

Political Economy of East Asian Development

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I. Introduction

The recent financial turmoil in a number of Asian countries and the continuing weakness of the Japanese economy during the 1990s have raised some doubts about the so-called 'Asian Model' of economic development. Opinions differ widely as to the nature and causes of the 'Asian crisis'. While some researchers have concentrated on the rapid liberalization of the capital markets as the main source, others have focussed on the domestic political and institutional sources of the malaise. Now that most of these economies are beginning to overcome the effects of the crisis attention will, once again be focussed on

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whether or not these economies can revert to the earlier growth trajectory into the 21th century.

The post World War II period has seen a number of Asian economies, in succession, grow at a very rapid pace. Following the heels of Japan, the first ever non-western country to industrialize and join the rank of advanced countries, Korea, Taiwan, Hong Kong SAR, and Singapore experienced substantial rates of growth in the 1970s. The 1980s saw another set of Asian countries, Malaysia, Thailand, Indonesia and, to a lesser extent, Philippines, registering sustained high rates of growth. In the 1990s, the phenomenon is seen to be spreading to China and possibly to some of the South Asian countries as well. One can make some interesting observations in this process. First, in an era when many developing countries in other parts of the world have failed in their efforts to propel their economies out of the quagmire of 'low level equilibrium trap' (Nurkse,1953), many Asian countries have succeeded. Second, as a number of econometric studies¹⁾ have shone, the initial conditions do not seem to be able to predict the high rates of growth in these economies. What accounted for the high and sustained growth rates in this region and why in parts of Asia and not somewhere else? These are some of the questions that have intrigued and fascinated the academic community in various disciplinary areas and has led to investigations in to what has sometimes been termed as 'Asian Development Model'. Whether such a model exists or not is a hotly debated issue.

While many researchers have dubbed the Asian growth phenomenon as a 'Miracle' (World Bank, 1993), some economists have dismissed it as mere extensive growth. Paul Krugman, the MIT economist, beginning with an article in Foreign Affairs in 1994, has shown that most of Asian growth in the postwar

1) See, for example, Easterly (1995) and Page (1994).

period (except perhaps Japan) can be explained by an increase in labor and capital inputs. Productivity growth has played very little part in the process. While it is possible to contest the Krugmanian contention by producing alternative set of figures, since econometric techniques of measuring productivity or efficiency changes are beset with numerous pitfalls²⁾, even accepting his contention does not distract from the fact that growth has tended to concentrate in one particular region of the world. It remains to be explained how and why the economies in East and South East Asia have been able to either circumvent or ameliorate the constraints on economic growth and development that countries in other regions have failed to do.

The double digit sustained growth rates registered by the Japanese economy during the 1950s and 1960s were considered abnormal at that time and were attributed to its peculiar organizational structures. Recent experience of other Asian economies registering equally high and sustained rates of growth indicates that the Japanese performance was in no way unique and growth was probably independent of organizational peculiarities of Japan. This realization has now led to a belief, on part of some, that there has been some Asian way of doing things leading to a development path different from that followed by the early industrializers. Others are not so convinced. The result is a heated debate over explanations of the Asian growth experience and there does not seem to be any consensus in sight.

2) Not only is it possible to contest the assumptions on which the estimates used by Krugman are based (see, for example, Rodrik, 1996), it has also been observed that in the initial stages of economic growth, the East Asian experience does not differ much from that of the early industrializers like the United States and Japan (See, Hayami, 1996).

Since Japan was the first ever non-western country to industrialize and is widely believed to have served as a 'Model' for many of the East and South East Asian countries, it is natural to look into the Japanese experience of economic development in order to get some clues as to the existence of any uniquely 'Asian' way of industrialization. Process of growth and development being complex, a wide range of factors can impinge on this process. Some of these factors operating in the region giving relatively easy access to foreign markets and technology during the immediate post World War II period to some countries may be a case in point. Moreover, the historical background and availability of resources may be different. To the extent that growth and development process is path dependent, manifestations in the form of organizational structures of the socio-economic system are bound to differ. On the other hand, it is also possible to discern a number of similarities in the process. For example, high rates of savings and investment, greater openness to external markets, relative abundance of labor, small scale farming, fairly good mass education systems and, a more widely talked about factor, activist governments.

In somewhat different vein, the recent developments in the Japanese economy may also be useful to pinpoint some pitfalls that the East and South East Asian economies may have to take into account as they move to greater maturity in their economy and society. How far the 'negative' lessons are useful for these economies will probably depend on particular situation of each country just as their development experience took a somewhat different path. In order to derive any implications, however, it is necessary to delineate the mechanisms behind the process of rapid growth and the eventual slow down in the Japanese economy to determine the underlying causes of the difficulties being faced by Japan in recent years. This requires a framework

that transcends the manifestations and attempts to look at the mechanism of growth in Japan.

The present paper is a modest attempt at reappraising the postwar Japanese economy in such a framework. In doing this, I approach the subject from the point of view of institutions and institutional change, where institutions are defined in the Northian sense of 'rules of the game', formal or informal (North, 1990). Needless to say that I have tried to adapt the Northian perspective for the purposes of the present analysis. The main advantage of taking this approach is that it enables us to bring together the discussion of markets, state and even culture in a unified framework. Before I go on to present my tentative analytical framework, it may be useful to briefly survey some of the major debates in interpreting the East and South East Asian experience of development.

II. Asian Development Experience: The Debate

Participants of all hues in the debate over the postwar Asian Development experience are agreed on the importance of high rates of savings and investment, an educated work force, relatively equitable distribution of income and export orientation in the growth process of the Asian countries. Some agreement on active government participation is also admitted. Even the most ardent supporter of the free market school, the World Bank (1990), has also acknowledged the role of the state in East Asian economic success. The major point of contention in the debate, however, is the question of primacy of state or the markets. The market school, in its most extreme form, contends that growth in the region occurred despite government

intervention. The statist school³⁾, on the other hand, believes that state intervention was indispensable for the success of these economies and without such intervention these countries would have been unable to achieve the present development levels. Besides the debate about markets (mainly economists) and state (primarily political scientists), cultural features of the Asian economies have also received popular attention. Confucian ethics of frugality, hard work, paternalism, loyalty, group mentality have been widely discussed as the sources of Japanese and other Asian success stories. Asian business practices such as long-term employment, seniority wages, long-termism (in case of Japan), family based business practices and personal relations (Chinese businesses in South East Asia), business groups, networks and state-business relations are sometimes seen as reflections of such cultural traits. While cultural explanations have a wide public appeal, the seemingly culture based manifestations, more often than not, have a perfectly reasonable explanation. That is why these explanations have to be taken with a pinch of salt. Still, there are models that rely on some form of cultural traits at the core of their argument.⁴⁾ In briefly reviewing the debate on East and South East Asian development experience I will concentrate on the state versus market arguments. Cultural argument will be very cursorily discussed. Again, as I have discussed the relative strengths and weaknesses of these two approaches elsewhere (Khosla, 1996), I will refer only to the barest details here.

3) The main argument for the statist school began with Johnson (1982). For further developed, see Amsden (1989) and Wade (1990).

4) Murakami (1987) is a very interesting approach to the political economy using mura-type organization as the centerpiece for explaining Japanese political economy.

1) The Market School

The neoclassical free market school, advocated by economists, stresses the role of efficient resource allocation through the functioning of competitive markets. The role of the government is restricted to provision of 'pure' public goods and a sound and reliable legal system. Key policies are integration with international markets, no or negligible impediments to imports and uniform incentives across productive activities. This curbs the ability of government to adopt wrong policies and allows it autonomy from vested interests.

The proponents of market school point to the relatively small state in and the openness of the East and South East Asian economies and contend that the rates of growth increased substantially as inward looking import substitution politics of the 1950s were discarded and more outward looking policies adopted. The resulting integration with international markets helped these economies to get their 'prices right'. With relative market prices reflecting relative resource scarcities, efficiency in resource allocation was achieved. At the same time, it helped them overcome the narrowness of domestic markets to exploit economies of scale. Government intervention also declined during this period due to fiscal constraints⁵⁾ which helped in good macro performance in terms of stable inflation and low interest rates (avoiding crowding out). In contrast, the countries following inward looking import substitution policies stagnated because of small domestic markets and choking-off of the private sector initiatives due to distortionary regulations. Intervention also caused inefficiencies by insulating domestic markets from international competition resulting in high cost inefficient

5) In Taiwan, it seems the share of public sector is still high though it has been declining.

industries. Entrenched interests⁶⁾ emerged with a stake in maintenance of status quo. Waste of national resources in the form of rent seeking activities further compounded the problems. Subsidization of inefficient industries added to public debt and to inflationary pressures. With prices divorced from relative resource scarcities, allocation was inefficient resulting in stunted growth.⁷⁾

While the neo-classical or the market school does allow for a greater direct role for the government, it is usually in the sphere of mitigating market imperfections so that the markets can perform their role more efficiently. Such a rule is primarily market enhancing and has been termed as 'simulating the markets' by Wade(1990). The pattern of resource allocation is still market determined. Even when state intervention is acceptable in terms of market school, the proponents believe that governments should stay clear of it. This is because while 'market failures' can cause some distortions and impose inefficiency costs on the economy, the possibilities of 'government failure' and the associated costs on the economy, the possibilities of 'government failures' and the associated costs cannot be ignored. It is claimed that the historical evidence indicates that government failures are much more common than the other way around.

2) The Statist Argument

In contrast to the market school, the developmental state⁸⁾ view, subscribed to primarily by political scientists, argues that markets cannot and generally do not, by themselves, generate growth and development. 'Enlightened' policy activism is necessary.⁹⁾ The prescription of the interventionist approach is

6) Olson (1982) refers to these as distributional coalitions.

7) A number of studies, for example, Little et.al (1970), Bhagwati and Sirinivasan (1975), Balassa (1977), Kreuger (1978) have documented the costs of ISI.

8) This view is represented by authors like Johnson (1982), Haggard (1988), Wade (1990) and Lee and Naya (1988).

that governments can and do significantly influence the level and direction of economic activity. The state has an important role to play in mobilizing and allocating resources in the right (desired) direction through regulation and control (Sen, 1993 and Bardhan, 1990). The government intervenes in resource allocation to deliberately 'get the prices wrong' in order to shift resources into strategic economic activities (Wade, 1990). As to the question why governments have been successful in East Asia and not in other countries, the argument moves to quality of intervention and nature of state (strong versus weak states) (Haggard, 1988; and Wade, 1990). Strong states with highly 'capable' bureaucracy are believed to be able to insulate themselves from interest group pressures and rent seeking activities, a trait not seen in 'weak' states or states with corrupt bureaucracy.¹⁰⁾ Arguments like nationalism and bureaucratic elite imbued with a deep sense of national purpose also find place in this explanation of Asian success(cultural traits!).

It is believed that, barring perhaps Hong Kong, the successful East and South East Asian economies (including Japan) have been characterized by relatively authoritarian political systems or 'hard' states(Wade, 1990) with an elite and managerial bureaucracy (competent and competitive) with sufficient autonomy in enacting policies that are in line with broader 'national' rather than narrow 'private' interests. At the same time close relationship between government and business is also considered important by many scholars such as Lee and Naya(1988), Zysman (1983) and Okimoto (1989).¹¹⁾ The networks

9) It is pointed out that in some Asian countries, Korea and Taiwan, for example, government share in GDP is much larger than in Latin American countries (Chawdhuri and Islam, 1993) and that most Asian countries have extensive regulatory structures (e.g. capital markets).

10) Bardhan (1990) points out that rent-seeking is better at explaining failures than the successes.

stem from common background of the leaders in government, bureaucracy and business (OB networks) and are reinforced by institutional arrangements such as consultative bodies.¹²⁾ These networks can be used to bring together the dominant interests in the economy and help in bringing about a broad based consensus in policy making.

3) The Cultural Explanations

As mentioned earlier, the cultural explanations tend to be very much subjective and ad hoc. No one can perhaps deny that hard work is important for individuals and societies. High savings and investments are important for building up the capital stock of an economy. An educated work force can adapt and respond to technological changes much more effectively. However, to say that the Confucian values in the East and South East Asian economies somehow have a monopoly in producing traits such as hard work, frugality and emphasis on education is perhaps attributing too much to the value system. While such values, if present, might strengthen other factors affecting these variables, these can perhaps never be the core variables in an explanation.

Besides the above mentioned traits operating at the macroeconomic level, it is also suggested that paternalism,

11) Chawdhuri and Islam (1993) points out that the close relationship between business and government produces quasi internal organization based on internalization of capital markets and subtle networks of long-term relationships. The internalization of capital markets (control over or ability to regulate financial flows) allows the state to minimize information and transaction costs for the quasi organization.

12) The practice of post retirement placements of bureaucrats in private sector firms, amakudari in Japanese, is also seen as one of the reinforcing channels.

loyalty and respect for authority within the Confucian value system have also been important at the micro level. These explanations are often cited in discussions of the so-called 'Asian' business systems which include widely different structures such as long-term employment, bottoms-up decision making, corporate loyalty, business groups, family businesses, long-termism and so on. Recent research in the Japanese business systems has made sufficient progress to cast serious doubts on the cultural element in explaining these manifestations.¹³⁾

4) An Appraisal

The discussion of various explanations of the East and South East Asian experience of growth and development above clearly indicates an overconcern with the manifestations of the process rather than the mechanism itself. Markets, states and culture do not emerge and operate in vacuum and are in effect the manifestations of the patterns of interaction among individuals, among groups and among individuals and groups. It is in studying these interactions that one can hope to find clues to the mechanism of modernization and structural change. Using either markets, state or culture as a constant results in rather static explanations. The common thread in the three different explanations is their impact on the incentive structure which determines the allocation of resources. In case of markets, it is the famous Smithian 'invisible hand' that determines the allocation and distribution pattern. Markets are conceived of as impartial arbiters of human interactions whether among individuals or among groups. The only requirement is a well

13) For example, Whitley (1992), Dore (1986) and Hamilton (1991).

functioning, impartial and enforceable legal system. This is the role of the state. In the statist school, the state performs or at least guides the pattern of resource allocation and distribution either directly or by altering the market incentives. In order to be successful, state needs to be free from narrow vested interests and be able to form some sort of consensus about national goals. If the government gets hijacked by narrow interest groups, allocational patterns can get severely distorted as numerous failed experiences of growth and development indicate. That is why a 'hard state' and an 'enlightened and competent' bureaucracy became important ingredients in the statist explanations of East and South East Asian development process. Cultural explanations being, more often than not, piecemeal are difficult to assess within the above framework and are unlikely to be independent.

The available evidence to date has failed to prove the superiority of one or the other of the statist or market school. Partly, this is due to the fact that there are no 'pure' market or statist examples.¹⁴⁾ It is, therefore, imperative to integrate the different approaches and study the dynamics of the process of development and modernization. A study of human interaction, among individuals and groups, and changes in these patterns over time seem to me the most promising approach in this regard. In analyzing the success of the East Asia and the failure of the Latin American and Sub-Saharan Africa to adopt successful policies, Teranishi (1996) has indicated that the

14) Erstwhile communist countries would be closest to the 'pure' form of state dictated allocation and distributive pattern. But the experience of these countries is not very favorable to the statist school. On the other hand the US and European economies, while close to being 'market' economies, cannot be construed as 'pure' cases. In any event, while looking at the developing countries, pure market cases are hard to come by.

manner of interaction between state and the private sector in relation to distributive conflicts could have been crucial.¹⁵⁾

In an attempt to integrate the various explanations of the Asian experience, I will try to present an alternative framework based largely on the institutional approach following Douglas C North. As this approach is still in a nascent form, I term it as a tentative alternative framework.

III. A Tentative Alternative Framework¹⁶⁾

We begin by assuming that people, as individuals or as groups, strive to improve their standard of living and enrich their lives. In the process, they interact with each other. Repeated interaction results in a learning process giving rise to certain rules within which such interaction can take place. These rules can be formal (various types of laws and regulations, e.g. property rights) or informal (societal norms, religious beliefs etc.). These rules of the game, devised by human beings structure human interaction and have been termed as 'institutions' by North(1990). Since learning process is continuous, institutions are constantly evolving. The purpose of these institutions, formal or informal, is to reduce uncertainties in the interaction process and allow the participants to engage in the pursuit of their objectives with some degree of confidence.

15) Incidentally, his analysis also shows that East Asian governments were not free from interest group pressures. The insulation hypothesis as posited by the statist school is, therefore, not supported by this analysis. Teranishi points out that the insulation of a part of the state, the part dealing with macro-policies, seems to have been insulated due to the nature of public-private interactions.

16) This section draws heavily on the work by Douglas North.

The institutional set up, in conjunction with the available 'physical' technology defines a set of opportunities and constraints within which members of a society try to improve their living standards. This pursuit takes place in an environment of scarcity and the participants compete with each other for a claim over the scarce resources. It will be natural for individuals with some common interest to come together and form groups. These collection of individuals into groups gives rise to organizational structures that form the basis of economic and political activity. Firms, trade unions, trade associations and cooperatives are some examples of economic groupings. Political parties, government, regulatory agencies, pressure groups representing specific interests, may be cited as examples of political organizations. Competition among individuals and organizations can take two different forms. First, these actors can try to improve their efficiency and hence competitive position. Alternatively, they can try to influence the allocation through redistribution. Though the two seem to be alternatives, they are, in practice quite interlinked. In narrower interpretation, the first alternative falls in the realm of economics and the later in the realm of politics. It is therefore quite clear that institutional framework can integrate the two aspects.

The repeated interaction among individuals and organizations results in accumulation of experiences over generations and gives rise to behavioral patterns that can be thought of as beliefs, culture or value system. These patterns become embedded in language, institutions and organizational structures. Insofar as this experience and learning differs between societies, the behavioral patterns will diverge and manifest in the so-called 'cultural' differences. Now experiences may result in modification of these behavior patterns and impinge on institutional and

organizational change. One main source of institutional change is extension of knowledge. Sources of new knowledge may be indigenous or exogenous. Increased interaction with other societies, by expanding the stock of knowledge can also be a source of institutional and organizational change. As new knowledge becomes available, it is sifted through the viewpoint of existing learning and is either integrated or discarded.¹⁷⁾ In this sense, learning and institutional change is highly path dependent but, by no means, a constant.

Competition among individuals and organizations with the institutional constraints provides for an incentive structure to invest in skills and expansion of knowledge base. While the existing matrix of institutions determines the viability of organizational structures at a given point of time, interaction between the two in an environment of 'scarcity' dictates the path of institutional and organizational change. A substantive change in the stock of knowledge and technology will shift the opportunity set and call for restructuring of institutions and organizations. The changed opportunity set may require a fundamental change in perceptions and institutional structures. Once this happens, competitive position of individuals and organizations, both economic and political changes and so does the interaction pattern.¹⁸⁾

17) Recent debates over cloning of human tissues and genetically modified foods are interesting examples. As technology for cloning and genetically modified crops became available, the initial outcry against perfecting and using these technologies was substantial. Gradually, however, perceptions of the society have changed towards greater acceptability. The change in our stock of knowledge has resulted in changing perceptions and institutional change.

18) For example, as new industries emerge and become competitive, the interest groups in the declining industries tend to be formed to lobby the government to change rules so that their pain is minimized.

Physical technology, in conjunction with institutional set up as reflected in economic and political structures determines the efficiency of a system. The interaction, over time, between institutions and economic and political organizations determines the dynamic efficiency. The societies in which institutional and organizational change in response to changing technological environment is smooth will succeed in improving their standard of living through an improvement in their competitive position.

Technological change is usually directed at reducing costs and improving competitive position of an organization. This may be a reduction in the cost of production or, in case of for example transport and information technology, transaction costs. Since institutions in a society are structured to reduce uncertainty in interactions among individuals and organizations, these also reduce transaction costs. By imposing legal constraints such as property rights and rules for enforcement of contracts the legal structure tries to provide some certainty to the interaction among various parties involved. This function, in some cases can be performed by informal constraints as well. For example, threat of ostracism, if credible, can be an effective deterrent to anti-social behavior. Since institutions, by reducing uncertainty, result in reduced transaction costs, I'm tempted to call these institutions 'social technology'.

The degree of competition among various organizations determines the incentive structure for introducing new technology, physical as well as social. As long as the existing institutional set up allows for expanding opportunities, pressures to change it will be minimal. But if the institutional framework becomes a serious constraint in terms of introduction of new technology, the framework will need to change and, in turn, require changes in economic and political organizations.¹⁹⁾ As

long as the organizational change can be managed within the existing institutional structures, change is expected to be smooth. More often than not, the required changes in institutions and organizational structures are incremental rather than revolutionary. Revolutionary changes are usually rare and far in between.²⁰⁾ Partly, this is due to the existence of complementarities and network externalities which give rise to entrenched interest groups. These interest groups try to perpetuate status quo generating institutional inertia. If the organizational changes require changes in the institutional set up, the process can be quite complicated. In case the change required is in formal institutional constraints (change in legal structures), political processes become quite important. Thus, a theory of political process based on interaction among various interest groups becomes integral to the process of institutional change. Changes in informal institutions are still slower as these require a fundamental change in the perceptions of the society which can be quite a prolonged and stretched out process.

It is this process of changing institutional and organizational structures in response to the needs of the individuals and groups of individuals competing in an environment of scarcity that is an important ingredient of growth and development process. Countries that are able to manage these institutional changes smoothly, and increase the efficiency of the system to introduce fruits of increased knowledge, are more likely to attain higher living standards or economic prosperity. This framework

19) Changes in firm types from family owned to partnerships to joint stock companies may be an example of changes in economic organization. Changes in government, fall or rise of particular factions are examples of changes in political organization.

20) The socialist revolutions are a case in point. One can also include changes in institutional and organizational structures introduced in a society as a result of its defeat in a war. Postwar Japanese reforms can possibly be classified in such 'revolutionary' change.

does not require similarity in institutional and organizational structures across countries to explain their success.

High rates of growth based on high savings, high investment, advanced technology, a well educated work force, export oriented production structure, and so on are, thus, just the manifestations of a successful change in institutional and organizational structures of an economy. In my view what distinguishes the East and South East Asian experience from that of developing countries in other regions is the success of these economies in shaping their institutional and organizational structures in a way that was conducive to the growth of their economies. In order to understand the modernization process in these economies, therefore, it is necessary to look at the processes underlying changing institutional and organizational structures in these economies.

Economic performance over time, in this framework is determined by institutions and institutional change through their impact on efficiency of the system. The strength of the tentative framework presented above is that it completely integrates the economic, political and cultural processes which influence the process of institutional change and hence performance. In the rest of this paper, I have attempted to interpret the Japanese experience of economic development, especially in the postwar period, within this framework.

IV. The Japanese Experience

While my main concern here will be the postwar Japanese economy, a brief overview of the prewar period is not out of place. More so, since in the alternative framework, presented in the previous section, historical path dependency is an important feature. Due to space limitations, the discussion of the prewar period here is very cursory and selective.

1) The Prewar Modernization

The beginnings of the process of 'modernization', as we understand it today, can be traced back at least to Meiji Restoration in 1867. From the viewpoint of institutional framework, however, late Tokugawa period was already showing signs of institutional changes based on the developments throughout this period. Just to point to some glaring examples, one can see the decline of the castle towns and spread of economic activities to surrounding rural areas. This was based on changing institutional structure and opportunities arising from the stringent regulation of the economic activity and its enforcement in the urban as compared to in the rural areas. Again, the working of the agricultural taxation system had increased the power of the rich farmers and they were extending their activities into fields of economic activity denied to them in the institutional set up of early Tokugawa period. Merchants were also moving into agriculture and the putting out system was becoming quite prevalent. All this goes to show that institutional change was already taking place even before the Perry's ships 'opened up' Japan to foreign influences.²¹⁾ The

21) For greater details of these processes, the reader is referred to Smith (1988).

changing competitive position of different groups within the society was already building pressures for changes in political and economic organizational structures in the society.

The opening up of Japan after the Meiji Restoration, suddenly expanded the stock of knowledge and technological horizon available to the Japanese society. But to make use of this new knowledge and technology, institutional structures had to be adapted. Since, as pointed out earlier, institutional change tends to be path dependent, the Meiji period can be considered as the era of experimentation with new institution building to make use of new opportunities. The introduction of new constitution and electoral system, changes in the taxation system, building up of legal structures, putting in place the infrastructure, education and financial systems etc., all were a part of institutional adjustment and change as the horizon of Japanese experience expanded. prime concern in this period was with setting up formal institutional structures suited to the need of new environment. Opening up of Japan came in conjunction with the unequal treaties enforced on it by western industrial countries. The need for adaptation to the new competitive situation was imperative.

A second period of institutional and organizational change began with the advent of World War I, around which time a number of new advancements in science and technology took place. The War itself created a set of opportunities for Japanese industrialization by reducing competition in the Eastern theater. The subsequent rise in profits and production demand, resulted in substantial increase in demand for labor, especially skilled labor. Labor organizations, asking for improved working conditions came up while the shortage of skilled work force induced the employers to call for good industrial relations by

setting up what is known as 'harmony society'. The interesting to note that workers at this time, being in high demand, were not very enthusiastic to the proposals put forth by the employers to lock them into their organizations. Again, while calling for industrial harmony, the pressure groups of employers consistently opposed labor reforms. The increased competition and adversity of the Japanese economy during the 1920s, especially the late 1920s, finally helped in setting up the system of long-term employment, on the job training and seniority based wage systems. The establishment of these systems was a response to the changing environment. It did not have anything to do with the prior cultural predilections based on Confucian values.²²⁾ The changes in the political organization during the interwar period, based on electoral imperatives (competition among different political parties) and prevailing interest group politics also reflect the changes taking place in the technological environment. Rise of the military in the later part of the interwar period can also be, though only to a certain extent, considered within this framework.

2) The Postwar Period

In the postwar period, one can distinguish two types of institutional change. First, was the forced change in the formal institutional structures introduced by the occupation forces in the immediate postwar period. Second, autonomous institutional and organizational changes occurred in response to the technological gap that had opened up between Japan and the more industrialized societies of the West. Both these changes had an important impact on the postwar Japanese

22) Khosla (1995; 1996) provides further details of this argument.

politico-economic structures and its modernization process.

Before we look at the interaction between institutions and the political and economic organizations in the process of rapid modernization in the postwar period, it may be useful to have a brief look at the changes occurring in this era. Having recovered to its prewar levels of economic activity by the end of the Korean war, Japanese economy grew at a tremendous pace. The rate of growth till the early seventies was on the average over 10 per cent per year. With the shift to floating exchange rates and the coming of the oil crisis in the early 1970s, this growth rate slowed down perceptibly to almost half of the previous two decades. This slower rate of growth continued during the 1980s. In the 1990s, with the bursting of the asset price bubble, the Japanese economy has been in a prolonged recession.

During the immediate postwar period, the Japanese economy used fairly wide range of regulatory structures and direct controls were very much in evidence. From mid fifties on, shift to indirect controls was taking place and the process of deregulation continued through the high growth period. Financial market reform began in earnest only in the 1970s and thereafter proceeded gradually through the 1980s. The busting of the asset bubble towards the end of the 1980s exposed various weaknesses in the financial system as well as its regulatory structures. Still, the reform process in this sector has been difficult to carry out. Only in recent years some changes of substance are being pushed though. By year 1000, Japan is looking to a substantial restructuring of its financial sector under its 'Big Bang' Programme. Besides the regulatory structures, the Japanese economy is also believed to have benefited from various informal arrangements. Most important of these are the '*gyuseishid*' or administrative guidance taken

recourse to by the Ministry of International Trade and Industry (MITI) and the *madoguchi* shid or 'window guidance' taken recourse to by the Bank of Japan (BOJ) to guide scarce resources into desired industries. These institutional structure for affecting allocation of resources have formed the basis for the statist (developmental state) argument to indicate the all pervasive role of the state in bringing about Japanese modernization.

Assumption of a competent and capable bureaucracy with a free hand to act in pursuit of 'national objectives' of growth and development is another important ingredient of the state led development school. Lack of corruption in the cadres of bureaucracy, coupled with weak political control due to factional fighting with LDP is seen as the source of bureaucratic success in transforming Japan.²³⁾

From the market point of view, integration of Japan with international markets, reduction over time of barriers to trade and fiercely competitive domestic market are taken as an evidence of market-led development process. In the private sector, various seemingly informal practices are seen to have contributed to the performance of the Japanese economy. The system of human resource management in Japan, characterized by life-time employment system (LTE), seniority based payment and promotion system (SPP), on the job training (OJT), job-rotation and enterprise unions has been much talked about. Also, featuring the literature about Japanese economic success is the role of the so-called 'main-bank' system and the keiretsu with stable long-term cross share holdings. The long-termism of the Japanese firms reflected in its supposedly non-profit maximizing firms along with the paternalistic attitude of the

23) Refer to the literature cited in footnote 8 or in Khosla (1996).

employers is often cited as the informal institutional basis of Japanese success. Cultural explanations attribute these features to Japanese value system. More plausible explanations from the existence and perpetuation of these characteristics until recently have become widely accepted.

I do not intend to get into the details of the debate over the market versus state in this paper. Suffice it to say that while some of the arguments presented by the statist school may have some substance, especially in the early postwar period, others need a careful investigation. Especially effectiveness of the government in affecting resource allocation using informal structures is highly questionable.²⁴⁾ The case of bureaucratic autonomy from vested interests as well as political control is also circumspect.²⁵⁾ In this remaining part of this section, I will try to interpret the salient features of the postwar Japanese economy within the framework developed in the previous section. For this framework to be robust, it should be able to explain not only the developments during the high growth period but also the period of slow growth and the 1990s.

3) Immediate Postwar Period and the Era of High-Speed Growth

Postwar reform in Japan introduced important institutional changes that determined many features of the postwar Japanese politico-economic system. Land reforms were intended to

24) See Khosla (1996) and the literature cited therein for a more detailed discussion of the state versus market argument.

25) Ramseyer and Rosenbluth (1993) makes a persuasive case for the effective political control over bureaucracy.

democratize Japan but proved to be instrumental in creation of a large and influential agricultural lobby. This resulted from coming into existence of a large mass of owner-peasants with small farms. This is reflected in the huge and continued resource transfers to this sector in the postwar period through the political process. It is only in recently that some of this protection is being dismantled. Deconcentration measures, especially those directed at dissolution of the zaibatsu, increased the degree of competition in the Japanese economy. The increased competition induced the firms to improve their competitive position through introduction of new technology, primarily imported from abroad. It is interesting to note there that while the above mentioned reforms were effective, others were rolled back after Japan regained political autonomy after signing of the Peace Treaty. Most notable was the Anti-Trust laws which while staying on the books were overlooked for most of the high-growth era. MITI was able to persuade the Fair Trade Commission (FTC) to exempt certain industries at certain times from the provisions of this law and form recession cartels to adjust production and prices. This happened quite often when particular industries face a situation of excess capacity. Even the zaibatsu dissolution was somewhat diluted by emergence of the so-called financial keiretsu. A possible reason is that these institutional changes were not conducive to improving the competitive position of the Japanese industry at the time. This reflects the resistance to forced institutional change.²⁶⁾ The success of the land reforms and deconcentration measures was partly due to changing perceptions about and weakening position of the affected organizational structures (landlords and the

26) If this agreement is accepted legal reform may not be enforceable in certain societies where support for such reforms is weak. A number of Asian economies have legal systems largely patterned on those of their erstwhile colonial masters but enforcement has always been a problem.

zaibatsu) during the World War II.²⁷⁾

Rapid introduction of new technologies in the 1950s and 1960s was perhaps instrumental in giving rise to a number of political and economic organizational structures along with the development of a specific pattern of the state-private sector interaction in Japan.

In order to maintain competitive position in an environment characterized by rapidly changing technology, the firms needed to respond quickly. Despite the existence of a good general education system and availability of some skilled work force, demand for skills outpaced supply. Building up a skilled work force and retaining it within the firm required a different organizational structure. The situation was similar to that during the 1920s and the experience of introduction of incentive structures in the aftermath of WWI provided a good recent experience to replicate. OJT was used to impart skills and the incentive-disincentive structure of long-term employment and seniority based promotion and payment systems were used to retain this skilled work force. Job rotation, while providing a career path for the employees, also resulted in what has been termed as firm-specific skills binding the workers close to the firm rather than a particular job. This resulted in enterprise level unions since the improvement in the situation of the work force became heavily dependent on the performance of the firm. At the same time, an increase in employees' knowledge of the production process within the firm increased efficiency and competitive position of the firm by eliminating the need for technical personnel for minor production line faults. This complex set of organizational structures resulted in development

27) For a detailed discussion of the process of postwar reforms, see various articles in Teranishi and Kosai (1993).

of internal labor markets, weakening the necessity to introduce more specialized education and training facilities for skill formation.²⁸⁾

While the organizational structures discussed above were primarily designed to meet the economic challenges posed by a rapidly changing technological environment, there were other effects too. Most importantly, as skills became firm-specific, investment in these skills by the workers could not be easily capitalized in the open market. This reduced ability of the workers to move out of the firm and industry within which they operated. Since the prosperity of the firm and industry also implied improvement in their own position, their interests coincided with the firm. Interest representation through enterprise unions within the firm and through industry wide trade associations at the inter-industry level became important. Improved competitive position (in the sense of efficiency as well as claim on resources through political representation) for one's own industry was synonymous with their own competitive position vis-avis their counterparts in other industries. The usual pattern of class (capitalist versus workers) based interest representation, therefore, did not develop to any great extent in Japan.²⁹⁾

For this pattern of interest representation by industries to be useful one needs to look for its political and administrative interfaces. In terms of political organization, though LDP was the governing party throughout most of the postwar period, it was constituted by a number of factions. None of these factions was, any time during this period, strong enough to completely

28) These issues are discussed in somewhat greater detail in Khosla (1995).

29) Discussion on interest representations here and the following paragraphs is greatly influenced by Teranishi (1996).

dominate the others. Political donations have been a long standing tradition in Japanese politics and given the multi-member constituencies till recently, the need for funds was substantial. This funding came from various interest groups establishing an interface with the political process. The factions therefore could be considered as representing specific interest groups. The adjustments in the conflicting interests represented by different factions takes place at the LDP's policy committees. The administrative framework was provided by the industry bureaus within the relevant ministries, each bureau dealing with one specific industry. These bureaus promote the interests of their respective industries within their own ministry and at the inter-ministerial level.³⁰⁾

A positive benefit of such a pattern of inter-industry distributional conflict representation is that it has little, if any, impact on macro policies. The inter-industry distributional conflicts are managed with the help of competition policies that impinge on inter-industry share in the value added and end up as a zero-sum game with no specific budgetary implications. The macro policy can be pursued in an environment free of direct influence of the pressure groups in an economy.³¹⁾ This probably explains the ability of the Japanese government to follow a

30) The system seems to have begun in 1920s in a rudimentary form and developed further during the period of war time controls (Teranishi, 1997). The practice of amakudari or 'descent from heaven' allowing Japanese bureaucrats to take up lucrative position in the industry they have been overseeing may be an added incentive for the bureaucrats to argue the case of the industry under their charge within the government.

31) Teranishi (1996), using the Latin American experience where distributional conflicts took the form of class-conflicts, shows that the direct intervention by the government by way of minimum wages, indexation and subsidies without regard to the type of industry, results in overshooting the budgetary constraints and results in inflationary pressures and uncertainty.

policy of nearly zero deficit and a counter-cyclical monetary policy during the high growth period thereby keeping inflationary pressures in check. The resulting stability proved quite beneficial for investment decisions by the private sector.³²⁾

Another important institutional adaptation in the postwar period was the establishment of deliberation councils with participation by trade associations, academics and government representatives to disseminate information. In an environment of rapid technological progress information regarding future demand-supply balances are imperative for investment decisions. Since the information dissemination structures in the immediate postwar period were poorly developed, the cost of gathering such information by individual firms and even government would be very high. Deliberation councils served to provide a forum for information exchange among firms and industries and helped the private sector in taking informed decisions. The indicative plans for the postwar period were based on the discussions in this deliberation council and therefore likely to have been influenced by the private sector intentions. Since these intentions were known before hand to the government, the fact that private investment followed the government plan cannot be a convincing proof of state-led growth.

The features of the Japanese capital markets can also be fairly well explained within the framework adopted in this paper. In rapidly changing environment and a lack of information dissemination and risk assessment channels, individuals could hardly bear the costs of gathering such information. In addition,

32) This argument looks a little shaky. It may be asked what prevented various bureaus coming together to demand resources beyond budgetary resources. One possible explanation can be the experience of hyper-inflation in the immediate postwar period which was relatively fresh in peoples' memories.

low level of financial assets in the household sector following the rampant inflation of the postwar period implied investor preference for safe instruments. Bank deposits were, therefore, the obvious choice. The banks, on the other hand, had better access to independent information. It therefore was natural that banking sector formed the core of financing of Japanese industry during the high growth period. Even for the banks, it was not possible to obtain all the necessary information and hence signaling an important role in avoiding overexposure of individual banks to particular firms. The main bank system played this role. Knowledge about particular firms' prospects through loan provisions can partly explain the holding of shares in the involved companies. The practice of historical cost based accounting practices, ensured that rising asset prices would increase the hidden value of the firm and hence capital gains on share holdings. Long-term and stable share holding in Japanese firms can partly explained by this divergence between dividend payments, that tended to be low, and the total expected yield including capital gains. The underdevelopment of stock market especially with low individual investor participation may have been another reason. Regulatory segmentation of the capital market in postwar period can also be seen as an attempt to prevent the banking and insurance industries to refrain from undertaking exceptional risks jeopardizing stability of the financial system. Probably it had something to do with political constituency considerations as well. The fact that the large city banks failed to influence the government in their attempt to integrate the whole of the banking industry during the 1960s and 1970s indirectly suggests that regional financial interests were able to prevail.³³⁾ Finally, assuring individual savers who had low level of financial assets that their savings will be safe³⁴⁾

33) See Ramsayer and Rosenbloth (1993) on this point.

34) My ideas on financial system and institutional change are relatively crudely formed

would be another consideration. Regulation in the financial sector also took the form of regulated deposit and lending rates which has generally been taken as an indication of low-interest policy by the government though some debate over this issue is still going on. One of the difficult problems to answer in the context of the financial system is that if deposit rates were regulated and there was a redistribution of surplus from savers to the financial sector was taking place, why did pressure groups opposing such a change did not materialize? Some possible answers could be that since savers tended to be small and widely dispersed and individual loss in surplus would exceed organizational costs. The corporate sector, though hit by compensating balances, would be reluctant to organize such groups since corporate sector was a heavy borrower and lending rates were also being capped. Moreover, various types of tax exemptions on savings were available to the small savers and the net loss of income from low deposit rates may have been canceled out. Politicians, on the other hand seem to be representing primarily guided by the mechanics of pressure group politics and requirements of political donations. The financial sector has always been an important player in this regard.

It is quite clear from the above discussion that postwar rapid industrialization in Japan was based on a complex interaction between the technological environment and institutional response to it. The organizational structures, economic and political, devised to improve organizational competitive position in an environment of rapidly changing technology were devised primarily to reduce uncertainties and transaction costs. Interest group pressures, however, also led to redistribution measures being adopted to advance the cause of some industries.

and further study is necessary.

Agriculture and coal industries are the prime examples of such pressures. As for why it was possible to affect such resource transfers, the rapid growth and concomitant rise in revenues can be cited as facilitators. While the cake was growing, the interest group pressures working through political mechanisms seem to have been able to work together to bring about mutually beneficial outcomes. Without this, the factionalized LDP would have not been able to stay as a single party let alone stay in power.

4) Post High Growth Era

Since the prime concern of this paper is process of rapid modernization, I will delve on the post high growth period very briefly. Still, it is imperative from the viewpoint of the framework presented here to be able to interpret the Japanese experience in this era.

By early 1970s, Japan had covered a substantial amount of technological gap with the West and the rate of technological change also slowed down. At the same time, environmental problems had become serious enough to generate political pressures to curb pollution. Legislation setting environmental standards was brought in forcing the firms to invest in environmental technology reducing the rate of return on investment. Advent of the oil shock (impact on relative competitive position of firms), emergence of structural trade surplus and shift to floating exchange rates brought external pressures on Japan to change its institutional framework. Accumulation of internally generated funds resulted in lowering demand for loanable funds from the banks. All these factors changed the environment within which the individuals and

organizations interacted.

While pressures for change started to mount, the entrenchment of interest groups that had benefitted from the previous institutional regime created resistance to change. Reforms began in the 1970s though the pace was quite slow. The internal dynamic of financial sector was already calling for reforms and external pressures added to this process. As a result, mid 1970s saw the beginning of the financial deregulation. The process speeded up somewhat during the 1980s but it had to wait till mid 1990s to impinge on the players and the government that a fundamental reform was imperative to raise the efficiency of the Japanese financial sector. The Big Bang Reforms, slated to complete in Year 2001 are directed to achieve this objective. The biggest issues stalling the progress of reforms in this sector have been entrenched interest groups. Removing the existing segmentation of functions in the financial markets has been contentious as has been the supervisory reform that would imply a reshuffle of areas of influence in the MOF and BOJ.

In the manufacturing sector also, the slowdown in the pace of technological change and increased competition in the international market has built up pressures for changes in organizational structures. With the mass-production industries gradually declining in competitiveness, high value added manufactures and services are becoming important growth areas. The skill requirements in these industries are different and less prone to the systems of OJT. But with institutional framework for development of such skills absent, in the external market, efficiency of the industry is slow to rise. During the 1970s, these problems were just beginning to appear but have taken serious turn during the 1980s. In 1990s, the much praised Japanese style practices are being seriously undermined.

The reduced possibility to increase the share of resources though efficiency gains, has led increasingly to a bitter struggle to influence distribution through political process. It is becoming increasingly difficult to obtain a mutually beneficial settlement for all the actors in the game. This is reflected in the growing factional strains within the LDP since the 1970s. In late 1980s, these strains finally came to a head and saw the LDP break up and fall from power. New parties were hurriedly launched and in the 1990s, we are witnessing the process of alignment and realignment of interest groups to find a new equilibrium.

Finally, the interests of the consumers are also coming to the fore and this cohort has assumed a greater electoral significance. The deregulation of agricultural markets and the gradual political reform during this period indicates the declining strength of rural lobbies. As new interest groups establish a new institutional framework that once again asserts the primacy of efficiency gains as a means to increased share of resources, one can expect the Japanese economy to regain an even keel. Till then, I has to cope with the uncertainties and turmoil that goes with the periods of fundamental institutional change.

V. Concluding remarks

Due to time and space reasons, I had to curtail the discussion of the Japanese experience to a manageable length. I hope, however, that this brief overview has indicated the importance of integrated approach to political economy in its social context. The framework of institutions and institutional change, in my view, provides a fruitful way ahead.

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