State capitalism vs. the free market: Which performs better?

By Michael Schuman
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For much of the past 30 years, the long-running, 20th-century contest between state and market had appeared settled. The strong, post-Reagan economic performance of the U.S. based on deregulation, free trade and capital flows and globalization appeared to confirm the virtues of liberal economic policies, while the collapse of the Soviet Union and the capitalist revolution in China proclaimed the death of state-dominated systems. Free capitalism had emerged a clear winner.

Or so it seemed. In the wake of the 2008 financial crisis, the debate over the proper role of the state in a modern economy has been reopened. In the U.S., Tea Partiers advocate their own version of "small government" to promote economic recovery, while President Barack Obama promotes more active government policy to create jobs. Others, meanwhile, wonder if Washington needs an "industrial policy" to nurture new sectors, like green energy, to help the U.S. compete with China. In Europe, politicians are grappling with how to regain competitiveness through liberalization while still maintaining the extensive social protection of their welfare states.

In emerging markets, however, a significant state hand in economic development is far less controversial. Many of today's up-and-coming economies either have had their state-led development period, or are still very much in the midst of that experiment – most of all, China. And it has not gone unnoticed among some analysts in the West that many of these same emerging markets have also generally maintained their growth despite the devastating global downturn. So as the market economies of the West falter, some have asked if "state capitalism," that mix of market forces and state control, can produce better economic results than the laissez faire economic models favored in the U.S.

Is that really the case? Is "state capitalism" superior to the free market?

Let's be honest. The current economic crisis is testing our most cherished principles of market economics. Unemployment remains stubbornly high and growth stubbornly slow, and debt is an escalating problem throughout the developed world. What we're dealing with is not just a recession, but a crisis of capitalism itself, as George Magnus, senior economic advisor at UBS, put it recently:

Our economic predicament is not a temporary or traditional condition. Put simply, the economic model that drove the long boom from the 1980s to 2008, has broken down. Considering the scale of the bust, and the system malfunctions in advanced economies that have been exposed, I would argue that the 2008/09 financial crisis has bequeathed a once-in-a-generation crisis of capitalism…It is a crisis of capitalism because our economic model and policy settings cannot produce sustainable growth, adequate income formation or employment creation.

So it's only natural that we've looked for solutions in countries that are still creating jobs and higher incomes – the best performers of the emerging world. And what have we found? The state is very much at the center of things. While it is true, of course, that no economy in the world today is a pure free market economy – all governments step into economic matters in one way or another – state capitalists do so in ways unthinkable in the U.S. For example, in state capitalists, governments influence bank lending, or outright own large and important segments of the economy. Their policymakers are more willing to guide the economy through bureaucratic fiat. All of these elements of state capitalism might sound just plain dangerous to many in the West. But the fact is that the failings of the advanced economies and the continued strength in emerging markets has made it much more difficult to claim free markets trump state capitalism. Here's how Ian Bremmer, president of consulting firm Eurasia Group explained matters last year:

It's now a G20 world, in which China, Russia, Saudi Arabia, and other state-centric players wield growing influence. When leaders of free-market democracies diagnose the global meltdown, they now face the skeptical smiles of those who believe that the free market has failed and that the state should play the leading role in guiding national economies… The financial crisis and market meltdowns in America and Europe have given state capitalism a big boost. In part, that's because Western economies are still struggling to their feet while China is again off to the races. It's now much harder for Westerners to champion a free-market system and easier for China and Russia to argue that only governments can save economies on the brink.

So, should we all become state capitalists? Is state capitalism a remedy for the ills the West is facing today? Not so fast. Today's state capitalists aren't performing as well as some believe.

The "model" state capitalist is China. Yes, the economy continues to grow at a stellar pace, and a big reason why is the role of the government. The country powered through the Great Recession to a great degree because of government stimulus, credit from state banks and investment by state corporations. Over the long term, the support of the state has also aided the country's rapid advance into global manufacturing.

But state intervention is having a clear downside as well. Too heavy a state hand – through, for example, bureaucratic meddling in the financial system and government control of the value of the yuan – is creating an economy with serious distortions, including rising levels of debt, excessive investment, even more excessive external surpluses, and a potential banking crisis. The Persian Gulf emirates, often cited as another state capitalism success story, have experienced similar problems. Dubai, for example, is still sorting through the fallout from a gargantuan, debt-driven real estate bubble, which to a great degree was inflated by state enterprises.

But most of all, anyone who believes in state capitalism should take a visit to Russia, which I did recently for a recent story in TIME magazine. Once considered a premier state capitalist, Russia's economy is now being strangled by the state. Under Prime Minister (and formerly President) Vladimir Putin, the state reasserted its authority, regaining its dominance over key sectors of the economy, especially the crucial oil and gas industry. Putin also redistributed oil money by increasing government spending and the size of the civil service. That sparked a pre-crisis consumer boom, but today the story is much different. State enterprises, favored by overbearing bureaucrats, are crowding out the private sector. World Bank surveys show Russia is becoming a harder and harder place to do business. Endemic corruption has soured the investment climate. Private capital is fleeing the country. Because of those problems, growth has never recovered to its pre-crisis levels, and most economic forecasts don't expect it will anytime soon. Even senior policymakers within the Kremlin are doubting the future of Russia's state capitalist model. One of them is Arkady Dvorkovich, a reform-minded economic adviser to President Dmitri Medvedev. Those who admire state capitalism "don't know what they're saying," he told me in a very forthright interview. "This way of doing things has exhausted all its potential, so we need to change policies."

Ironically, what Russia and the other state capitalists need is a strong dose of market reform – deregulation to free up entrepreneurship; better rule of law to attract investment; greater emphasis on commercial viability to prevent wasteful investment. So even though it is true that free capitalism has fallen on hard times, a better system has not yet emerged. State capitalism is not the solution.