yet, starkly contrasting market and state ignores the way that both have been closely intertwined. Indeed, across the different economic and political systems in Asia, a common feature has emerged in which government and big, diversified and mostly family-owned business groups work in close connection to support their mutual interests. Through such ties, Asia has found a solution to many of the problems of economic development by a different type of coordination. Whilst highly effective in a phase of extensive growth, such connections carry less beneficial consequences. Not least, the accumulation of market power and the restraint of competition that result from preferential ties between business groups and political power. At the same time, the lock-hold of business groups limits growth in the formal economy, in employment whilst also stoking inequality. Further, as Asia searches for greater innovation to drive progress, such close ties are far more likely to stand in the way, deterring new entrants and holding back the creation of more broad-based innovation. Breaking down the entrenched power of connected business groups will require new policies that address head-on the distortions that these connections create. These include measures to deter recourse to the business group format itself.

JEL Classification: L5, L22, O25, O53

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Corresponding author:

Simon Commander

Altura Partners

E-mail: scommander@alturapartners.org

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Introduction

Among the debates about the reasons for Asia's extraordinary renaissance in the past half century, an enduring source of argument has concerned the roles played by the market and state. The loci of controversy pit those who see markets as the antidote to state failure and those who perceive an active industrial policy as a solution to widespread market failures, particularly in the coordination of the development process².

Yet, simply distinguishing between development led by the state or through markets fails to capture the ways in which they are intertwined. Irrespective of whether government policy has tried overtly to shape the configuration of production and markets or not, actual structures and outcomes display significant similarities across many Asian economies. Specifically, large and diversified business groups, predominantly privately owned, work very closely with governments in mutually beneficial ways. Some of those benefits materialise through directed aid – financial and otherwise – provided by the state, not to mention protectionist policies and supportive regulation. But that is only part of the story. At the same time, business groups also provide support to politicians, helping them attain some of their economic policy objectives as well as generating private benefits for them and their families. These transactional interactions ensure that an accretion of market power and excessive concentration is a central and common consequence.

We have termed these close and resilient relationships between governments and business in Asia the *Connections World*³. By such ties, Asia has for many years found a solution to many of the problems of economic development through a different form of coordination. This solution cuts across both state and private sectors and relies on tight, mutually beneficial association between the main players. That these paths have largely converged across Asian political systems raises some interesting questions. A further implication is that emphasising the dichotomy between state and market in analysing Asian economic development may largely miss the point.

'Models' of development

To simplify, two highly stylised 'models' of development have been commonly contrasted (Williamson, 1990; Stiglitz, 2000). The first is a competitive model where the economy is populated by multiplicities of companies with relatively few pockets of market power and where the state has limited direct involvement in the economy, either through ownership of companies or through regulatory or industrial policy. This stylisation hardly conforms to any Asian reality. Even so, most Asian economies rely heavily on the market, in the sense that most employment and production is in the hands of private firms. This is also true for both China and Vietnam where the allocation of resources has been increasingly – if not entirely – decentralised.

A second model is one where the state explicitly aims to direct economic development, either through a planning mechanism and/or by placing significant reliance on state

² See, for example, Rodrik, (1997) and (2007); Spence, (2021)

³ See Commander and Estrin (2022).

owned enterprises for implementation. Although widely adopted including in Asia pre-1990, this approach hardly captures Asia's development process adequately. More relevant is the way that the state has played an activist role in the framework of a market economy⁴. This has been through industrial policy where a variety of instruments have been used to support specific sectors or activities. They have included the creation of clusters, provision of incentives for technology adoption, as well as the deployment of finance, including through subsidies and/or tax breaks to activities or sectors deemed to be strategic. Considered anathema in many advanced economies (and textbooks), such policies have been seen as crucial in creating new and often internationally competitive industries, as well as orchestrating shifts into higher value-added activity.

The arguments for adopting industrial policy are mostly about addressing market failures. These can encompass mechanisms for identifying costs, including any discrepancies between private and social costs and benefits. They may also involve addressing coordination failures, not least by building long-term relationships between public and private sectors where public inputs are seen as complements to private production. Coordination can involve putting in place complementary up- and downstream investments that can help projects succeed. For instance, strategic infrastructure investment can build anchor structures (e.g., a transport node or a large factory) to coordinate expectations and realise strategic complementarities. In principle, such cornerstone investments can generate large self-sustaining spillovers.

Industrial policy that has targeted specific sectors or activities – so-called vertical industrial policy – has been a notable feature of South Korea and China in particular. The former's success in creating a manufacturing base has been attributed to the deployment of these sorts of policy. This has led to the emergence of, *inter alia*, strong shipbuilding, automotive and electronics sectors. However, it is important to note how high levels of export orientation among companies receiving public funding have been a consistent and powerful source of market discipline for major Korean companies. Successful export orientation has been central to companies – such as Samsung or Hyundai – building strong international reputations.

China too has pursued strategic goals, using Five Year Plans, but with more mixed success. For several decades, the Chinese approach was to rely on state-owned companies to implement but in recent decades this emphasis has shifted⁵. As such, many activities considered strategic have been implemented by privately held companies, even if ones that have very close connections to political power. The sources of market discipline have been less clear. Many of the 'national champion' companies have benefited from protection from competition, particularly from abroad. Other components of industrial policy have included the creation of special economic zones, as well as differentiated tax treatment and subsidy provision.

Elsewhere in Asia, phases of engagement through industrial policy have been far more episodic. They have mostly led to the creation of, or support for, loss-making public

⁴ Amsden (1992); Bardhan (2016)

⁵ Lardy (2018)

sector companies and a dissipation of resources. Simply put, this summarises much of India's experience, let alone that of most of the smaller economies.

In short, industrial policy has aimed to support the emergence of activities – and sometimes sectors – that would not have, absent public policy actions, come into existence or would have taken far longer to appear. The consequences of such policy show up in production and trade structures which may be at a scale or timing that is in advance of what might have been expected, given the level of income and other correlates of development. However, considerable care has to be taken when identifying the sources of any such disparity. After all, much of the growth in India's software and IT, as well as pharmaceuticals, sectors – some of the main components of India's modern economy – arose due to an *absence* of regulatory-cum-policy actions by government.

The lie of the land

If neither caricature model provides a convincing description of how middle-income Asia has come so far, what sort of framework should we consider? Probably the best starting point is to consider the actual economic landscape and then ask how it came to be formed.

Despite differences in the composition of output – some of which can be attributed to industrial policy – several common features exist across emerging Asia. One is the presence of dual economies. By this is meant the distinction between formal – regulated, taxed and productive – parts of the economy and the informal –unregulated, untaxed, low productivity and mostly smaller scale. This distinction is very much alive and kicking throughout Asia – in China or Vietnam as in India or Bangladesh. In addition, there are similarities in the size distribution of companies. Small-scale firms numerically dominate. Yet, few manage to grow over time. There is a relatively thin sliver of medium sized companies and a very small number of large companies. The size distribution of companies thus has a pyramid-like shape. Most of the base of the pyramid is contained within the informal and untaxed economy.

It is what the peak of the pyramid looks like that is especially informative. Here are to be found a range of companies. Some are state-owned, although that number has been falling significantly over time. Even so, state owned enterprises (SOEs) remain an important part of the landscape, not least in China and Vietnam. Self-evidently, they remain the companies most responsive to politicians and political direction. Others are multinationals that form a part of the foreign direct investment that Asian economies have attracted. But the major component comprises companies that are part of Asia's numerous business groups. These are collections of firms, diversified in their activities and sectors of operation but sharing a common owner, often controlled through pyramids or crossholdings. These business groups are, for the most part, family owned, often with a dynastic dimension⁶. Most have a focus on their domestic markets, although this is changing, not least through a growing volume of acquisitions abroad. What this quickfire summary indicates is that irrespective of the broad characterisation for the range of Asian economies – socialist, capitalist, authoritarian, democratic – they all share some common features. Namely, they have a combination of state-owned or

⁶ Khanna and Palepu (2000)

controlled/guided companies and private business groups dominating the formal part of the economy. These two ownership forms have, moreover, something important in common. They are both highly suited to the Connections World. That world is populated by politicians, political parties, SOEs and private businesses. Their ties to each other allow the various parties to search out and secure mutually beneficial interests in a highly transactional way. For politicians, those interests may encompass campaign contributions, as well as the creation of jobs at expedient moments and locations. For the business group owners, the benefits commonly include access to preferential finance, public contracts as well as securing protection from competitors. Their interactions also tend to have an element of reciprocity about them. For instance, businesses sometimes get tasked with executing or funding projects of political significance. No wonder then that during the COVID-19 pandemic, business groups were very active in supporting public health and other initiatives for addressing the crisis.

The business group format – it should be noted – is one that is absent in most of the advanced economies. This is primarily attributable to this business format being legally proscribed. For example, pyramids and crossholdings were effectively made illegal in the USA during the Roosevelt era. Even in other emerging markets, the ubiquity and impact of Asian business groups is not replicated.

There are a variety of reasons for why business groups are such an important form of business organisation in Asia. Using pyramid-like structures for complex, opaque and diversified holdings facilitate control by the dominant family. At the same time, they can be seen as a response to institutional weaknesses, such as in the markets for capital and management. To address these institutional deficiencies, business groups internalise a broad range of business activities, as, for example, in capital raising or addressing problems in securing adequate managerial and other staff. Many major business groups – Tata Sons was one of the earliest and best examples – create a management cadre for their numerous businesses. Using internal capital markets can also facilitate pursuing a range of objectives that can include serving the interests of their political partners. However, it could have been expected that as those market gaps and institutional weaknesses began to be addressed, the need to function as a business group would wane. Yet, even as the economies of Asia have become more developed, the grip of business groups has tended to strengthen rather than weaken⁷.

The point to be emphasised is that these features and their modus operandi cut across political systems and institutions, even if the latter affect the shape and structure of these networks. Further, these powerful business groups have been able to entrench themselves across a wide range of sectors. This has resulted in significant concentration of market power both in specific markets and across the economy as a whole. As an example, in South Korea, Thailand and Vietnam, the revenues of the ten largest firms (which includes both public and private companies, listed and unlisted) accounts for over 40% of GDP and approaches 30% in the Philippines. Even in India and China, that share is around 15%. Overall concentration ratios are high, indeed, throughout Asia. Although many of these entrenched companies are efficient and create ‘good jobs’, they do so to a limited extent. Most businesses and workers remain locked into the other part – the large informal economy – populated by many small, low productivity entities.

⁷ Carney et al (2011)

The ability of these business groups to entrench themselves has also had striking consequences for the accumulation of wealth. Asia has spawned a remarkable growth of billionaires and very rich individuals over recent decades, most of whom are business group owners or scions of such dynasties.

Coordination by other means

How have so many different parts of Asia ended up having such similar characteristics, not least the central role accorded to business groups? Further, why have they persisted and indeed sometimes increased their stranglehold over the economy, even as market imperfections have waned?

For sure, some of these business groups were built through explicit industrial policy, as governments searched for national champions. The South Korean *chaebols* mostly trace their origins and subsequent growth to strong support from the state. Even if some of the leading Chinese companies had entrepreneurial roots, close ties have subsequently linked them umbilically to the state (e.g., Huawei, Tencent, Alibaba and Baidu). Other major business groups, such as Tata Bros., in India or several of the large Indonesian groups, owe their origins to strong support from earlier governments. But this is only a part of the story.

The answers lie in the combination of factors. Business groups not only suit the transactional framework of the Connections World but they also allow governments to overcome some of the coordination constraints holding back growth. Business groups are not just able to internalise externalities that might limit growth. They are also attractive to politicians due to their ability to leverage and allocate resources (including from the state) and hence achieve scale. As such, this has been a major conduit for achieving implicit coordination. Indeed, it has been argued that this allows the state to outsource infrastructure and allied investments to a small number of business groups and their hugely wealthy (and politically connected) owners⁸.

In other words, what is far more prevalent than explicit industrial policy is that Asian politicians and governments – at all levels – have invested in their relationships with preferred businesses. Mostly, this has been without reference to strategic policy goals. Allowing some business groups to control major parts of the economy eases any coordination problem, especially when business groups have a presence up and down value chains. An additional attraction is that in the connections world, politicians only need to deal with a relatively small number of business group owners in order to influence much of the economy. In other words, by conferring advantage on a relatively small number of businesses and business groups, most Asian economies have in effect implemented a form of industrial policy even if not designed or designated as such.

Strong connections help certain businesses build commercial and market strength and then entrench themselves. Moreover, it is striking how persistent, once established, such business groups have been and the levels of concentration that have been achieved. That is not to say that there is no turnover – after all some groups fall out of

⁸ Tooze (2022)

political favour while others acquire such benefits. But, in general, once established, relatively few of these groups fade away.

In short, trying to design *ex ante* what the economy should produce in line with enunciated policy goals has been a minority taste throughout Asia. But there has been an implicit or tacit preference for specific forms of business organisation and market structure. This has resulted in a significant degree of *de facto* coordination.

Asia's Differences

Asia's growth performance has, of course, been quite remarkable. In 1953 South Korea's income per capita was around 25% of the global mean. By 2019, it was close to 150%. In the same period, China jumped from 15% to 50%. Other Asian economies have also seen impressive gains. This has not been replicated in other regions. Clearly, the Connections World has not been a barrier to economic growth in the past half century. This is in part because of the *de facto* coordination that the Connections World has delivered.

However, there are two caveats that need be made. For a start, some economies in Asia have performed better than others, suggesting that the impact of the Connections World may vary. Further, some of the same features may be found outside of Asia. For example, there are significant business groups in Latin America and in the Middle East and North Africa. Indeed, close relationships between government and business are hardly unknown elsewhere. So, the obvious questions are – why have connections had such a positive – if variable – impact in Asia and why has this not been replicated in other emerging economies and regions?

Differences within Asia

Starting with the variation within Asia, economies such as Pakistan and the Philippines have consistently under-performed relative to those at the frontier. In the latter, income per capita relative to the USA was only slightly higher in 2018/19 than it was in 1980, while Pakistan's slow increase still only left incomes at around 10% of the US at the end of the period. Part of the reason appears to lie in the degree to which these local Connections Worlds are configured and the extent to which they are embedded.

A way of thinking about this is to consider the intensity of connections and the dimensions. It is not just how common connections are, but how close are the relationships between businesses and politicians. In other words, there may be pervasive links between business and politicians, but these may be spread over large numbers of actors. By contrast, in a place like the Philippines, those connections – and the ones that really matter – are formed around a very limited number of players. These players occupy strategic positions in the networks. The intensity of connections will reflect the weight of specific sectors and parts of the economy where connections play a central role. In turn, the intensity of connections and their locus in the formal economy is closely related to the extent of economic concentration and, with it, the degree of market power that connected entities possess.

Relating the intensity of connections to the extent of economic concentration in a country is informative. In the case of the Philippines, there is a very high intensity. Not only are there strong and pervasive links between businesses and political players but

the dominant businesses are themselves compressed into a remarkably small number of business groups and interests. These groups are in turn controlled by a very small number of extremely wealthy families. This has translated into strong and persistent concentration in markets, let alone in influence and power.

Pakistan also illustrates how the type of players and the network characteristics matter. In this case, the role of the military has imparted a very specific configuration. Aside from complicating the measurement of concentration and influence, the military's presence has held back the development of new sectors and activities, not least through the dominance of military spending in the fiscal process and the resulting allocation of public resources.

Differences with other regions

Turning now to the experience of other regions, family-owned business groups have certainly been present in Latin America and the Middle East. In the former, business groups stood centre-stage in the major economies and were viewed as key instruments for achieving growth. This was certainly true in Argentina where family owned, large and diversified business groups were a major part of the firm landscape from the 1930s. Aside from common problems relating to succession, since the 1990s a deteriorating macroeconomic and investment context has led to significant numbers exiting and not being replaced. In Brazil, business groups again mostly have characteristic family ownership and are diversified. Many were formed pre-1950, often with significant support from the state⁹. Increasingly, their business strategies – as in Argentina – have involved internationalisation. The reasons for why this has been the case are clearly complex – including as a response to growing competition at home – but hedging risk against exposure to domestic market volatilities and shifting political preferences has also played a role. Indeed, those volatilities can mostly be traced to the adoption of populist policies, themselves a response to the perceived concentration of resources and wealth that the business group-state nexus generated. Such political volatility has also been a feature of Turkey where incumbent business groups – mostly formed in the 1920/30s – have faced a shift in political tastes and policies over the last two decades.

What is evident is that while business groups in Latin America have drawn on their connections to politicians and parties, the volatility of the political domain has led to two related – and endogenous – phenomena. The first is impermanence in institutions and policies. The second is the willingness of governments to pursue inflationary finance for funding military, social or other preferred spending programmes. This has ultimately sapped the incentive to hold domestic assets or invest domestically. Developmental goals have consequently proved not only ephemeral but often non-viable. Needless to say, this has incentivised strategic behaviour designed to leverage rents and/or exchange rate arbitrage.

In short, despite many similarities in terms of configuration and modes of operating, the incidence, longevity and characteristics of business groups elsewhere mostly differ from those in Asia. For a start, in the latter there is a far longer history of this form of business organisation. Probably the best-known Indian business house – Tata Sons – traces its history back to the 19th century, as do some of the Chinese business groups

⁹ Aldrich and Postali (2010); Fracchia et al (2010)

(*hongs*). Further, the number and sectoral coverage of the Asian business groups exceeds by far that registered elsewhere. There are also major differences in the resource bases and resulting sectoral exposures. In Latin America and the Middle East, there has been a strong bias towards natural resources, whether of fossil fuels, mining, other commodities and finance. In the Middle East, aside from the heavy focus on natural resources, military-owned or controlled businesses have often occupied a prominent role in the economy. This is particularly true in Egypt. At the same time, connections have tended to be closely tied to the ruling autocrats, monarchs and their respective families. This combination has ensured a high intensity of connections.

By contrast, Asian business groups have more commonly developed as large scale diversified corporate vehicles centred around industrial activities, such as in chemicals, vehicles, electronics, food processing and steel. When linked to exposure to international markets – a prominent feature in East Asia particularly – competitive pressures were brought to bear on domestic producers that partially offset some of the concentration effects inherent in the business group model. Asia's relative absence of natural resources and the resulting sectoral positioning thus made it easier for business groups to provide the coordination and internalisation of externalities in the development process. Further, relative to the natural resource-rich economies, it limited the scope for rent-seeking and corruption.

There has also been the role of public policy. Before the deeper contours of the modern connections economy were clearly etched, much of Asia in the post-colonial period had adopted explicit developmental goals and targets. In some instances, this was driven by geo-political imperatives – Taiwan and South Korea – but also by a common need to propose income and employment solutions for their substantial populations, significant shares of which were mired in poverty. Those solutions were commonly pursued through industrialisation. Indeed, the advance guard of Asia – the so-called Asian Tigers (Singapore, Taiwan, South Korea) – explicitly drew on Japan's experience of reconstruction post-1945. Importance was attached to large business-led industrialisation directed or, at the least, informed by industrial policy. These broad developmental goals were then aided by external support from the rich economies and international financial institutions. The confluence of these developmental goals with the selection of preferred business vehicles for their execution subsequently deepened the foundations of the connections economy.

A final point concerns some salient historical differences. In Asia, European colonialists typically conquered well-established states with longstanding formal and informal institutions and culture. In other words, there was a tradition of reasonably stable institutions including property rights and the rule of law. This was not for the most part true in other regions, one consequence of which was the relatively tardy creation of an institutional context for supporting the emergence of large-scale businesses.

Where is Asia heading?

Our discussion obviously raises the question of whether Asia's performance can be maintained going forward. There are several reasons to suggest that at a minimum, growth in the leading economies may slow. Unfavourable demographics have already begun to emerge, notably in China. The prospects for extensive growth based on the dual economy – transferring labour from the rural agricultural sector to an industrial

urban environment – are becoming far less favourable, with economies increasingly needing to pivot towards intensive growth, based on increases in (presently, rather low) labour productivity and technological innovation. The need to shift towards innovation is clear and increasingly recognised as such by governments, particularly in East Asia. To the extent that such shifts prove feasible, there is also the question of whether this will require Asian institutions to mutate towards formats that are more commonly observed in OECD economies?

Key features of the connections world stand as impediments to such shifts. For a start, large parts of the economy – jobs and workers – are locked into low wage, low productivity activity in the informal sector. Further, whilst the connections world has delivered coordination, the central players and their objectives are not necessarily aligned with the need for greater innovation. That is because the fruits of this coordination have also been very high levels of concentration not only in particular markets but also across the economy. Market concentration and the place occupied by powerful business groups stands in the way of creative destruction, tying up resources in allowing inefficient firms to survive, while restricting new entrants. And even when connected business groups have innovated, they tend to be a brake on innovation in the wider economy, as they limit the incentives for non-affiliated firms to innovate, not least by restricting access to markets and the availability of external financing. The fact that the greater part of the economy is locked in informality also naturally limits the incidence of innovation. Yet, neither businesses nor politicians have sufficient incentives to deviate from the mutually rewarding relationships that have spawned these features.

Policy response

To progress much further up the development ladder, the Asian economies will need to come to grips with the entrenched power of the Connections World. That will take the adoption of measures designed to induce the transformation of business groups into more transparent and better governed business organisations, while also radically weakening the links between politicians and business. There is a raft of policies fit for such purpose. They include changes to corporate governance that undercut pyramidal ownership structures, mergers and cross-holdings, as well as the imposition of inheritance taxes and supplemental taxation of established business groups whilst also shifting to new types of competition policy, including targeting levels of overall competition in the economy. After all, it took radical action by Roosevelt in the early 1930s to eliminate the business group format as a viable vehicle in the US. Limits were placed on the number of levels or tiers, higher taxes were imposed on inter-group dividends, consolidated group tax filing was eliminated, and constraints imposed on financial institutions acting as controlling shareholders as well as on business groups controlling public utilities. This was done, however, at a time of economic depression and backlash against incumbent companies.

The adoption of such policies is unlikely to occur with ease in Asia because the mutual benefits from market entrenchment and political connections outweigh any gains to the current players from reform. However, some of the changes that have been adopted in South Korea – such as the recent introduction of a 50% inheritance tax rate – reflect the appreciation of the risks associated with the high levels of concentration that have been allowed to occur, even though the economy is very open and subject to international

competition. Even so, for business groups to become less pervasive and for the business-politics nexus to weaken, it will require a far wider and more robust policy response across Asia: something that has yet to be discerned.

Conclusion

Asia's approach to coordination has yielded notable benefits but has also serious drawbacks. Not only does it result in high levels of concentration but the groups that benefit may do so mainly because their owners are good at playing the connections game. Many interactions between business and politicians also tend to suffer from being corrupt, whilst the attenuation of competition that results impedes improvements in efficiency and can bolster rent seeking. Because ownership is so concentrated, the model has also led to an extraordinary explosion of wealth for a handful of oligarchs alongside economic insecurity for the vast majority working in the informal sector.

Moreover, while this model may have helped boost extensive growth through the concentration of resources in the hands of business group owners and the state, it is becoming less advantageous as the emphasis shifts increasingly to innovation-led growth. In fact, the connections world is in many respects an impediment to broad based innovation. That is because the loci of innovation get narrowed to existing incumbents. In some instances, this may also be associated with perpetuation of a discretionary cycle of financial and other support. In these ways, feed-back loops form which serve to perpetuate the existing structures and their associated institutions. This holds back the entry of new companies and hence the emergence of virtuous Schumpeterian renewal and innovation cycles.

In sum, what was an advantage for earlier stages of development based on greater accumulation of capital and labour is now becoming a serious disadvantage. Moreover, the nexus of mutually supporting connections stands as a barrier to change. If Asia's policy choices cannot best be understood in terms of the state or market dichotomy, future policy choices will nevertheless undoubtedly require significant rebalancing and far less emphasis on achieving coordination through business-politician ties. This passage is not without precedents. In what are now advanced economies, it has taken substantial time and policy change to break down the business group format. And, even then, this has still left considerable scope for political ties and anti-competitive behaviour.

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