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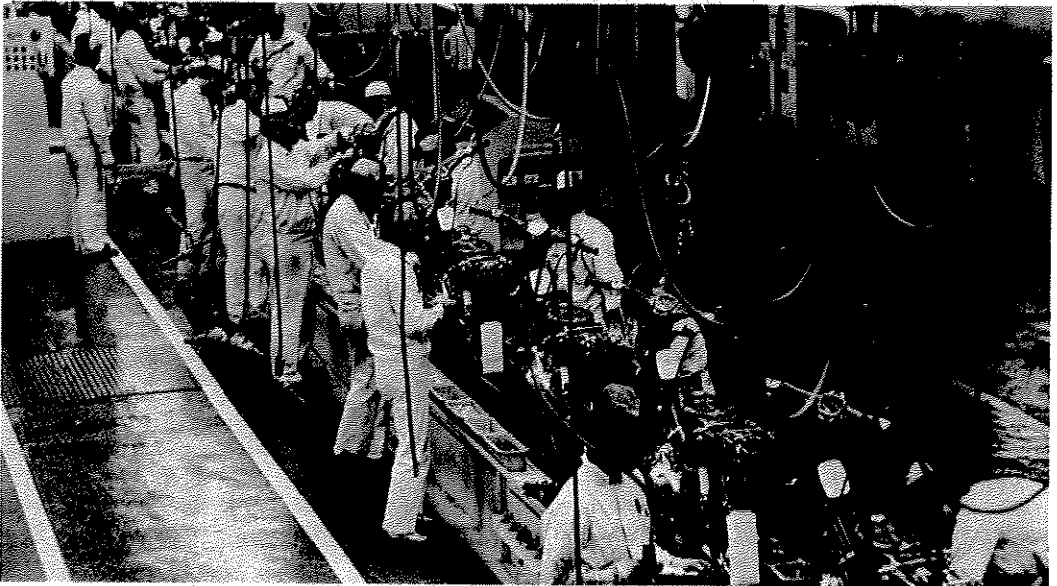
MANHATTAN REPORT

ON ECONOMIC POLICY

MANHATTAN INSTITUTE FOR POLICY RESEARCH

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Industrial Policy, Part I: The Japanese Model



Above: Japanese Assembly Line

Below: American Unemployment Line

Wide World Photos

Industrial Policy, Part I: The Japanese Model

Declining productivity and rising unemployment in many of America's basic manufacturing enterprises are the reasons why a growing number of individuals claim we must embrace an "industrial policy" designed to revitalize industry, reclaim markets lost to foreign competitors, and increase employment.

Originally, when industrial policy first surfaced during the Carter Administration, it was called "reindustrialization," and it meant subsidies to or bailouts of declining or sick industries. But now the emphasis has shifted away from saving old industries where the outlook is bleak, and toward new, "high technology" sectors where the profit and employment future seems bright. For the most part, proponents want measures like targeted tax breaks and investment credits, job retraining and educational programs, and increased federal spending on research and development. But some advocate better "cooperation" between business, unions, and the government; and others want wage and price controls, or even centralized credit allocation, i.e., economic planning.

Industrial policies have an unpromising track record in England and Western Europe, and command-type planning in the communist countries is a disaster. Nevertheless, many insist that industrial policy can work, and that it has worked—particularly in Japan.

Japan after World War II is clearly a great success story. Between 1951 and 1973, its economy grew at an average annual rate of 10 percent in real terms, while Japanese workers' real wages tripled. Since the mid 1960s, Japan has ranked third in total GNP behind the U.S. and the U.S.S.R., but ahead of West Germany and France. Throughout this period, unemployment has been unbelievably low—averaging between 1 and 1.8 percent in the 1960s and early 1970s. Although the growth rate of the economy has slowed in recent years, it is still impressive; and of course, the success of Japanese manufacturers in America and Europe is legendary.

It is also clear that Japan has achieved its success in tandem with a degree of "partnership" between big business and planners in the government's powerful bureaucracies that is quite unusual by Western European or American standards. Japan has pursued an industrial policy, and its economy has grown spectacularly. For that reason it is important that we Americans understand their past experience while we contemplate our own future.

In the upcoming months, the MANHATTAN REPORT will explore the emerging debate on industrial policy in America in light of the lessons we can learn from Japan. In this issue, we interview Dr. Hugh Patrick, Professor of Far Eastern Economics and the Director of Yale University's Economic Growth Center, on the relative importance of planning to Japanese economic growth. Thomas Pepper, Director of Hudson's Corporate Environment Program, and Jimmy Wheeler and Merit Janow, both of the Hudson Institute's Professional Staff, discuss the implications of Japanese industrial policy for America, based on their recently completed report to the Departments of Commerce and State, and the Trade Representative's Office. Finally, we consider the Honda Motor Company's rise to prominence—as George Gilder tells it, in an excerpt from his forthcoming book.

MANHATTAN REPORT ON ECONOMIC POLICY

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The Japanese Economic Miracle: An Interview with Hugh Patrick

Manhattan Report—Is Japan an example of a successfully planned economy?

Hugh Patrick—Japan is not a planned economy in the sense of the Communist bloc nations. Most resources in Japan are allocated through the private sector; and their government is small relative to other advanced industrial nations. The government owns very little of the means of production.

Japan has had five year economic plans, but they were “indicative.” They were essentially projections of what the government thought the growth rate of the economy was going to be. They were used to help the state formulate its macro-economic policies and budget priorities, such as how much the Ministry of Transportation or the Ministry of Construction could likely plan on spending, and so forth. The five year plans did not set specific industry targets, nor were they binding on the allocation of public or private sector resources.

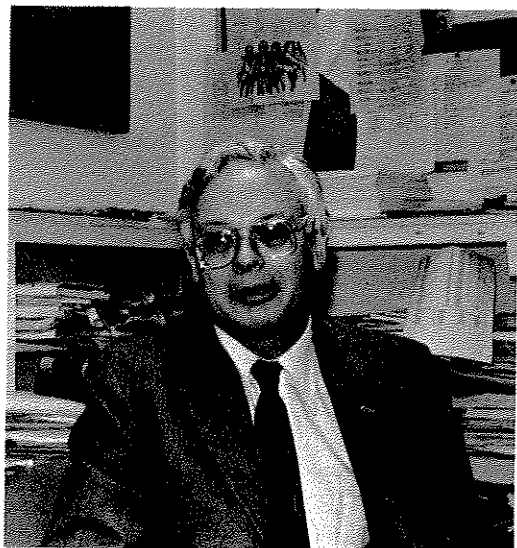
MR—How about the “industrial policy” of the important government bureaucracies, such as the Ministry of International Trade and Industry (MITI)?

Hugh Patrick—The essence of Japanese industrial policy was the selection of industries or groups of industries to receive differentially favorable or unfavorable tax, finance, or technology import treatment, etc., relative to other sectors, giving them a leg up in the market place.

On the broad sectoral level, it is clear that during the fast growth period, roughly from the mid 1950s to the mid 1970s, Japan consciously allocated resources not to housing or consumer credit, but to business; and particularly to certain big businesses. Agriculture, which was a lagging, not a leading, growth sector, also received special help. During this period in the U.S., on the other hand, we allocated resources to aerospace and defense, to agriculture, and to housing—the latter through the favorable tax treatment of mortgage interest payments. So, in this sense, the U.S. also made “industrial policy” decisions, although our priorities were different.

You must keep in mind the profound difference in the position of the American economy versus that of Japan or Germany at the end of the war. Japan was devastated, in desperate straits. They knew that reconstruction of their industrial base had to have priority; reaping the fruits, in terms of more and better housing, would have to come later. Also, having lost the war and their empire, sacrifices could be asked of everybody.

We must also distinguish between the broad support government policy gave to all industry, such as import quotas and tariff protection for manufactured products, and the differential ad-



Hugh Patrick, Yale University

vantages to specific, targeted industries.

MR—Did Japanese manufacturing firms grow through exploiting the domestic market, or were they export oriented from the start?

Hugh Patrick—One of the misunderstandings about Japan is the role of foreign trade. Japanese exports as a share of their GNP are really quite low—12 or 13 percent—compared to the European Common Market countries. Almost every industry that has grown in Japan grew initially in the domestic market. Some of them achieved sufficient strength to compete in world markets, but that came later.

MR—That sounds like the American pattern in the late 19th century and early 20th century.

Hugh Patrick—That’s right. We take for granted the free trade environment in the post World War II era; we forget our own very extensive history of protection for manufacturing enterprise.

To return to Japan in the high growth period, one may say that the planning bureaucracy, such as MITI, aimed mostly to identify and favor industries it perceived as future “winners,” though to some extent it also helped “losers” to “rationalize.” The two losers in the mid 1950s and 1960s were cotton textiles and coal mining. They continued to protect these industries from imports. But oil was allowed to replace coal in many cases; and textile firms were encouraged to scrap some spindles and move into synthetic fibers and other materials.

In other industries where an “excessive” number of firms developed, the government attempted to encourage mergers. The automobile industry is an excellent example. But the remarkable thing was that the government’s policy was a failure. They did not succeed in bringing about

"In the rapid growth era...private sector dynamism was so strong that the government's role was more to restrain demand than to stimulate it."—Hugh Patrick

industrial consolidation nearly to the extent that they hoped to do. And in retrospect, it was probably wise that the industry was allowed to evolve on its own. Certainly the idea that the market was saturated proved, in retrospect, to be in error. There are now some half-dozen major automobile firms in Japan.*

The automobile industry is a very good example of a non-strategic industry that grew *without* differentially beneficial or unique government favors. Like virtually all industries it grew in a protected domestic market because the demand for automobiles grew; and then it began to penetrate international markets.

For that matter, the consumer electronics industry was never selected by the government as a priority industry, either.

MR—But these two industries are the ones we in America virtually identify with the competitive threat posed by "Japan, Inc."

Hugh Patrick—The Japanese government did favors for every industry, and there were many industry-specific tax benefits, accelerated depreciation measures, etc., that existed also. But neither automobiles or consumer electronics got really special deals. And domestically, competition in these industries was strong. A lot of firms could and did enter, and many were shaken out. As a whole, they grew very well outside of MITI's industrial policy.

The steel industry, on the other hand, was one of the favored few. But here too, the industry grew primarily in a domestic setting, although Japanese firms did export maybe a fifth of their output to Southeast Asian countries. It wasn't really until the late 1960s that the steel industry could compete internationally, particularly in America and Europe.

MR—Did industrial policy aim ultimately at creating export industries? Did the government attempt to foster monopolies among their favorites?

Hugh Patrick—No. I think the general strategy of industrial policy was to identify industries regarded as important for the domestic economy and then nourish their growth. But within the context of special measures, and given the import protection umbrella, the government did foster or create a number of firms that could compete with each other to reduce price, improve quality, innovate technologically and so forth. Take petrochemicals, for instance. Instead of allowing one firm to develop multiple plants, MITI would insist that new firms be set up, quite often as subsidiaries of companies in related chemical fields. The aim was to have four or five competitors, rather than just one huge firm.

MR—This seems to be a different pattern than the one pursued by many developing countries enamored of planning, where specially favored import-substitution industries are state monopolies.

Hugh Patrick—Most countries that have pursued import substituting industrialization have been much less successful than Japan. They have been content to stay behind their protected domestic market, but without the vital internal competitiveness that existed in Japan. Another difference has been that when the Japanese industry became reasonably strong in a global context, the special trade protections and government incentives have been removed.

I'd like to add here that we mustn't think Japanese planners picked winners flawlessly. The government tried to develop some industries that failed, or at least did not succeed all that well; and we tend to forget about these. Commercial aircraft and shipping are good examples. The private, commercial banks were not willing to follow government leadership, because they did not see great profit opportunities. Banks were willing to follow the government's strategic industry policy when they saw great prospects. But simply because the government laid its blessing on an industry, or made funds available to it, did not mean that the banks would follow. And they were not required to follow. The credit allocating mechanisms of the Japanese were much freer, looser, and market-oriented than some writers about Japan imply.

Indeed, looking at Japanese industrial development as a whole in the postwar period, I think the predominant source of its success was the entrepreneurial vigor of private enterprises that invested a great deal and took a lot of risks. The main role of the government was to provide an accommodating and supportive environment for the market, rather than providing leadership or direction. Unquestionably, government planning bodies were important in a few industrial sectors, but not in many others, which flourished on their own. That's why I have always felt that, when looking at Japan, the real question is, what made entrepreneurs so willing to invest so much, so willing to take so many risks?

After all, it is not as if the government guaranteed the existence of all firms, or even those in the favored sectors. When an industry is in trouble because of a recession, or because of structural difficulties, they will try and help it over the rough spots. But not everyone will continue as before. They do not guarantee specific firms. If a particular firm makes bad decisions they are willing to let it go down the drain.

MR—Does, or can, Japan pursue industrial policy as it used to?

*See *The Entrepreneur*, p. 12 *infra*.

"The total tax taken out of Japanese personal income is substantially less than in the U.S."

—Hugh Patrick

Hugh Patrick—The situation is quite different than it was ten or twenty years ago. There are many more interest groups in the political process to be satisfied. You cannot ask people for the same types of sacrifices.

Another point is that when Japan was a follower nation catching up, it could look to the U.S. for a model of what its future industrial structure might be. The future is now much more uncertain; it is harder to pick who will be the winners ten or twenty years down the road.

Moreover, Japanese firms in many industries now face competitive threats from the rest of the world, and they must pay attention to the problems of adjustments even more so than in the past.

In some textiles, for instance, Japan is facing stiff competition from the developing world. And in any energy-intensive industry, such as petrochemicals, pulp and paper, aluminum, etc., the future is not bright at all.

Finally, Japan is no longer the protected market it once was. The domestic market is open to imports, which implies relatively less ability on the part of government to channel investment through trade policy, or, as in the days of adverse trade balances, through control of foreign exchange.

MR—On the other hand, the government, in tandem with business, some argue, is gearing up for a major assault in the high technology areas, like computers.

Hugh Patrick—The government clearly encourages research and development (R&D) through tax policies and other measures, though much less through direct government spending than in America. The lion's share of our R&D is defense related, and they don't have that. A far greater proportion of their R&D goes to commercial purposes.

On this computer business, I would be a little wary. The government may end up spending a great deal, and it may be to ultimate good effect for Japanese industry. But even if this happens, one will be unable to conclude that the government had been the indispensable, vital factor. After all, the amount that the private sector spends on its own is not unrelated to what the government spends. Just because the government spent it would not mean if they didn't, the private sector would not have.

What we can learn from the Japanese is the importance of thinking through long-run strategy about how a society and an economy should develop; and the importance of fostering a set of institutions and policies within which entrepreneurs can operate, investors can invest, and, in general, the economy can grow. With growth, problems of unemployment do not loom so menacingly, and paying for the problems of growth is much easier.

I think that is the essence of what might be called supply-side economics, Japanese style: to provide greater inducements for savings and investment, research and development, and technological innovation; and to keep government macroeconomic activity within reasonable grounds accordingly. We seem to be groping for some American equivalent.

The Japanese are, however, very pragmatic about economic policy and do not believe very much in the invisible hand. That's why there is much greater tolerance for positive intervention and leadership, although the government does not try to command too many resources for its own use, or crowd out private investment, as it were. The Japanese, for instance, distrust so-called "excessive" competition, and tend to be quicker generally than Americans to seize upon "market failure" as a reason for government intervention.

MR—Quicker than Americans? That's hard to believe.

Hugh Patrick—On the other hand, their understanding that the world is the relevant market, and not Japan, is a big practical difference in their attitude toward antitrust and giant enterprise.

MR—Would you attribute low levels of government spending on social programs, or defense—or budget balancing—as a positive growth factor?

Hugh Patrick—In the rapid growth era until the early 1970s, private sector dynamism was so strong that the government's role was more to restrain demand than to stimulate it. It opted for small government—little on defense (for other, very sensible reasons) and social welfare—and a balanced budget. It was a classic case of relatively tight budgets and relatively easy money.

The story has been very different since the first oil shock. Private saving continued at a very high rate while business investment slowed. Once the inflationary surge of 1973-74 was brought under control the government engaged in a very stimulative fiscal policy, with budget deficits much greater than those in the United States. At the same time it tackled problems not handled in the high growth era, notably social welfare, pollution control, and housing.

It is not widely known that since 1970 there has been a substantial increase in government spending in social welfare areas: its share of GNP doubled, rather quietly, from about 5 percent to about 10 percent. Since the U.S. share is around 12 percent, the Japanese are now approaching our level.

They have had national health care programs for a long time, and there are of course arguments

(Continued on back cover)

The Changing Face of Japanese Industrial Policy: A Report from the Hudson Institute

Manhattan Report—Certain businessmen complain that the close cooperation between business and government—"Japan, Inc."—gives Japanese firms unfair competitive advantages. And some liberal intellectuals attribute Japanese superior economic performance to the close guidance of business by the government planning bureaucracy, exemplified by the powerful Ministry of International Trade and Industry (MITI), which directs investment capital in the economy towards industries it decides are most in need of it.

Do you think we should model our industrial policy on Japan?

Thomas Pepper—Japanese planning to date has usually been identified as one of the most successful examples of "indicative planning" in the world, the other example being France. To the degree planning has succeeded in Japan, however, it has done so because of some very particular circumstances; because these circumstances have been, and are, changing, the importance of planning has been declining.

Japan at the end of World War II was in ruins. Now the Japanese market economy is much bigger and more complicated. Planning its direction from the center is far less feasible. You used a phrase that might be good to discuss here—the famous, or infamous, "Japan, Inc." We would argue that this "company" is "going out of business;" and it has been going out of business as a result of its own success. In other words, to continue the metaphor, it can't keep the market it once had because its products have become obsolete.

Jimmy Wheeler—Even in its heyday, it is not at all clear that the government directed the economy into areas that otherwise might not have developed. Actually, the process was more one of businesses and government agencies working to try and achieve certain basically agreed upon goals, initially survival and recovery from wartime devastation, and then to catch up to the West by high economic growth.

Thomas Pepper—It was virtually self-evident that the steel mills should be reconstructed, though you still might want to give some credit here to the company executives who, instead of reconstructing the mills as they were before, went beyond what might otherwise have been self-evident and bought the latest technological processes, with the encouragement of the government planners, of course. But the process was less one of the government's guidance to contrary-minded businessmen than one of mutual consultation.

Similarly, there was no serious disagreement that the priority industries were steel, heavy manufacturing, and chemicals; no one thought the future lay in Christmas tree lights, toys and

plastic flowers, and other light manufacturing export industries. The Japanese moved as rapidly as they could to develop first a domestic market and later an export market for steel, and then for electronic products, starting with transistor radios. Then they developed black and white television sets, color television sets, and now the VCRs. They keep trying to move step by step.

MR—When you think of a bureaucracy making decisions that have large implications for the allocation of credit, you wonder about winners and losers. More for A means less for B, and so on. Was there so strong a social consensus that no conflicts between A, B, C, etc. arose?

Jimmy Wheeler—There is absolutely no question but that political favoritism and back-scratching occurred, particularly in a country where there may have only been two or three large firms with the capability of going into chemicals, or whatever.

There were certainly conflicting interests among the various actors in this government and business decisionmaking process, but these took place behind the scenes, as it were. Once the plans emerged, they were "consensual."

MR—So you're saying that dominant firms within the industries in the high growth era did not typically use the bureaucracy to get extra special benefits, to beat up on their competitors?

Jimmy Wheeler—We must always remember that Japanese capitalism has been and remains a highly competitive, market system. Certain preferential benefits were given to various industrial sectors or industries, and occasionally even to specific firms or groups of firms; but within these targeted sectors, or industries, the various firms competed against each other for capital and customers, quite vigorously. Japanese incentive programs have typically been set up to avoid supporting the weak. For example, preferential loans were available to the chemical industry through the Japan Development Bank, but the total was limited. Evaluation procedures were set up such that the best firms or projects got the bank loans; those which couldn't demonstrate good commercial prospects didn't.

Merit Janow—Remember too that in the early 1950s, the Korean War was a great boon to Japanese economic development. More important, however, was the fact that the pie was getting larger; people were not so preoccupied with the size of his neighbor's slice.

But I would add one caveat to Mr. Wheeler's comment about the competitiveness of the Japanese economy: the priority given to basic manufacturing was itself the reason why overcapacity developed. This problem is now haunting Japan. Thus, although the planning mechanism can be

"We must always remember that Japanese capitalism has been and remains a highly competitive, market system."

—Jimmy Wheeler

credited with aiding industrial development, it must also share some responsibility for other problems that have developed.

Thomas Pepper—We could spend days discussing the amount of favoritism and sweetheart deals that occurred. Two prominent political figures—former Prime Ministers Messrs. Sato and Fukuda—were both implicated in scandals in the late 1940s and early 1950s, while they were serving in the government. They were never prosecuted and went on to become Prime Ministers, in spite of the so-called "black mist" that surrounded their careers. Given the critical importance of growth, these peccadilloes just didn't seem to have priority in the system as it operated at that time.

MR—What happened in Japan after the Second World War sounds to me vaguely similar to the "Great Barbecue" after the American Civil War that Mark Twain wrote about.

Jimmy Wheeler—More than vaguely similar.

MR—So Japan, Inc., paid dividends in more than one sense. How have things changed?

Merit Janow—We have found through our research that in almost all areas, direct government intervention in the economy has declined in a relative sense over time—be it window guidance by the Bank of Japan, financial intermediation, allocation of loans by institutions like the Japan Development Bank to priority industries, infant industry protection policies, or special tax policies biased toward investment in particular sectors. These policies still exist, but their focus has changed, and in some areas the activity has declined absolutely as well as relatively. A reason for this is that in addition to the goal of economic growth, there are now new competing political interests and priorities—such as environmental control measures, social welfare programs, the desire for increased leisure time, and the like.

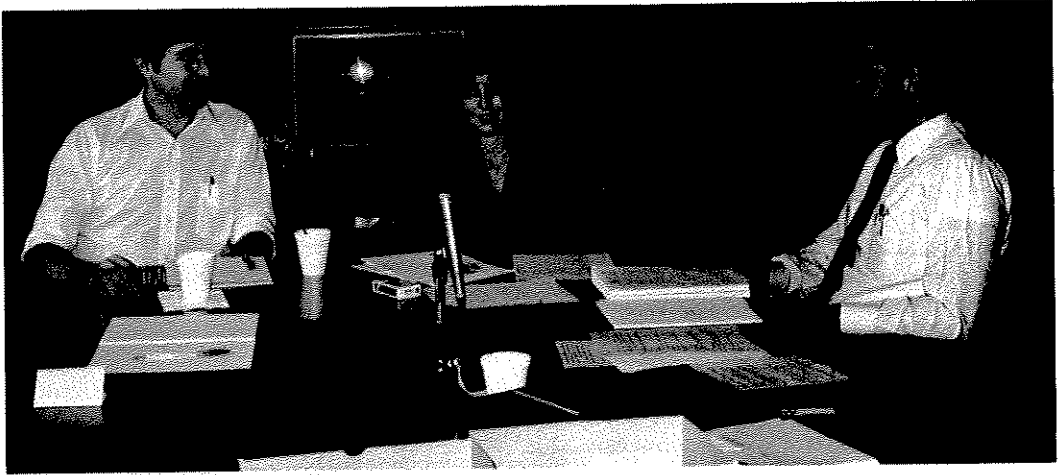
Thomas Pepper—In any case, Japan, Inc., is decentralizing, and probably will continue to decentralize, from the standpoint of the government-business partnership, and even from the standpoint of business organization itself.

Comparison of Japanese and United States Economic Performance

	JAPAN	U.S.
<i>GNP (billions of current dollars)</i>		
1952	16	348.2
1980	1,040	2,626
<i>GNP per capita (current dollars)</i>		
1952	188	2,217
1980	8,902	11,566
<i>Gov't Current Expenditure as % GNP</i>		
1952	10.9	20.1
1979	24.2	31.5
<i>Ratio of Savings to Disposable Personal Income</i>		
1970	18.2	8.0
1980	19.4	5.6
<i>All Motor Vehicle Output</i>		
1952	101,259	5,561,796
1980	11,042,884	8,009,841
<i>Raw Steel Output, Millions of Tons</i>		
1952	7.7	93.2
1980	122.8	111.8

SOURCES:

OECD, *Main Economic Indicators*; *Statistical Abstract of the U.S.*, 1981; American Iron and Steel Institute, *Annual Statistical Report*; Motor Vehicle Manufacturers Association, Detroit, Michigan.



Jimmy Wheeler, Merit Janow, Thomas Pepper

Jimmy Wheeler—The other important thing to keep in mind about Japanese industry has been the absolute need to export. Japan was always short of foreign exchange, right up until the mid and late 1960s. Adverse foreign balances actually kept Japan from growing any faster than it did. Japan had to export, and to do so its firms had to be internationally competitive.

Oligopoly has been the accepted, in fact the preferred, model for Japanese industry throughout the century. They really don't have our hang-up about atomistic, "perfect competition." But their big firms are vigorous, even intense competitors.

MR—Does Japan have an antitrust policy like America?

Thomas Pepper—There is an antitrust regulatory agency, modeled after the American Federal Trade Commission. In Japan it's called the Fair Trade Commission (FTC). It was set up during the Occupation period, specifically because the American authorities thought there was not enough competition in the economy. Yet the Japanese FTC is not as broadly accepted or established as its American counterpart.

MR—Would you see a case in Japan like the American government's prosecution—or some would argue, persecution—of IBM?

Thomas Pepper—That hasn't happened in Japan; it's against their traditional way of doing things. Incidentally, I feel that American antitrust policy may be becoming more realistic, and one factor may be the Japanese challenge. There is greater understanding now that, as Professor J. Fred Weston of UCLA has argued, it is the world market that should be the standard against which you measure market share. As long as you have free trade, that's a form of antitrust.

Merit Janow—The two most visible cases involv-

ing the FTC were the merger of Yawata and Fuji Steel in 1969, which eventually produced Shin Nippon Steel, or the New Japan Steel Company, the largest steel company in the world; and allegations of price fixing after the first oil shock. In the first case, the merger was contested initially by the FTC, and they introduced certain caveats such as the divestiture of certain facilities. After some wrangling the merger went through, with some minor, undramatic changes.

The second, more spectacular case brought by the FTC charged the Petroleum Association in Japan with price fixing during the 1974 oil shock. This was the first criminal proceeding brought against Japanese companies, and the FTC actually won the case. Some regard this as heralding a permanent rise of FTC influence. I would disagree. Rather, it is part of a gradual trend, not a dramatic increase in influence.

MR—Japanese businessmen, you seem to be saying, do not worry so much about "clearing" their mergers with some government agency as do American businessmen with the Justice Department.

Jimmy Wheeler—Such clearance is low on their list of concerns. But mergers don't take place in Japan the same way they do here. Japanese mergers usually occur only in cases of near bankruptcy, where the takeover of one company by another is really necessary to preserve the assets and jobs of the weaker partner.

Moreover, the role of equity in Japanese firms is different from its role in American business. A far greater percentage of the typical postwar Japanese manufacturing concern's capital requirements—up to 70 or even 80 percent—are met by bank loans rather than by stock. Some have argued that this permits Japanese managers to plan strategy for a longer run than in America,

“...American antitrust policy may be becoming more realistic, and one factor may be the Japanese challenge.”—Thomas Pepper

where Wall Street demands results, now. At any rate, Japanese companies do issue stock, but much of it is held by the banks who are the company's major creditor, or other group firms.

Thomas Pepper—The role of the individual stockholder in Japan is much lower in importance than in America. Just in case a stockholder didn't realize this and he were to attend an annual meeting and ask an embarrassing question—like the American corporate gadfly Lewis Gilbert—there would be a large and physically robust person to throw him out of the meeting!

Jimmy Wheeler—Incidentally, if you look at the way Japanese companies are capitalized, you begin to get an inkling of how powerful government policies can be, even if the absolute size of subsidies, tax breaks, financial packages, etc., are not. Japanese use policy as a “force multiplier,” to use military jargon, to leverage a lot of private finance. For instance, the commercial banks provided far greater loans to enterprises than would be tolerated in this country; and the banks in turn relied heavily on borrowed reserves from the Bank of Japan. This of course gave the central bank considerable leverage on the companies, indirectly through the commercial banks. So decisions about which industries were to be favored by the various government ministries and the central bank had enormous repercussions. When the Bank of Japan, the Ministry of Finance, or MITI spoke, people listened! This control has declined substantially but remains important, especially for high technology and declining industries.

Thomas Pepper—The traditional pattern of oligopoly may even be changing in their frontier, high technology industries.

The frontier is by definition an area where no one is an established expert, and where government planners don't and can't know more than private sector entities. Take the case of the so-called fifth generation computer project, which the government is directing. Many in America are worried that “Japan, Inc.” is going to blast us out of the water, and that we need to reply in kind. But there is another way of looking at this, and that is to see this project as a last desperate attempt by the government to try and keep some kind of centralized role in a rapidly changing and decentralizing industry. The companies may not be so keen now to cooperate with each other.

Merit Janow—What Mr. Pepper is getting at is that some of the specific instruments or mechanisms used by the Japanese government to promote growth in frontier industries are becoming unnecessary or unacceptable to domestic firms as well as foreign governments. Growth is occurring without any government assistance, and attempts to direct it by the government are in some cases



Made in Japan

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inappropriate, as well as contrary to the spirit if not the letter of international trade agreements.

Thomas Pepper—Another problem is that the Japanese government has been running large budget deficits for about seven or eight years. There is a lot of backed-up debt, and relatively speaking, the government cannot afford to put the amount of capital into industrial development as it did in the past. And in fact, it has recently tended to put its money into social infrastructure.

MR—It sounds as if Japan, as it becomes more developed and affluent, faces problems similar to America.

Thomas Pepper—Quite similar.

MR—Yet we look to Japan for guidance about how to get out of our pickle.

Thomas Pepper—On the basis of our research, we do not recommend the Japanese planning model for United States' industrial policy. America has a higher per capita income, a higher percentage of Gross Domestic Product in the service sector, a lower percentage in agriculture, and is in some sense still ahead of Japan in the broad structural meaning of the term economic development. As Japan approaches us in these indices, the old methods of planning in Japan no longer work as well. To adopt instruments that the Japanese are discarding seems to us illogical. There are some specific institutions or practices we might want to consider or adopt, but not the whole system—lock, stock, and barrel.

We make a distinction in our study between a planning function and a policy coordinating func-

tion. It is doubtless correct to say that American economic policy has not been well coordinated. So it may be worth considering something comparable to the National Security Council for the economy—a small White House group with a staff of about fifty people, who would be responsible for preparing material to be discussed at White House economic policy meetings in roughly the same way the National Security Council has been more or less successful in helping coordinate defense policy.

Merit Janow—One of the central unresolved issues that's facing this country is the degree to which manufacturing industries are necessary for economic and national security reasons. This is not something that the U.S. government can "solve" but it is an issue that must be addressed. An Economic Council could therefore address such domestic, macro, micro, as well as international economic issues.

MR—Suppose this Council concluded there was no long term future for the American steel industry, or the automobile industry, or any industry X whose workforce was organized into one of the national unions; and that the best government policy was "benign neglect." I wonder about the future of the Council. For that matter, I wonder if all the subtle and not-too-subtle influences that the various factions may bring to bear upon the political process may not influence this Council's deliberations in the first place.

Thomas Pepper—You've raised a central issue. Some people believe that even a group serving in a merely advisory capacity would itself be too prone to lobbying. Herman Kahn, the Research Director of Hudson Institute, argues that it is best not to have such a lightning rod that would attract special interest groups. It's only in special circumstances, like Japan during the reconstruction era, where a policy of phasing out industries at government direction can work.

Jimmy Wheeler—Nevertheless, there are uses for coordination. In the late 1960s and early 1970s, there was an explosion of interest in Japan about environmental protection. There were disastrous problems which threatened public health. They implemented very stringent environmental control standards, much more stringent than in the U.S. But at the same time, they also adopted policies to mitigate the costs, and the effects, on Japanese competitiveness and economic growth. There were special accelerated depreciation measures for acquiring particular kinds of pollution control devices or other other devices designed to achieve environmental goals. There were special kinds of low-interest rate loans given by existing government financial institutions to support these goals. There was a coordinated

policy.

Moreover, most special measures targeted to achieve narrow goals have been designed as "sunset" laws; they didn't all become a permanent kind of life-support or subsidy system for the industry, such as one sees so often in Western Europe.

Merit Janow—There is another difference between Japan and the United States with regard to declining industries. When an industry is in serious structural trouble in Japan, they don't worry as much whether the source of the trouble is domestic or international competition. In the U.S., however, a great deal of attention is directed toward determining whether imports are to blame.

In order to be eligible for government assistance, in Japan, an industry must demonstrate severe overcapacity—more than one-half of the firms must be in dire financial condition and so on. The "source" of competitive decline, whether it is due to domestic or international forces, is less important. The system works well because government assistance is explicitly linked to mandatory industry adjustment, including capacity reductions, reallocation of labor, and so on. They don't just pour money down the drain to keep non-competitive facilities alive.

MR—Why don't they let the market accomplish the same mandatory reduction program—through bankruptcy?

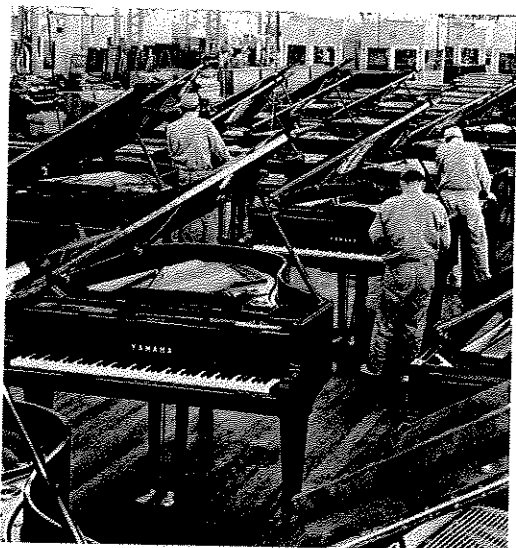
Jimmy Wheeler—That's the preferred way, of course. But the question is, given the political realities, how to best get structural adjustment where change will affect a lot of jobs, or is concentrated in a certain geographic area.

Thomas Pepper—Interestingly enough, there is impressionistic evidence that suggests we have more geographic mobility in America than people used to believe, such as the movement of people from Michigan to Texas. Out of necessity, people do move; and though some have had bitter experiences, others have found life in the sunbelt not such a bad alternative to the snows of Lansing.

MR—What about labor mobility in Japan? What are the outstanding differences?

Thomas Pepper—What jumps to mind is the so-called lifetime employment system, where Japanese employees receive a moral pledge that they will not be laid off. But some key details of this system are often overlooked. Only a certain part of the labor force has lifetime employment. And secondly, job security is not a free lunch. For example, instead of being laid off, Japanese workers must be flexible, and are often shifted around within either a company or a large group of companies to jobs they may not like at all. Also, these

"On the basis of our research, we do not recommend the Japanese planning model for United States' industrial policy."—Thomas Pepper



Consulate General of Japan, N.Y.

Piano Manufacturing

workers are morally obliged to stay with the company they started with. There is far less inter-company mobility in Japan than in America.

It's often been said that this permanent employment thing is a great advantage to Japan, especially with regard to automation. The employee isn't so worried about losing his job; he knows the company will find him another one. But as the Japanese economy becomes more developed, people do begin to feel they have a proprietary interest in certain kinds of jobs, and may not want to move to another one. And remember, they can't jump ship and move to another company as easily. So now you're beginning to see a kind of breakdown of the old system. And then, of course, there is the problem of the people who are not covered by the lifetime employment system.

Jimmy Wheeler—Which is considerably more than 50 percent of the workforce. Actually, only about 30 percent of the workforce is under the lifetime employment system.

Thomas Pepper—Many who are not are employed by the subcontracting, or *kanban*, system, where there is little job security indeed. In the automobile industry, for instance, Toyota keeps inventory costs way down. It snaps its fingers and auto parts appear. And when Toyota doesn't want such parts, they don't appear. That's great for Toyota. But for the auto parts producers and their employees, life doesn't look so great. These small companies are under constant pressure just to survive.

MR—One reads that Japanese employees are paid by a bonus system. They're paid lump sums at certain times of the year that amount to a con-

siderable percentage of their total compensation; but the bonus may evaporate, depending upon the firm's prosperity. That sounds to me like a disguised profit-sharing system.

Thomas Pepper—You could also call it a loss-sharing system.

MR—But there is certainly something to be said in favor of wage flexibility, like it used to occur in the so-called bad old days in American industry. After all, you keep your job.

Jimmy Wheeler—It's like putting people on commission with a base salary. That kind of profit-sharing system reduces the fixed cost element of a relatively fixed labor supply. It also has other side benefits, namely the tendency to increase the savings rate of the country substantially. This is useful for capital formation.

MR—What about the Japanese union movement?

Merit Janow—There are several large federations, but they don't have a union movement like our own. Many of their organizations are company or "enterprise" unions. These are not industry-wide, and they have a vested interest in the profitability and success of their companies.

MR—Do the politically oriented federations have the kind of clout the AFL-CIO does here?

Thomas Pepper—No.

MR—In summary then, the argument we often hear in the West—that as society becomes more complicated, less freedom and more social planning is necessary—does not seem to be a necessary inference from the Japanese experience?

Thomas Pepper—Correct. Japan is one of the great economic success stories in world history. And in the immediate postwar era, given the desperate straits of the economy, government planning mechanisms played an important, if not fully measurable, role in reconstruction, and then in fostering high growth. But the decisions that had to be made then were not all that complicated.

We don't want to leave anyone with the impression that the Japanese Ministry of International Trade and Industry is a paper tiger, or that it and other planning bodies no longer have any influence. But relatively speaking, there will be, in our view, a continuing decline in the effectiveness of the direct and specific instruments available to the Japanese government to promote growth. The trade-offs are more difficult, more divisive, and indeed less easy to reconcile with trade liberalization policies. Moreover, centralized planning decisions appear to be less easily made when the frontier, pioneering industries are in question. Decentralization and flexibility appears to be the route that is being taken. And insofar as American industrial policy is concerned, that may be the major lesson. □

The Entrepreneur

by George Gilder
Program Director
Manhattan Institute

"Japan," George Gilder writes in the excerpt of this book, which will be published next year by Simon & Schuster, "offers a challenge to much of the conventional wisdom of the world's intelligentsia, both right and left, about how economies grow." Given the kinds of economic planning and intervention discussed earlier in this issue of the Manhattan Report, clearly it "will not do, for conservatives to present Japan as an example of laissez faire or even economic liberalism." "Yet the voices of the left," enamored of state direction, "will have equal trouble in claiming for their side an economy which boasts the lowest taxes, welfare benefits, and share of government spending in the industrialized world, as well as some of the weakest unions, most rigid sex roles, and most repressive social disciplines of any modern society."

But most of all, it will not do to forget the entrepreneurs, men like Konosuke Matsushita of Panasonic or Masaru Ibuka and Akio Morita of Sony. Or " 'Mr Thunder' himself, a rakish lad, who dropped out of school to race automobiles (he nearly died in a racing crash). He is Soichiro Honda, running a motor repair shop in Hamamatsu, dousing impertinent tax men with a fire hose, and driving a car full of Geishas off a bridge (all survived)!"

Honda, in fact, was to become the world's single most brilliant and successful entrepreneur of mechanical engineering since Henry Ford. But [after the war,] his car immobilized by the fuel shortage, [Honda] was having trouble getting food for his family. He decided to solve this problem by the novel device of attaching a motor to a bicycle. His neighbors were impressed enough to get Honda to make more. Using a small gasoline engine used for electrical generators during the war, he contrived a makeshift motorbike and sold scores from his little repair shop until the surplus motors ran out. Then he decided to build motors himself.

His problem was government controls on gasoline and restrictions on the manufacture of gasoline-using machines. In overcoming them, Honda displayed the same defiance of difficulty that he earlier showed in circumventing cement rations by making cement himself and would later demonstrate in surmounting government regulations on automobile pollution. Honda built a motor that ran on *pine resin*, which he recalled had been used as a substitute for aircraft fuel toward the end of the war. "We squeezed the resin from the pine root," Honda says, "then mixed it with gasoline bought on the black market. The mixture gave off such a stench of turpentine that I could insist that we were violating no gasoline controls by operating the motorbikes."

With the income from his ramshackle but popular contraptions, Honda then set out to design and manufacture a real motorcycle—Mr. Thunder's "dream of speed"—as a means of locomotion for Japan as it overcame its postwar shortages and began again to think of moving fast and free.

[Honda] came to understand that a commercial breakthrough would come not to the company with roaring machines which could captivate the swashbuckling spirit of youths who wished to overtake cars through the Hakone Pass, but to the company which could lure millions of ordinary Japanese off their bicycles. Within a year after the launch of the Dream, Honda became that com-

pany, by creating a small, cheap, and efficient "cub" engine which either ran on Honda's red and white frame or clipped conveniently on to a bicycle. It was this relatively quiet machine, contrary to his own rambunctious inclinations, which brought Honda the roaring success he sought. It sold massively through Fujisawa's network of bicycle shops and Honda was awarded an Emperor's blue ribbon in 1952 for his contributions to Japanese industry.

The "super cub" turned out to be one of those breakthrough products which transforms and consolidates an industry. Before the super cub there were fifty motorcycle companies in Japan purveying a variety of equipment, ranging from new versions of Italian scooters to huge swashbuckling Harleys. From toys to symbolic war wreckers, the motorcycle field appeared to be a hopelessly fragmented and thoroughly mature market, full of special niches, to be served by small companies with possibly high margins, but without much promise for long-term growth. Motorbikes seemed to be an "inferior" good, like potatoes, on which people tend to spend less as they grow richer—precisely the kind of product which MITI wished to discourage in Japanese industry.

The super cub changed all that. Honda produced a step-through bike which combined the power and excitement of big machines with the convenience and efficiency of the scooters, built it in his modern integrated factory, advertised it to a mass market ("You meet the nicest people on a Honda"), [and] priced it well below the competition. By the time the dust had settled ten years later, the fifty Japanese motorcycle companies had dwindled to four and Honda dominated the world market for motorbikes.

Honda's achievement in the auto industry offers a cautionary tale to theorists who try to use the experience curve as a rigid predictive tool. In retrospect, everything that happens is self-evidently possible. But any expert looking at the world auto scene in 1966 would have called it perhaps the least accessible of major world industries. The last

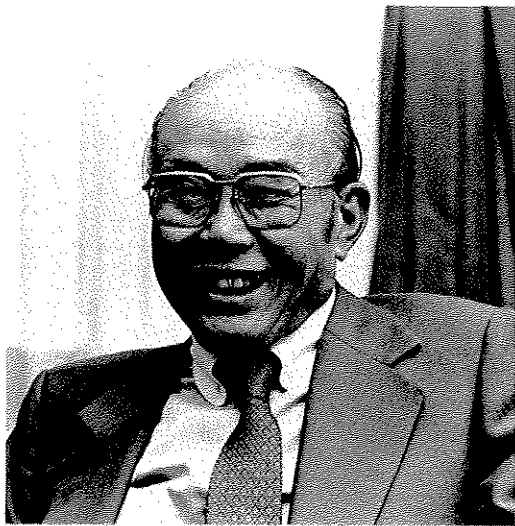
"The creation of new auto companies picked up as MITI's protections and subsidies were removed."

—George Gilder

U.S. entrant was the ill-fated Kaiser-Fraser of 1946. A new company might launch some specialty vehicle for some forgotten niche of a connoisseurial market (though many of the existing specialty car producers were in dire straits). But, for all practical purposes, it would have seemed impossible that a company which had yet fully to enter the business in the late 1960s would be moving toward world dominance in 1983.

Such a pessimistic view certainly prevailed at Japan's Ministry of International Trade and Industry. In the 1960s, as Japan began opening its economy tentatively to the world under the prompting of the Organization of Economic Cooperation and Development (OECD), the International Monetary Fund (IMF), and the General Agreement on Tariffs and Trade (GATT), MITI worried that its frail industries would be swamped by huge American cartels. MITI officials returned from Europe with terrifying tales of "the American Challenge" as limned in Gothic strokes by Jean Jacques Servan-Schreiber. In particular, so they feared, Japan's imitative and fragmented auto industry—long protected from foreign competition by MITI's own policies—would tumble helplessly before the juggernaut of General Motors, Ford, and Chrysler. MITI proposed that Japan's ten auto firms be combined into two, namely Nissan and Toyota, and that new firms be prohibited from producing four wheeled vehicles. In the summer of 1960, MITI sponsored legislation in the Diet to achieve this goal. By some accounts, it was only the riots by Communist-led students and workers, on a rampage against President Eisenhower's proposed visit, that prevented quick passage of the bill. With Tokyo paralyzed and the Kishi government tottering, hearings on the proposal were postponed and opponents gained time to mobilize against it.

Nonetheless, even though legislative progress was halted, MITI continued its efforts to consolidate the Japanese automobile industry and keep out foreign cars and capital. Nissan was persuaded to absorb Prince, once a major Japanese company. Mitsubishi Heavy Industries, a ship builder not then in the auto industry but Japan's second largest company behind Nippon Steel, was being nudged toward merger with Isuzu. Some MITI leaders, who had opposed auto investments in the 1950s because it implied massive imports of iron and oil, Japan's scarcest resources, renewed their appeals for disinvestment in the 1960s. Their earlier objections had failed in part because of Korean War demand for jeeps and other military vehicles. In the early 1960s, they returned to the fray with the kind of eco-esthetic and strategic case that Emma Rothschild later popularized in the U.S. in her book *The Decline of the Auto Industrial Age*. Not only were cars



Soichiro Honda

Courtesy of Honda Motor Co.

wasteful and polluting, but they represented a mature "sunset" industry inevitably to be dominated by established foreign companies.

Japan's entrepreneurs, however, refused to see it that way. The creation of new auto companies actually picked up as MITI's protections and subsidies were removed. By the mid 1960s, Suzuki, one of Honda's chief motorcycle competitors, already had entered the fray with a mini-car, and Toyo Kogyo, a machine tool firm, was contemplating introduction of a Mazda with a Wankel rotary engine. Then in May 1969, Mitsubishi Heavy Industries, the spearhead of the giant Mitsubishi *keiretsu* which had been attempting to absorb Honda, finally demolished once and for all the MITI plan. In an act which the MITI Heavy Industries chief described as hitting him like a pail of water poured into his ear while he was sleeping, Mitsubishi announced an agreement not with Isuzu or Honda, but with Chrysler, a dread foreign leviathan, to form an entirely new auto company in Japan. By the end of the year, the "Colt Gallant Hardtop," soon to become the "Dodge Colt" in the U.S., began streaming off Mitsubishi's assembly lines, and a year later the firm had leapt into third place in Japan's auto industry. Shortly thereafter, General Motors bought 34 percent of Isuzu and Ford invested in Toyo Kogyo. Meanwhile, European governments nationalized—or otherwise reinforced with the financial clout of their national treasuries—a further array of automobile behemoths, including France's Renault, British Leyland, Germany's Volkswagen (40 percent owned by a provincial government), Sweden's Volvo and Italy's massive Fiat. Such was the line-up of Honda's worldwide competition by the early 1970s.

But Soichiro Honda had a plan. Although his

competition was little aware of it, the plan had begun several years before. It involved none of the approaches followed by his rivals. It entailed no mergers, no government finance, no huge bond issues, or even large borrowings from banks. In a stunning display of strategic degrees of freedom, he announced his entry in auto racing. He would build a racing car which would win at Le Mans. To fulfill this goal, he set up a separate Research and Development Company at Honda, free of all the distractions of short term projects, free, as Honda himself would stress, to set improbable goals and to fail. Honda saw that the route to the top of the automobile industry—like all his own previous success—was through freedom and failure.

On the surface, its success seemed utterly unlikely. Not only did Honda rise up after Japan's auto industry was deprived of MITI's favor and protection; Honda had to enter in the teeth of MITI's fervent resistance. Honda's strategy seemed ridiculously haphazard and undisciplined: hiring a team of top engineers whose average age was twenty-eight under the leadership of sexagenarian Soichiro Honda—then wasting them on the creation of racing cars; keeping them on this project for several years, then yanking them off it just as they were close to world dominance and celebrity; sequestering them in a research institute, then assigning them not to the engineering of a saleable vehicle, but to the solution of the problem of automotive pollution; giving them a two-year deadline, while requiring them to exclude all short-term remedies which impaired engine performance or gas mileage—in other words, proscribing all the known solutions favored both by bureaucracy and by other companies. It seemed less a commercial strategy than an old man's fantasy.

The first results were less than auspicious: a sports car which wowed the connoisseurs of engines, but failed in the market; a mini-car which seated just two Japanese-sized passengers and was tipsy at its top speed of 50 miles per hour. Even when the research and development team actually produced a motor, the CVCC (compound vortex controlled combustion engine), which eliminated most pollutants by burning or suppressing them in the combustion chamber, it was unclear that Honda could design a marketable chassis for it or that Honda's motorcycle salesmanship could suffice in the auto market. Nonetheless, while the research project was still underway, Honda had boldly constructed a huge new factory to manufacture its expected new cars. Moreover, there was good news from the U.S. The Environmental Protection Agency (EPA) approved the CVCC prototype as meeting all pollution requirements without the use of a

catalytic converter or unleaded gasoline. Although Detroit experts dismissed the feat, saying it was applicable only to mini-cars, Honda's engineers then set out to adapt first a Chevy Vega and then two Chevy Impalas to the CVCC formula. These modified cars were brought to the U.S. in the fall of 1973 and again, much to the embarrassment of Detroit, passed the EPA tests, with only modest reconstruction of the engines and an actual improvement in fuel economy. Honda had demonstrated its possession of a truly unique technology. At the same time, it was beginning to show some success in selling its new Civic in Japan with ordinary motors. Ford applied to sell it in the United States with the CVCC engine.

At that point, in 1974, however, Honda incurred what appeared to be two terminal setbacks, one self inflicted, one partly imposed by OPEC. In a move exactly paralleling an earlier decision by Sony to sell all its products under its own name in the U.S., Honda rejected the Ford offer. That decision, though appealing to company vanity and long-term goals, drastically reduced and delayed foreseeable sales in the U.S. The second catastrophe was the worst recession in the postwar history of Japan, causing auto purchases to plummet about a third in the first quarter of 1974 while consumer prices lurched up some 2 percent a month. That seemed to portend a drastic reduction of potential sales and profits in Japan.

Honda, however, like Bill Durant in 1908 before him and Henry Ford in 1912, turned dire recession into a radical break in the history of the auto business. Partly because of still rising demand and partly because of the expense of anti-pollution devices and the pressure of inflation, Japanese auto makers had hiked their prices some 8 percent in the fall of 1973 and then by nearly 50 percent in January 1974. Because the hikes merely reflected inflation—with wholesale prices up 57 percent and manufacturing wages up 74 percent between 1972 and 1975—all Japanese auto firms were expected to go along, particularly smaller firms like Honda with shorter production runs, higher unit costs, and dwindling or disappearing margins. In the event, all Japanese auto firms did go along, except Honda. By its refusal, Honda in real and competitive terms was radically lowering its prices and assuring huge losses and possible bankruptcy if sales did not massively rise. It was a classic moment of decision in business history, a bold gambit of pricing ahead of the curve. In fact, Honda's price cut was more than twice as large proportionately as Henry Ford's in 1912.

According to the Galbraithian school of economic analysis, the automotive industry has fundamentally changed since [the Ford] era. The large companies are now in control, administer-

“...Honda’s price cut was more than twice as large proportionately as Henry Ford’s in 1912.”
—George Gilder

ing prices at will and controlling consumer responses with their huge advertising and marketing campaigns. Honda, new to the industry, commanded no such market power. In essence, it was betting the company that Galbraith was wrong about the very industry on which he focused his argument. As Sol Sanders wrote in his excellent company history, the entire automobile industry held its breath to see what would happen.

Within months the outcome was settled. As usual, price elasticities of demand proved unexpectedly high. While Nissan (Datsun) and Toyota saw their sales drop by 40 percent, Honda’s sales rose by 76 percent over the previous year in an upward surge which continues still, nearly a decade later. Honda’s pricing policies, combined with the best technology in the industry—the lowest pollution and highest fuel economy—had created a new automotive titan, the first plausible claimant to the mantle of Henry Ford.

By 1982, Honda was by far the fastest growing auto company in the world, leaping up the list of the world’s largest non-American industrial corporations (it jumped from 68 to 48 in 1981), passing all Japanese automakers except Nissan and Toyota. More important, it had introduced a new model, the Honda “City,” which would allow it rapidly to close in on the leaders. A relatively commodious mini-car, roomier than the Civic, it goes 68 miles to the gallon (45 mpg in Japanese city driving), surges through a quarter mile in 18.6 seconds reading 70 miles per hour, exceeds 90 miles per hour in fourth gear, and costs \$3,299 in Japan (\$3,631 with a portable motorbike in the trunk for use in emergencies or for transport from remote parking areas, a common problem in Japanese urban areas). The critic for *Car and Driver* magazine hails the City as “precisely the inexpensive, unpretentious, efficient and fun-to-drive car that we need to put America on wheels again.” Another product of one of the company’s callow research teams (average age twenty-seven), the new Honda prompted *Car and Driver* to a momentous comparison: “Just as the Model T was the right car for the first twenty years of this century, the Honda City could well be the right car for the last twenty years.”

Nonetheless, this car was unavailable in America during the early 1980s. Because of the “voluntary” quotas on Japanese automobiles (termed “voluntary” because they are negotiated by the executive branch rather than enacted as law by Congress), Honda’s imports have been severely limited. Like nearly all trade restrictions, the quotas brought results both perverse and ironic. The chief beneficiaries may well have been Nissan and Toyota, whose established market shares were protected against Honda. The chief business victims of the agreement may well turn

out to have been General Motors, Ford, and Chrysler, which were faced with Honda’s response: a new stress on its fancier up-market entries, the Accord and sporty new Prelude. Honda also opened a new production facility for these models in Ohio, which is projected to increase Honda’s U.S. sales by 40 percent. Inevitably hurt the most, however, were America’s consumers and the businesses which serve them. By reducing as much as 50 percent the costs of automobile transportation for its purchasers, the City could have conferred a substantial stimulus to the American economy, releasing funds for growing businesses of all kinds, while in all likelihood encroaching little on Detroit’s most profitable lines. In this age of economic self-abuse, though, “voluntary” trade restraints are very popular. They offer the throngs of Washington masochists as much pain and as small benefit as tax hikes and price controls, without requiring the embarrassment of public enactments.

Honda is likely to surmount such obstacles of the U.S. government as easily as it overcame the obstruction of MITI. Like Sony, it is one of those great entrepreneurial companies which seems to feed on resistance and grow stronger. The question is whether these companies are in any way characteristically Japanese. Both have avoided heavy dependence on Japanese banks, both have pioneered in American equity markets, both have led their industries in building American facilities for both manufacture and marketing. Both, in the midst of meritocratic Japan, disparage the importance of academic credentials: Honda with only eight years of education; the well-schooled Morita [of Sony] writing a Japanese best-seller in the mid 1960s which scandalized many with its title, *Don’t Mind School Records*. Some observers feel that the two companies are extraordinary anomalies in Japan—rare products of unique personalities during a period of postwar opportunity and turmoil—and that their like will not be seen soon again. As Japan faces increasing problems of pollution, overpopulation, and resource scarcity, so the argument goes, the government role in the economy will necessarily become increasingly powerful and inescapable and innovation will require ever larger business and bureaucratic structures, leaving little or no room for entrepreneurs like Honda and Ibuka [of Sony]. This argument has been familiar in the United States for several decades now, and its proven fatuity here should give pause to its proponents with regard to a country which proportionately generates twice as many business starts as the U.S., boasts seven times as many small manufacturing companies, and maintains reserves of savings, available to business, at least twice as large as comparable American funds. □

Hugh Patrick

(Continued from page 5)

that the money is squandered inefficiently, that doctors grab too much, and so on, just like in this country. The real increases have been in old age benefits, particularly as they are linked to the cost of living, as the population has begun to "age." This social security problem in Japan has been causing great anxiety about the future. In fact, the debate is remarkably similar to the one here.

MR—Are they concerned about the effect government old age programs have on the amount of money individuals save from their current income, and the ramifications for capital formation?

Hugh Patrick—There has been less immediate concern about these issues since Japan has extraordinarily high savings rates, but some thoughtful specialists are worried about such possibilities in the longer run.

My impression is that the U.S. personal savings rate as a percentage of disposable income has not varied a great deal over the last century, but has been fairly stable at around 7 to 8 percent. Japanese savings rates before the Second World War were probably on that order, although we do not know exactly. Only since the late 1950s has their savings rate taken off. In 1974 it reached a peak of 24 percent, though it is now about 17 or 18 percent. Yet no one is certain what accounts for these extraordinary numbers. Some argue that the high cost of housing and poor mortgage credit

markets have forced people to delay housing purchases and to save to meet high down-payment requirements. Another contender is the strong value put on savings for ones children's education; another contender is the need to save for ones own retirement. But the exact reasons and their relative importance have not been sorted out.

MR—How about taxation?

Hugh Patrick—The total tax taken out of Japanese personal income is substantially less than in the U.S. There are large exemptions, so that perhaps 30 percent of the population don't pay any income taxes. Interest income on up to \$15,000 of savings deposits is exempt from tax and considerable evasion is tolerated; dividends and capital gains are taxed preferentially from the taxpayers' standpoint. After that, the system is actually quite progressive, with the maximum rate 70 percent.

MR—What lesson, in sum, do you think we should learn from Japan's impressive growth?

Hugh Patrick—I don't think there is any one simple lesson. Nor would it necessarily be easy or even wise to import their ways of doing things, not at least without careful adaptation to our very different culture.

Nevertheless, I do think it is very important that we develop here a longer perspective on economic policy, and adopt a more consistent set of measures conducive to investment, entrepreneurship, and economic growth. □

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