

# Japanese Economic Development and Laos: We Can Change!

This article is based on the lectures and seminars that I gave at NOSPA (National Organization for Studies of Policy and Administration) in Lao PDR in September 1996. This lecture was financially supported by the Japan Foundation. However, the views expressed here is the author's.

# Japanese Economic Development and Laos: We Can Change!

## Introduction

"We must change!" is a catch phrase of a Japanese automobile company used in its commercial message. As this shows, Japanese economies (and also Japanese society) are now at a turning point. Laos is also at a turning point. At macro level (or at country level), we must change if we want to develop further. However, at the micro level (or at individual level), it does not necessarily mean that everybody should change. Some people may change while others may not change. Even a small proportion of the people may lead the changes of the country. At macro level, Laos must change in order to introduce market economy, which is already accepted by the government and people. Even though we understand that the direction of change is towards market-economy, we do not know yet who will lead the change in which way. The history of Japanese economic development shows that it developed through trial and error. There are some success stories of Japanese government and Japanese companies but there are much larger number of failures. It is not correct to appraise the Japanese government for their industrial policies because many of them were not successful. The lesson that we have to learn from Japanese economic development is that there were many efforts of the government and people in a diversified manner. This is a process of searching for promising enterprises, industries, etc. Who will play this role? It seems that the failure of socialist countries is the lack of people or organization which play this role. In a market economy, this role is played by entrepreneurs. They are guided by the opportunities to make profit. Some of them may make a big profit but other may make a big loss. Even for those who succeeded may make a big loss in the next year. Their enterprise may be very risky but they have a chance to make a big profit. Schumpeter emphasized their role in economic development.<sup>1</sup>

---

<sup>1</sup> Schumpeter, J. [1926].

Their role is to destruct old systems in order to create new systems. This is called "creative destruction" by Schumpeter.

I want to emphasize the role of "creative destruction" in this lecture, too. As mentioned above, this process is achieved through trial and error. We may fail or we may succeed. We cannot say "We must change!" because we may fail at individual level. Therefore I use the phrase "We can change!" which implies that we may succeed in some probability and so that we should try anyway. It should be noted that this does not mean that everything can be done. Social value should limit the activities that are harmful to Laos, for example, deforestation.

### The Direction of Economic Development for Laos

Usually people believe that Laos is a less developing country and therefore cannot be a developed country in the near future. So long as the macro-economic figures such as per capita GDP (Gross Domestic Product) are concerned, this belief is undeniable. Such a figure cannot jump from US\$350 at present to, for example, US\$10,000, within a few years. This is the nature of macro economic statistics. But if you look at the Lao economy at micro level, you will have a different idea. Laos may have a potential to become the best in the world in a certain sector, though nobody knows which is the sector yet. If the Lao government and people devote their efforts into the sector and also they are lucky enough, they can succeed to become the best in the world. This is an application of the idea of "We can change!"

Laos need not (or should not) follow the same development path as Japan because the economic and international conditions are different. For example, population size is different, natural resource endowments are also different, and so on. Therefore it is not useful to learn about the Japanese economic development itself. In this lecture I emphasize the lessons that can be derived from Japanese economic development and can be applicable to Laos. One of the lessons is the importance of the efforts of Japanese people to produce the best products in the world. The role of the government is to guide their efforts to a certain direction.

When the resource is limited, the resource should be used efficiently. The government budget is also a limited resource and should be used efficiently. When Japanese tried to recover from the damage of the second World War (1939 - 1945), the Japanese government set coal mining and iron steel industries as priority sectors and devoted the government budget. Its impact was large enough to stimulate other industries through inter-industry relationship as shown in the input-output tables.<sup>2</sup> For Laos the government budget is also a limited resource, like as many other countries. Therefore it should set priority sectors and devote its budget to those sectors. Then what are the priority sectors of Laos? Which sector should the Lao government promote as a leading sector? It is not my duty to answer this question but it is the duty of Lao people. We cannot say which industry should be promoted, given the resource endowment. The classical economics was deterministic and insisted that the priority industry can be determined by resource endowment. But the modern economics is becoming less and less deterministic. In the next section I will explain the new idea, which is called "evolutionary theory of economics" or "evolutionary economics" in short.

### Evolutionary Theory of Economic Development

The difference between the evolutionary economics and the orthodox economics is caused by the basic idea or the philosophy. The orthodox economics such as classical and neo-classical economics insists that the economic situation is determined by only the technology, taste and factor endowments, which are called TTFE. For example, a labor-abundant economy should specialize in labor-intensive industry while the capital-abundant economy should specialize in capital-intensive industry. Now we discuss the case of Thailand. When Thailand opened its economy to the international trade in the mid-19th Century, Thailand

---

<sup>2</sup> Input-output table is a matrix which shows the flow of products from one industry to another. From this table, we can calculate the numerical impact of an additional products of an industry. This is called linkage effect. Forward linkage is the effect of an increase in output of a industry, for example, iron industry to those industries which use iron as input. Backward linkage is the effect of an increase in output of a industry, for example, iron industry again to those industries whose product is used as input in iron industry. To set coal mining and iron industries was to emphasize the forward linkage.

was land-abundant country and therefore specialized in rice production. This change is consistent with the orthodox economics. However, if this argument is true, Thailand could not change its development pattern until its population increased to be a labor-abundant economy. Now the question is "If Thailand becomes a labor-abundant economy, can they become an industrial country automatically?" If it is true, we are very happy because you just increase the population size so as to make your country labor-abundant if you want to industrialize your country. However, this was not true. Thailand had to pass through the period of import-substitution in order to accumulate capital and technology. This was the period for preparing industrialization.

I heard a very simple-minded case. That is, a Japanese economist advised to Lao government officials to increase population size to at least 10 million so that Laos has a sizable market to attract foreign investors. In this world, however, there are many labor-abundant countries but many of them fail to industrialize. We can learn from the Japanese economic development that we need efforts for industrialization. They devoted their efforts to improve the conditions for industrialization, such as institutions, education, technology, infrastructure, etc. If there is something that you can learn from Japan, it is not the Japanese management style or industrial policy but the efforts to introduce and adapt foreign technology and to produce the best products in the world. The Japanese management style is only a result of their efforts and adapted for the Japanese situation in a historical situation. This means that many of the Japanese experiences may not be suitable for the current situation of Laos. There are many differences between the two countries such as technology, taste, factor endowments, international situation, culture, tradition. Lao people should try by themselves to change its economy. As a result of efforts, Lao people will innovate its own style of management which is consistent with the tradition and culture of Lao people. Evolutionary theory analyzes this process. It is no longer deterministic because economic situation is determined not only by the factor endowment but also the efforts, tradition, culture, and so on. For example, the Japanese

management system will not be introduced to Laos because it is not suitable for the Lao culture. It should evolve in order to become compatible with Lao culture. What we can say is that Lao people should innovate new management system which is comparable to the Japanese one. Thus "We can change!" is an implication of the theory.

# Part I. Japanese Economic Development

## Chapter 1. Meiji Restoration(1867)

Usually it is believed that Japan started its modernization (or Westernization) in the mid-19th century when she opened its economy by signing the Peace and Amity Treaty in 1854 and the Amity and Commercial Treaty in 1858 with the USA. This open-door policy brought about a big change to the Japanese political system. In 1867, Shogun Tokugawa Yoshinobu return the reins of the government to the Emperor. At this moment the age of Samurai ended and the age of Emperor revived. Emperor moved from Kyoto to Edo and the capital city was moved from Kyoto to Tokyo (the old name Edo was changed to Tokyo at this occasion).

This political change was actually a shift of power from Shogun to those Samurai in western Japan. There were four classes in Edo period. The top is Samurai, the second is farmers, the third is manufacturers, and the bottom is merchant. When the Samurai accumulated knowledge, manufacturers accumulated skills and merchants accumulated capital, then there occurred a movement to destroy the four-class system. It was the Western impact that promoted this movement. And Samurai in western Japan succeeded to replace Shogun.<sup>3</sup>

Westernization was not a process to replace the Japanese tradition by Western elements. It was a process to reinforce the Japanese society by Western elements. Some restrictive elements were removed and replaced by the Western factors. The liberal idea of Fukuzawa is an example as will be mentioned below.

When the new government was established after the Meiji Restoration, various reforms were conducted. For example, in 1868, the constraints on the

---

<sup>3</sup> This is the merit of "opposition party". When there is a radical change in international situation and the ruling party cannot meet the change, the opposition party may be able to meet it. In general terms, diversity can bring about stability in some cases.

transportation were removed so that people can travel the country freely. The monopolistic industrial organization (Ton-ya kabu, Kabunakama) which prohibited new entrance to the industry was also abolished. In 1869, the status of farmers, manufacturers and merchants was abolished and the farmers were allowed to change their works (before they were not allowed to do so). In 1871, the government allowed farmers to sell their rice and cultivate as they wish. And in the same year, the noble class people were allowed to engage in industries. In 1872, DENNMA SUKEGOU were abolished, farmers were allowed to sell their land and engage in business and commerce. All these reforms were aimed to liberalize the constraints introduced in the Edo period.<sup>4</sup>

Fukuzawa Yukichi (1835-1901) was an influential intellectual in the early Meiji period. He was born as a son of lower-class Samurai and he learned Dutch and then English studies. During this study he became acquainted with the Western Liberalism. He hated the Japanese feudal society which constrained his father, a lower class Samurai. For Yukichi, the feudalism was the enemy to revenge for his father.<sup>5</sup> He and his colleague were the first people who introduced economics to Japan. For Fukuzawa, the Western social principle that respects the liberty of individuals was more important than economics itself. Liberty is the indispensable human right and makes the society prosper as the classical economics insists. Later, he changed his idea and became nationalistic and expected entrepreneurs to emerge. It was a way to compete with the Western countries.<sup>6</sup> For this purpose, the problem of income inequality was less important and can be set aside.

---

<sup>4</sup> It can be said that the new emerging class always requests to remove regulations which constrain their activity. And the emerging class often leads the economy in the next era. Therefore it is important to change regulations according to the changes in the situation. Deregulation is an important issue in Japan, too. However, it is a very difficult task because those people who are benefited from the existing regulations oppose it and because deregulation may destroy the merit of the present system. Anyway, we have to change regulations if we want to change the situation.

Somebody talked to the author that the problem of Laos is the lack of regulation. It is sure that laws and regulations are not enough in Laos. And this is the cause of trouble with foreigners. However, what is meant in the text is the regulations both written and unwritten which restrict people's activity.

<sup>5</sup> This is translated from a passage from Fukuo Jiden (autobiography).

<sup>6</sup> This situation is similar to the present Japan when people expect venture business and capital to emerge.

## Japanese Industrialization: Precondition

Various changes for modernization occurred after the Meiji Restoration in 1867 but we should not miss the important of the precondition, which were prepared during Edo period. We will discuss the education and technology as the precondition.

During Edo period, education was already wide-spread all over Japan. Children could learn reading, writing and calculation at schools called "Terakoya."<sup>7</sup> Lower Samurai class was so poor that they have to depend on education (selling of knowledge). In order to sell their knowledge, they have to acquire new knowledge because old knowledge became obsolete and had no worth to sell. It is interesting to note that these lower class Samurai lead the controversy concerning the foreign policy at the end of the Edo period.<sup>8</sup> This is the supply side of education. As for the demand side, it indicates that education was useful for their life and improving their living standard. As a result, at the end of Edo period, various kind of basic knowledge such as reading, writing and calculation as well as Confucianism, SHINGAKU, etc. were spread to common people. These knowledge made it possible for Japanese people to accept foreign knowledge and adapt foreign technology. As a result of the spread of education, the literacy rate was 43% for male and 10% for female in 1868. And in 1875, 54% of school age boys and 19% of school age girl went to school. These figures are much higher than those in developed countries in the 19th Century.<sup>9</sup>

In Japan, close-country policy was adopted in the early 17th Century. Before that, there were active trade among Asian regions, such as Japan, China, southeast Asia and between Asia and Europe. Japan imported form China, Southeast Asia, and so on. When Japan closed its economy, trade was monopolized

---

<sup>7</sup> "Terakoya" means "temple hut" but this does not mean school was located at temple.

<sup>8</sup> Scholars who wrote reports for the government may not have the power to change anything.

<sup>9</sup> Nakamura Takafusa, *NIHONKEIZAI: SONO SEICHO TO KOUZOU* (Japanese Economy: Its Growth and Structure), University of Tokyo Press, 1981. pp.59-60.

by the Edo government. Japanese people who could not import had to replace the imports by domestic production. This was an industrialization by import-substitution.

During the two hundred years of closed economy, there was a period of growth attained by opening land for cultivation. But when the pace of opening-up of land was slowed down, the surplus of the economy decreased and as a result the Edo government and also local governments suffered from budget deficit. Then they began to encourage local industries to increase their revenue. The policy promoted experiments and innovation at local level. This became the technological base of industrial development in Japan.

Those local governments located in the western Japan succeeded in this kind of industrialization. These local governments are at advantageous location, that is, they are close to China and Ryukyu (Okinawa). From them, they could import new technology. (In a sense, they smuggled modern goods and technologies.) When they accumulated economic power through industrialization, they worked to restore Emperor system and replace the Edo government.<sup>10</sup>

### Comparison between Thailand and Japan

There are many similarity between Thailand and Japan in the 19th Century. Japan opened its country in 1854 while Thailand (Siam at that period) opened its country in 1855 by signing the so-called Bowring treaty with England. These treaties were unequal in the sense that these two countries surrendered the right to fix the tariff rate by themselves and accepted extraterritorial rights to the Western countries. Another similarity is that the modernization (or Westernization) was conducted under the reign of King Chulalongkorn (reign 1868-1910) and Emperor Meiji (reign 1867-1912). Their periods of reign and roles in modernization are similar to each other. The fact that both countries were not

---

<sup>10</sup> Even during the Edo government the Emperor system was still existent but not effective. These western local governments supported Emperor in order to be authorized by Emperor to replace the Edo government.

colonized is also another similarity.

In spite of the similarities, their development patterns were very different to each other. For the eyes of the Western people who visited both countries in the 19th Century, it seemed that Thailand would develop more than Japan because Thailand had richer natural resources than Japan. As the classical economics predicts, Thailand specialized in the rice cultivation and became one of the biggest rice exporters in the world. On the other hand, Japan was not so abundant in natural resources as Thailand but abundant in educated human resources. Thus Japan specialized in textile industry. Japanese people worked hard to catch up the Western industrialized countries. For them it seemed to be the only way to avoid colonization.<sup>11</sup>

The impression of the Western observers is very informative in understanding the difference in the development path. For them it seemed that Japan had no promising export industry while Thailand had rice industry. The impression might be true at the early Meiji period. The technological level of Japanese industry was so low that they could not compete in the world market. However, the technology was not static and could be improved by transferring Western technology. Thus Japanese could change its development path by their efforts in transferring technology. This understanding is less deterministic than the classical economics.

It should be noticed that it is not easy to change the development path. It needs the efforts of the people and the government. The import-substituting industrialization policy in the 1950s and 1960s was the case for developing countries. The socialization can be understood as an effort to change the development path. Unfortunately it could not succeed and have to turn to market economy and open-door policy. We will discuss the failure of the planned economy in this lecture. In the next section we will see the case of Japan in the Meiji period.

---

<sup>11</sup> This was not a necessary condition as the case of Thailand showed.

## Chapter 2. Industrial Policy of Meiji Period

### Theoretical Background of Industrial Policy

We can divide economic theories into two types: The one insists the importance of the industrial policy and the other emphasizes the role of the market mechanism and therefore rejects (or at least minimizes) the role of industrial policy. Until the 1960s the former was dominant among developing countries. However, it could not succeed except for a few cases like Taiwan and Korea. Therefore, after the 1970s the latter became dominant and many international organizations such as World Bank and foreign advisors recommended (or forced) developing countries to adopt the market-oriented policies. Nevertheless, the former was still recommended by Japanese and other East Asian countries because they are thinking that their success in economic development was achieved by the industrial policy. *The East Asian Miracle: Economic Growth and Public Policy*, a World Bank research report was a result of a research initiated by the Japanese government. Its purpose was to take the experiences of the East Asian countries into consideration for the development policy of developing countries. And the report seems to admit the effectiveness of public policy on condition that it is market-friendly. "Market-friendly" means that the public policy does not distort the market mechanism. This argument still assumes that development path cannot be changed by the public policy.

These two arguments are extreme. Reality lies between them because both Market and government are not perfect. There is market failure as well as government failure. Economics usually accept government intervention if there is market failure. Even though Western economists insist that government should not intervene in industries, their governments strongly intervene in some industries. A famous case is the Airbus Industry of Europe. This case makes American economists pay attention to the strategic theory of international trade.

## Technology Transfer

We have seen that the industrialization in Edo period was a kind of import -substituting industrialization. When Japan closed its economy in the 17th Century, they have to replace the imported goods by domestic production. This type of industrialization is called "import-substitution." Even in the Meiji period, industrial policy was the same type. During the Edo period when Japan closed itself, the Western technology developed far beyond Japan and other Asian countries. Therefore Japanese had to catch up to the level of Western technology. The Japanese government adopted various kinds of policies. Firstly, the Japanese government sent missions to Europe to learn the Western technology. Even the local governments also sent missions to Europe. For example, Kyoto government sent technicians of a traditional weaving industry (Nishijin, name of a town) in Kyoto to introduce modern technology. This traditional industry was faced with the competition from imported textiles. They succeeded in introducing Western technology, developing their own technology and weaving more delicate, complicated, and beautiful clothes. And they could survive and until now Nishijin is still a famous weaving town in Kyoto.

It is not easy to introduce foreign technology because the technology was developed in a different circumstance and usually is not suitable to the other countries. The imported technology should be adapted to the new situation. This process is called "adaptive innovation." Orthodox economic theories insist that a labor-abundant country should introduce labor-intensive technologies. This argument, however, neglects the adaptive process. You should not limit yourself to the labor-intensive and therefore cheap technology if budget allows you to do so. Introducing new technology is to increase knowledge and production possibilities. In economics terms, this means to expand production possibility frontier. To introduce foreign technology is often very expensive and risky. That is, the expanded production frontier may not be used. In spite of this fact, the imported technology will have a larger impact if it spread widely in the country and is applied to other industries.

The case of Nishijin shows the adaptation and spread of foreign technology. The technology that Nishijin introduced from France in the late 19th Century was a capital-intensive one. In those days Japan was a labor-abundant, less-developed country. Therefore the imported technology was not suitable for the Japanese resource endowment. Adaptation was needed for the technology to spread in Japan. Efforts were devoted to make the weaving machine cheaper. It should be emphasized that there were many local engineers who learn from their experience. As mentioned as a precondition for industrialization, educational level was high in Japan. And this was the base of the local engineers. As for the weaving machine, the adaptation was occurred to replace the steel parts by wooden parts because steel parts were more expensive than wooden parts. The cheaper machine was spread to the weaving industry and made the product cheaper and more beautiful.<sup>12</sup>

Another interesting case is also concerning textile industry. Western textile technology was introduced by the local government (Satsuma Han) at the end of Edo period. The Meiji government also introduced Western technology both as a public enterprise. But these enterprises were not successful because of the capital-intensity as was the case of Nishijin. They needed adaptation. A Japanese student (Mr. Yamabe) was studying law in England but he was asked by Mr. Shibusawa who was a very famous industrialist in Japan to solve the problems of Japanese textile industry. And he went to Lancashire to learn technology while working as a worker. When he learned the technologies, he brought back them to Japan. When he brought back the technology to Japan, it was not suitable to the Japanese situation. The Japanese engineers changed the production system so as to use more labor. They introduced two shifts operation and operated the factory 24 hours per day.

---

<sup>12</sup> After the appreciation of Yen in the 1980s and 90s, the weaving industry in Nishijin is losing its competitiveness against cheap imports. Laos has the very beautiful traditional weaving technique but the case of Nishijin shows that even the traditional weaving needs technological innovation and new design according to the changes in tastes of people.

Thus Japanese people tried hard to learn Western technologies and adapt them to the Japanese situation. The process is not merely the process of choosing a suitable technology from the existing stock of technologies according to the comparative advantage of the country but a process of adapting modern technologies to the situation of the country. Technology transfer is not something given or offered from outside but something you look for.

This argument corresponds to that of learning process. The economic theory of learning process assumes that the longer the period of production the more experience and knowledge is accumulated and therefore the production process becomes more efficient. This arguments, however, neglect the efforts of people to learn and adapt as mentioned above. If they concentrate their efforts to improve the production efficiency, the learning process becomes quicker and smoother. On the contrary, if they do not concentrate and just continue the operation, there would be no accumulation of knowledge and know-how. This indicates the importance of incentives to improve efficiency and competitiveness.<sup>13</sup>

### Foreign Advisors

Another policy to modernize Japanese industries was to invite foreign engineers and advisors. Some of them worked for the government offices and some of them worked at government model factories. In Thailand, there were many foreign advisors, too. It was a Thai tradition to employ foreigners in the government.<sup>14</sup> After the opening of the country to the Western powers, the number of Western advisors increased. English advisors were the majority and dominated the important ministries such as Ministry of Finance.<sup>15</sup> The differences between Japan and Thailand was that Japan could do without those advisors soon while Thailand is still depending on them in some aspects. The purpose for inviting

---

<sup>13</sup> In a market economy the incentives come from profit. This is an aspect that the planned economy could not take into consideration.

<sup>14</sup> In the Ayutthaya period, Ayutthaya was an international city and many foreigners including Japanese worked for Ayutthaya dynasty.

<sup>15</sup> There is a controversy whether they were really influential or not.

foreign advisors was different between the two countries. For Japan they were invited to Japan in order to learn technology from them and when the technology was transferred to Japanese, those foreign advisors were replaced by Japanese engineers. On the other hand, for Thailand they were a part of government permanently because they were lack of competent personnel to replace them.

So long as a country depends on foreigners or foreign country, it cannot develop in their own way. Efforts should be devoted to replace foreigners by their own people. (Now I am giving a lecture like an advisor. I hope that Lao experts will replace me and speak about Japanese economy in the near future and that NOSPA need not invite a Japanese scholar.)

### Model Factories

The Meiji government, at first, tried to promote modern industries by establishing state enterprises. The government established a wide range of industries such as coal mining, iron mining, textile, cement, silver mining, copper mining, gold mining, alcoholic drink, sugar, ship building, agricultural machine, grape farm, railway, etc. Most of these companies were established only within 10 years. They have to depend on foreign engineers because of the lack of technology. The number of the foreign engineers reached to 213 in 1874 but decreased to half, 103 in 1880. This decrease is partly because technology was transferred to Japanese and partly because enterprise itself was failed. The purpose of these companies was to introduce Western technology into Japan. However, this purpose was not achieved because the Western technologies were not suitable for the Japanese situation. The technology had to be adapted to the Japanese situation.

As is often the case of import-substitution policy, these enterprises were not efficient at the beginning and could not raise the government revenue. These large investment was a burden for the government. The government deficit aggravated inflationary pressure and the government decided to privatize these state enterprises and sold many of them to private sector. This is a part of the policies to reform government budget and monetary system, which was called

"Matsukata Deflation." The state enterprises were sold at a lower price than their market price. This means that those who bought the state enterprises received subsidy from the government. They had a close relationship with the government and therefore were in a advantageous position. Some people criticized this practice as corruption but this is accountable on the ground that the government gave subsidy in order to promote industries. The important thing is that those who bought the state enterprise had knowledge of the industry and the will to conduct the business. The purchase of state enterprise was not a portfolio investment which aimed to make a profit by selling it to other people. They were entrepreneurs who had the will to develop industries.

The fact that those people had a close relationship made it possible to ask the government protection in the case of emergency. When some of them faces with competition from abroad, they asked protection and competed with foreign companies. The Japanese government protected them because it had an intention to develop Japanese capitalists. To depend on foreign capital was to lose a large part of the profit to foreign countries.<sup>16</sup>

Many developing countries protected infant industries but failed to make them grow-up. They protected too much and too long to improve their productivity. The Japanese companies could not be protected "too much and too long" because of the limited government budget and unequal treaty of trade. Therefore they have to face the competition from foreign companies and improve their productivity.<sup>17</sup> This competition brought about the incentives to learn, improve, reform, innovate, etc. and this is the merit of the market mechanism which was lacking in a planned economy. It should be noticed that even in Japan there are many failures. Not all

---

<sup>16</sup> The efforts to industrialize in many developing countries after the Second World War was for the same purpose. They tried to be independent economically. Import-substituting industrialization and socialization were the efforts for this purpose.

<sup>17</sup> The protection policy is very difficult as many failures in developing countries shows. Nowadays this kind of policy is not popular because international organization and foreign advisors recommend market mechanism. This is a return to the colonial period or the age of "forced free trade" in the 19th Century. Even in the colonial period the living standard of the people increased as the theory of international trade insists. However, the colonial economy dominated by foreign capital.

the industries could survived in the competition. The government cannot be perfect and we must be satisfied with a small portion of success and accept failure. From failure we can learn many things. For the Japanese, there were a channel between the government and the private sector which made the policy change timely. We will discuss this topic later.

### **Experimental Farms and Laboratory**

Japanese government, both central and local, established experimental farms and laboratories to improve the quality of products, production technology, etc. It should be emphasized that these activity was conducted by public sector and government officers as researchers. Their salary was not high but work hard for their community and local industry. When their innovation was successful, those who received the profit was the local entrepreneurs and not the researchers. These researchers worked hard for the community and the community highly appraised their efforts.<sup>18</sup>

---

<sup>18</sup> This social value is decaying gradually in the last few decades and students do not want to choose science or engineering.

## Chapter 3. The Wartime Economic System

### The Heritage of Military System

During the Second World War the Japanese economy was in trouble because imports were limited and also a part of its production capacity must be devoted to military production. In order to attain the most efficient use of the existing production capacity, Japan introduced a kind of planned economy. The social organization was also changed to be suitable for efficient production. The characteristics are (1) cooperation between the government and private sector and (2) cooperation between capitalist (management) and labor (union). The cooperation between the government and private sector were necessary to attain the required level of production of goods. The private sector should report its production level and other information concerning its industry to the government. The cooperation between capitalist (or management) and labor (labor union) was also necessary to increase the production efficiency of factories. This cooperative relationship evolved to be the Japanese employment system such as long-term employment, seniority principle after the war. It is because the situation was the same as in the wartime. The production capacity was destroyed in the war and Japan had to produce a certain amount of goods by limited capacity in order to afford their people. They need efficient production system.

In this system the Japanese government could control the private sector through this channel (at least partly). The private sector had to submit a report about its investment plan. The reason for this practice was to check whether the investment was suitable for the situation of Japanese economy at that time and to prevent over-investment. Over-investment in an industry was considered to bring about excessive competition and destroy the industry at last. Generally speaking, the private sector follows the guidance of the government, especially MITI (Ministry of International Trade and Industry). However, for some critical industries such as steel and automobile industries, the private sector could not accept the guidance. Even after the resolution of business group (Zaibatsu), still

there existed business groups, though their control over its member company became weak. Each business group wanted to one complete set of industries within its group, which means that a group has a wide variety of industries from steel to automobile. If each group had a steel company, the production capacity seemed to exceed the optimal level of the industry. Therefore, the government tried to limit the number of steel company but this guidance was against the intention of some business group and at last more steel companies were established against the guidance of MITI. This is a case that government guidance was not necessarily effective always. Another case is the automobile industry. There was a controversy whether or not Japan should invest in the automobile industry. For those who opposed the investment, the industry seemed to be not suitable for the level of economic development of Japan at that time. The industry was the one that should be invested when Japan developed more. Their idea was that of comparative advantage, that is, the labor-intensive industry is suitable for labor-abundant country while the capital-intensive industry is suitable for the capital-abundant country. They thought that the automobile industry was too capital-intensive to be established in Japan and could not compete with US automobile industry. On the other hand, those who support the investment in automobile industry thought that it is necessary for the future development and that when the industry did not have competitiveness the government should protect and support the industry. Their idea was those of infant industry, that is, when an industry is established and does not have competitiveness the government should support and protect it. Finally the Japanese companies began to invest in automobile industry.

In this sense the Japanese planning was not a plan that everybody should observe. The private sector was more aggressive than the government. They had to compete to each other in a small market and as a result they could increase their productivity. "Good plan" is not a plan that controls everything but one that makes everybody work harder, improve productivity, and bring about innovation.

It cannot be said that the infant industry theory is always right. There are many cases of the failure of protection of infant industry in developing countries.

Even in Japan there are many cases of failure of infant industry. The reason of failure was that the industry could not improve its production efficiency. Who will try hard to improve its production efficiency when they know that the government will help them whenever they are in trouble. The success of Japanese automobile industry was due to the time-limit of protection policy. They knew that the protection policy was to be abolished in the near future and they had to improve the competitiveness so that they can compete with the cheap and better quality imports. Ever-lasting protection policy cannot make the infant to grow up. This is true not only for industrial level but also for country level.

Another message of the success of Japanese automobile industry is that the target should be higher than what market mechanism predicts. The argument of market mechanism is very static and neglects the effect of learning, experience, accumulation of knowledge, etc. These factors change the comparative advantage and the static comparative advantage is sometimes misleading.<sup>19</sup>

### Japanese Employment System

The another heritage of Wartime system is the Japanese employment system. This is a system of cooperation between management and labor (union). This cooperation is established by offering a system of salary which encourage its employees to work hard, which is a combination of long-term employment and seniority principle. The long-term employment assures the employees to work until the retirement age, 60 year old or so. And the seniority principle assures the salary will increase according to the age which corresponds to the years for which the employee worked for the company because it is not often for Japanese to

---

<sup>19</sup> Exercise: Can Laos establish an computer industry in its country in the near future? You may feel pessimistic. It will be difficult to establish a computer factory due to the lack of experience. But it is only a part of computer industry. Computer software industry can be established if there is computer network and personnel like India. The development of computer network makes the location less and less important. You can contact everybody in the world through Internet. Through this network you can even produce a computer of Laos brand. You just order the other companies in the world to manufacture parts and assemble them to make a computer. This kind of manufacturing is called "fabless". What is important is idea how to make a cheap computer with good quality. Capital is not important because you need not invest a large amount of capital to build a factory. This is one possibility. Whether this possibility becomes reality or not depends on the efforts and idea of people.

change their companies.<sup>20</sup> This is because it is difficult and disadvantageous to move to other companies. Firstly, those who quit a company are considered to have caused a trouble to the previous company and therefore it is difficult to be accepted to other companies. Even when they can find out a new job, their salary would not be so good as before. This kind of employment system is desirable for employees because they do not worry about changing jobs. They have only one option, that is to work for the company. This promoted loyalty of the employees.

This system is endurable so long as the salary is increasing. When Japanese economy grew fast, Japanese companies could increase the salary. But not now because the Japanese economic growth slowed down. This makes some Japanese unsatisfied and try to reform the Japanese employment system. We will discuss this topic later.

---

<sup>20</sup> This is true only for certain kind of occupation especially for white colors.

## Chapter 4. Economic Growth after the War

When Japan was defeated in the Second World War, Japanese lost capital stock (factories and infrastructure) and manpower. Japan had to recover from these damages under democratic system. When GHQ came into Japan, it ordered the Japanese government to reform its military economic system to be more democratic because they thought the democratic society would not cause war any more.

The economic reform composed of three parts: One is resolution of business group (Zaibatsu), the second is promotion of labor union, and the third is agrarian reform. The resolution of business group was aimed to remove the economic power which was monopolistic and also the source of military power during the war. The investment company which lied at the core of business group and controlled its member companies.<sup>21</sup> The promotion of labor union was expected to serve for the same purpose as the resolution of business group. To strengthen labor union means to weaken the power of capitalists. The agrarian reform was also expected to serve for the same purpose by creating more equal agricultural society. By the reform the landless farmers became owner of small farm land and large landholders disappeared. The small farmers became the supporters of the conservative political party for almost all period after the World War II. This brought about the political stability in Japan.<sup>22</sup>

During these reforms, the old generation was removed from influential positions and younger generation replaced them. There emerged a large number of young managers, executive directors, presidents, etc. I would like to emphasize the role of younger generation in reform.<sup>23</sup>

---

<sup>21</sup> The role of investment company is now re-evaluated again because it is expected to increase the efficient allocation of investment.

<sup>22</sup> This political stability contributed the Japanese economic growth. But political stability does not necessarily mean to contribute economic growth. When the economy needs reform, the political stability might be obstacle because conservative political party is not willing to change the current system. This point also will be discuss later.

<sup>23</sup> The same phenomenon that the younger generation led the economic reform was observed in the Meiji

## Unbalanced or Priority (Keisha) Production System

When Japanese people tries to recover from the damage of the Second World War, they decided to devote its limited resources into some strategic industries such as steel and mining. The steel industry was important because it supplied basic materials for manufacturing sector. And mining industry was important because it was also used in many industries. Both of them were basic industries and had a wide impact on Japanese economy though inter-industry linkage. This strategy of economic policy was called KEISHA SEISAN HOUSHIKI in Japanese.

This strategy is similar to a development policy known as "unbalanced growth." This policy aims to stimulate certain industries which have a large impact on the whole economy. The impact can be measured by the backward and forward linkage effects by using the input-output table.<sup>24</sup> The basic idea of this methods can be explained as follows: Assume that there are only three industries called A, B, and C. Assume that the product of industry A is used as input of industry B and the product of industry B is used as input of industry C. (For example, imagine industries A, B and C as coal, steel and machinery, respectively). The backward linkage measures how an increase in output of industry B will increase the output of industry A. And the forward linkage measures how an increase in output of industry B will increase the output of industry C. The larger the impact, the more suitable the industry as the strategic one.

This strategy assumes that no bottleneck exists. If there is a bottleneck, the impact does not spread to other industries. For example, if the production capacity of industry A (coal industry) is limited, the stimulation to the steel industry is just to increase the price of coal or imports of coal because of shortage

---

restoration in the mid-19th Century. Old generation is usually conservative because they have to maintain the current system while younger generation usually takes the initiative to change because they are not satisfied with the current system. Of course, there are many exceptions.

<sup>24</sup> The input-output table is a matrix which shows the flow of products from industry to industry.

in supply. In this case, a development strategy called "balanced growth" is suitable because this strategy aims to increase the production capacity of every industry of the economy. The choice between the balanced and unbalanced growth strategies is depend on the situation of the economy, what is the bottleneck of the economy. The analysis of inter-industry relationship is therefore important.

If there is no bottleneck, the unbalanced growth is desirable because the overall (both direct and indirect) impact of a certain amount of government budget is bigger. Therefore, the Japanese government adopted this strategy after the war. And the private sector responded to the stimulation of the government development expenditure. It should be emphasized that the active private sector was an important factor of the success of this policy.

### The Role of MITI

It was believed that MITI (the Ministry of International Trade and Industry) had a very important role in promoting manufacturing industries and guiding investment. Now people are changing their idea to emphasize the role of the private sector more than MITI. That is, the private sector had led the industrial development and that the role of MITI was rather backward-looking, that is their policy was effective only to protect the declining industries. Both of these arguments are two extremes. The truth may be between them. We can point out some contributions of MITI. One is the role of insurance. If MITI announced to promote a certain industry, people could believe that the industry would receive supports from MITI and other ministries in case of trouble. Such "insurance" will promote investment by reducing risk to the company.

The Japanese companies usually finance its investment by indirect finance, that is borrowing from banks.<sup>25</sup> This was a way to minimize the influence of stock holders. Borrowing from banks is less risky than the direct finance through stock market because investors in stock market are risk taker. This means

---

<sup>25</sup> The role of semi-public banks are also important in directing the fund to strategic industries.

that risky investment might be welcomed by investors in stock market. However, if a company borrows from a bank for a risky project, the bank may not be willing to lend. There was a restriction on interest rate. In Japan, the interest rate was kept low as a policy to promote investment. Therefore they could not increase interest rate for such a risky project. MITI supported investment by acknowledging the importance of the investment, which implied that the project would be supported by the government. This was the insurance by MITI.<sup>26</sup>

### Export Promotion

Japanese people were taught that the export was vital for the Japanese economy because Japan lacks the natural resources and therefore have to depend on imports of raw materials. In order to import, Japan have to export manufactured goods. Japanese people feared that Japanese economy would not survive if this cycle was not established. So Japanese people worked hard to find out export market in foreign countries. For this purpose, the large trading companies (Sogo-shosha in Japanese) took an important role. These big trading companies not only engaged in import and export but also arranged Japanese foreign direct investment (FDI). They looked for suitable locations for FDI and partners for joint venture and often financed the investment by themselves.

### Japanese Management

Japanese management system is a system to make everybody in a company work hard where everybody must work hard and receive more. There are two main concepts to characterize this system. One is the long-term employment and the other is the annual wage increase (or seniority system). The former means that employment is assured until their retirement age so long as they do not make

---

<sup>26</sup> A problem of this policy is that MITI did not know which investment would be successful. If a project failed, a part of the loss was covered by the government. This affected the government budget adversely. Risky projects should be financed by private capitalist through stock market. They are risk-takers and will open up new opportunities for the future development. The role of venture capital is similar to this.

a serious loss to the company by illegal actions. The second assures that salary will increase automatically, irrespective of their works. Companies count only the years during which a worker worked for the company. Therefore if a worker moved to another company, he/she has to start from the beginning of the wage scale. This means that Japanese companies do not evaluate their employees by their experience and this practice makes it difficult for employees to move to another companies. This promotes the loyalty of employees to the company and makes them work harder.

This is a kind of exploitation if employees are not received a part of the profit that arises from their hard work. However, the Japanese system was not exploitation because employees were also benefited by salary increase and bonus. In order to assure salary increase and bonus, it was necessary for Japanese companies to keep increasing their revenue. If the manager increases the wage payment at the expense of profit, the company will lose the fund to invest.<sup>27</sup> And if the company reduces the investment, then the company will be lost in the competition. Thus Japanese companies have to increase wage payment and dividends and investment. This system is sustainable only when the companies is growing very rapidly. Now Japanese economy turned to the phase of low economic growth and it become more difficult to sustain this system.

### Japanese Management

In Japanese society, people are cooperative and very equal. The decision making is highly decentralized.<sup>28</sup> In a sense, the Japanese society does not willing to accept leadership. They neither want to be a leader by themselves nor want

---

<sup>27</sup> A company can increase wage payment by reducing profit. However, if profit is decreased, the fund for investment will also be decreased and as a result the future profit will also be decreased. Lower wages and dividends today will increase the possibility of more wages and dividends in the future.

<sup>28</sup> This sometimes means that there is no body to take the responsibility. This has both positive and negative aspects. The positive one is that people can be bold because they need not to take the responsibility. And the fact that his failure is not blamed means that he feels honest to the community or company and that the feeling to belong to the company becomes stronger. This feeling makes Japanese people work hard for the company.

other people to be a leader. This system may be suitable when no structural change is needed or when there is an example to catch up such as the United States. But when there is no such an example to follow or when they need creative change, this system will not be suitable. The latter aspect is pointed out as a weak point of Japanese economy now.

The competitiveness of Japanese economy came from the equality among people and companies. Competition among people can be seen in the Japanese employment system which will be taken up in the next section. Here, we point out the excessive competition. The Japanese wage system is equality-oriented rather than efficiency-oriented. The latter insists that wage should be determined according to their work. It is generally believed that the latter is the principle of capitalist countries while the former is that of socialist countries and this is the reason of the failure of planned economy. Why did Japan succeed in economic development with such a equality-oriented system? The excessive competition is an key to understand this phenomenon. Excessive competition is a situation in which companies in an industry compete to each other "too much." It is difficult to measure the degree of "too much" but we do not worry about this at this moment. This situation is occurred when there are several companies with similar size and when they have to compete to each other to survive.<sup>29</sup> This situation is similar to perfect competition in economic theory rather than monopoly or oligopoly. Thus, equal society encourages competition so long as the efforts are evaluated correctly by income or other measures.

### Japanese Employment System

The competitiveness of Japanese employment system can be explained by the case of university graduate who begins to work in a manufacturing company. In Japan, the university graduates have to find out a job before they graduate

---

<sup>29</sup> On the other hand, the planned economy guaranteed the existence of companies even though they are inefficient and therefore the system lacked the incentive to compete and innovate. In the field in which they competed such as military and space technology, they could develop their technology.

because if they fail in this period it becomes extremely difficult to find out a job, especially for big companies. At present, there is an agreement among Japanese companies not to contact university students before May of the last academic year of university<sup>30</sup> and have examination to select students after July. Even though companies are not allowed to examine the students before July, they actually examine the students and agreed with the students implicitly. Big companies can find best students before July. Those students who are not accepted by the big companies have to continue to contact smaller companies. These students lose chance to work for a big company forever. It is once for all chance.<sup>31</sup> Japanese society is a very severe society at this point. In Japan, the competition to enter a group such as company, university is very severe but once he/she is accepted, it becomes easy to survive in the society. Once he succeeded in joining a company, he can work until his retirement (about 60 years old) even though he might not contribute to the company much or even make a rather serious mistakes.<sup>32</sup> One reason is that the labor law protects the labor but more important reason is that the company protects its employee so that the employees may feel obedient to the company and therefore work harder for the company.

When a student begins to work for a manufacturing company, he is firstly send to a factory to work with the workers (mostly high-school graduates<sup>33</sup>) whatever he studied at university. For the students who studied law and economics, it is not necessary to work at factory. The true purpose is to work with workers and understand their feeling. Even executive directors often go to factory to talk with factory workers and listening to their complaints. Through this

---

<sup>30</sup> In Japan, academic year starts from April and ends in March. Usually Japanese university system is four-year undergraduate course, two-year master course and three-year doctor course. Therefore the last year of undergraduate is usually the fourth year grade.

<sup>31</sup> This is a mechanism to concentrate good students to big companies. It is easy to expect that a big company will win the competition with smaller companies in recruiting students.

<sup>32</sup> Here we must distinguish between men and women (or he and she). There is no discrimination between them until entering university but when they join companies women are discriminated. Women are expected to quit the company after they marry to save the wage cost. However, this practice is changing because this is not efficient and companies prefer more efficient allocation of labor.

<sup>33</sup> In Japan, almost all people finish the high school level.

communication the executive director improve the practice in the factory and company. This atmosphere is the basis of unity and incentive to work hard in Japanese management.

For this system to be viable, it is necessary for all employees to share the fruits of their efforts. Salary increase is one of the case. When the Japanese economy was growing fast, it was not difficult to distribute the increasing income to all employees either by salary increase or by bonus or both. Through this process employees felt royalty to the company and the company became even a part of their life. As a result of this practice, Japan became one of the most equal society in the world.

At many aspects of Japanese society people compete very severely and work hard. Even students are studying hard. The top of Japanese companies work harder than their employees. They come to the office very early in the morning and work until late, sometimes mid-night. They work hard to show their employees an example how to work hard. Unless the top work hard, why do their employees work hard? This is also the same for the government officials. When a person in a lower rank begins to work harder, then another person will follow because the latter does not want to lose in the competition. And when the two person work hard, another person will join them. The more people work harder, the more people join them. Thus the Japanese society became a hard-working society. This is called "emulation effect." The hard-working syndrome is spreading all over the world and already came to Thailand. Laos will also be affected by the syndrome when she joined ASEAN to catch up with them.)

This equal society has weakness. When the economy and also the company is growing, there is no problem because everybody can receive a share of the growth. However, when the economy's and also the company's growth slow down, there is no pie to distribute to everybody. In a more serious case, some of the employees maybe got fired. For the Japanese company, to fire its employees is the last option. They first restructure their company and reallocate their employees. Only when this is not enough, they will fire their workers. This practice is accepted

to maintain the incentive to work.

Now Japanese economy is entering to this phase. If Japanese companies try to maintain its equal system, there arises complaints. Some people may feel unsatisfactory if they receive the same salary as those who work less. In a rapidly-growing economy, this dissatisfaction can be compensated by other measures such as higher position. But this is not effective in a slowly-growing economy. This is a contradiction of work incentive in a equal society. Thus, Japanese companies are introducing the annual salary system which evaluate their work and pay according to their contribution to the company. This system is just introduced and it is not sure that this system become dominant in Japan because Japanese people do not like such a competitive system.

### American Management

In order to understand the characteristics of the Japanese management system, it will be compared with the American management in this section. It should be noted that arguments are simplified here in order to make clear the difference between them. In reality, there is a wide variety of management system in each country.

The American management is characterized to be individualistic and market oriented. This system is not cooperative as is in Japan and therefore is considered not suitable for manufacturing industry which needs cooperation among workers and managers. The recent recovery of American automobile industry is partly due to their efforts to introduce Japanese production system. However, there are those industries which need creativeness rather than cooperation such as information technology. And these industries are considered to be the leading industries in the future. This idea brings about the pessimistic expectation of the Japanese economy.

The difference between Japan and the United States is the function of labor market. In the United States the labor market is so developed that everybody try to move to better job. In economic terms, the American labor market can attain

efficient allocation than the Japanese case. On the other hand, the Japanese labor market is internalized in the company and it is very difficult to move to other companies. In this situation, Japanese workers have to worry about the performance of their company and this became their royalty to the company. This effect may overcome the inefficient allocation of labor in Japan. The past rapid growth of the Japanese economy may be partly explained by this effect.

The contrast between the dynamic American economy and the Stagnant Japanese economy at present makes some Japanese people to change its society towards more individualistic American-type economy. It is not easy to expect the impact of the more individualistic labor market to the Japanese economy. It may spoil the royalty of workers and as a result the competitiveness of Japanese manufacturing industries.

## Chapter 5. Japan at the Crossroads

### FDI after ENDAKA: Hollowing-out of Japanese Economy

The hollowing-out of Japanese industries has been a serious problem since the appreciation of Yen in the mid-1980s. After the appreciation of Yen, many Japanese manufacturing companies transfer their factories to abroad, especially to the Southeast Asia. At the same time, the "bubble economy" occurred as a result of expansionary economic policies which affected to delay the economic reform. When the Japanese economy was losing its matured manufacturing sector, they could not establish a new leading industries such as information industry. In this aspect Japan is far lagged behind the United States.

Information science develop very rapidly in recent years. You can access to almost all over the world by INTERNET. You can get information from all over the world by accessing to HOMEPAGE. For example, you can get the information of Myanmar such as the economy, investment promotion policies, tourism. You can send you message to your friend in foreign country by E-mail. We can work together by E-mail. The development of information technology promoted the globalization. Information network promoted not only Internet but also INTRANET. Intranet is a computer network within an organization such as company. Every body can contact their president by Intranet. Intranet enable quicker decision making and more efficient communication. The introduction of Intranet to Japanese companies is changing their organizational structure.

In the age of globalization, innovation, creativeness, new idea, etc. become more and more important and the location becomes less and less important. In the near future Japanese engineers may have their office in Laos while working for Japanese company in Japan if their job can be done by the computer network and the location in Laos is profitable and comfortable. This possibility depends on the efforts of the Lao government to improve infrastructures and tax incentives, etc. Another example is the case that a Lao company produces computer. Even though the company may not have their own factory, they can export their computer. Such

a company is called FABLESS which means "without factory". You can order the parts of highest quality and cheap price around the world and then order some factory to assemble them into a computer. All these contacts may be done by the Internet. What is decisive in the success in this industry is your idea and access to the information of producers. Computer software is also an example for such a case. India is successful in this aspect.

Thus the world is changing rapidly and accordingly Japanese economy also has to change in many aspects. Until the end of the 1980s Japanese economy was considered to be successful. But the current depression makes people realize the problems of Japanese society and management system. What has been considered as the factors of Japanese economic development is now considered to be reformed. For example, the Japanese employment system might be reformed to be more individualistic.

There is a controversy in Japan whether the government expenditure should be increased or decreased. Those who insist to increase argue that it is indispensable to recover from current economic depression. Their argument is based on the classical Keynesian policy. On the other hand, those who oppose the Keynesian policy argues that it will just aggravate the government budget situation. The effectiveness of the Keynesian policy depends on the economic situation. When there is just a shortage of demand, the government may compensate the shortage by increasing expenditure. But when the economy needs structural change, the Keynesian policy may result to retard the change. The inefficient sector which should be replaced by more efficient sector may survive due to the policy. This situation is similar to the case of declining industries. They often ask the government to increase the subsidy to their industries. And the government justifies the increase in subsidy as a measure to avoid unemployment. But this retards the structural change.<sup>34</sup> Combination of both will be a correct policy.

---

<sup>34</sup> This argument should be distinguished between the declining industries and infant industries. The latter has the possibility to receive subsidy in order to accelerate structural change.

## Chapter 6. Japanese Education

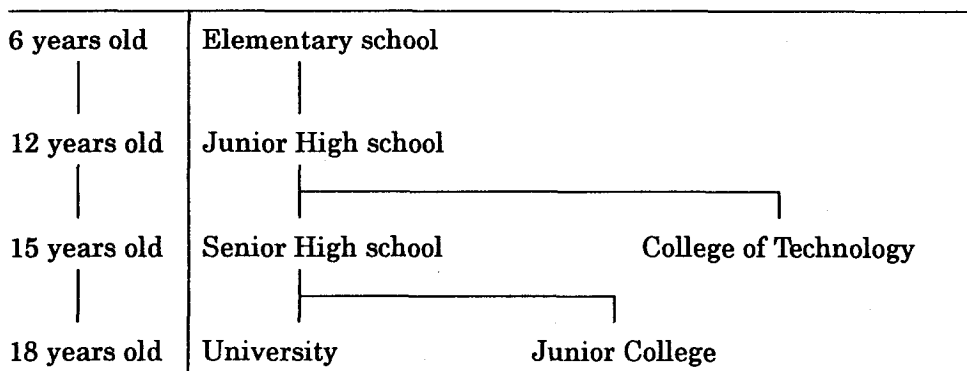
This section explains the Japanese educational system and discusses the role of the education in Japanese economic development and the current educational problems in Japan.

### Japanese Education System

In this section I will explain the current education system in Japan.

Academic year starts in April and ends in March. There are three long holidays, that is, summer, winter and spring. The summer holidays continue for 40 days in July and August, the winter holidays continue for two weeks including new year holidays.<sup>35</sup> Class hours are 45 minutes (15 minutes break) for elementary school, 50 minutes (10 minutes break) for junior and senior high school and 90 minutes (10 minutes break) for university.<sup>36</sup>

Currently the Japanese educational system is as follows:



Elementary school and Junior high school are compulsory and the school attendance ratio is almost 100 percent. The ratio of advancing to senior high school increased gradually from 58 percent in 1960 to 90 percent in the mid-1970s and

<sup>35</sup> The length of summer and winter holiday varies according to the climate. In the North region, the winter holiday is longer than this because of the cold climate.

<sup>36</sup> There are some variations according to school but the difference is not so much. The Lao system is different from Japanese. At NOSP the class hour is only 50 minutes and it seemed to me too short because I am used to talk for 90 minutes.

reached to 96 percent in 1994.<sup>37</sup> The college of technology (or vocational education) was popular until mid-1970s. Since then, more high school students chose to go to university. The ratio of advancing to university increased from 8.2 percent in 1960 to 26.7 percent in 1975 and became stable thereafter. This means that the demand for university education reached saturation point in the mid-1970s.

In the 1980s the ratio of advancing to graduate school began to increase reflecting the social demand for higher educated students. As the demand for the higher education increased, the demand for vocational education decreased because their educational level became not enough for the Japanese society. This phenomena shows that the educational level would be changing according to the social demand. And the social demand is mainly determined by the level of economic development. Therefore, it might be said that the educational level should be up-graded according to the economic development. Or in other words, lower education should be emphasized when the level of economic development is lower. It is not deniable that Laos should emphasize lower education but this does not exclude the possibility to promote a certain field of education and research. It is a strategy of Laos to choose and promote a promising field of science for Laos in the future. The field may reach the international level and attract foreign researchers to Laos.

The history of vocational education in Japan may be useful for Laos. In Japan, labor shortage was a serious problem in the 1960s when the Japanese economy grew very fast and demand for labor also expanded rapidly. Private companies had to employ lower-level school graduates because the supply of higher-level school graduates are limited. So the companies sent these workers to vocational school to upgrade their educational level. For some big companies, they established their own vocational school to educate their employees.

The same phenomenon has been observed in Thailand since the late 1980s. When the foreign direct investment (FDI) flooded into Thailand in the

---

<sup>37</sup> Asahi Shinbun JAPAN ALMANAC 1996, p.240[0].

latter half of the 1980s, the shortage of engineers became a very serious problem. On the supply side, the supply of engineer or graduates from faculty of engineering is limited because engineering was not popular in Thailand at that time. On the demand side, the newly established factories by FDI needed a large number of engineer. As a result, the shortage of engineers became serious. The salary of university graduates from faculty of engineering began to increase very rapidly, sometimes their salary was higher than that of their professors. In this situation, it became very easy for them to move to other companies which offer higher salary and when they found a better job, they moved quickly. Every time they move to a new company, they receive higher salary.<sup>38</sup> This phenomenon made the companies to decide to employ graduates of vocational school and educate them by themselves. This is similar to the Japanese situation in the 1960s.

Japanese educational system was succeeded in supplying manpower to industrial sector by upgrading the educational level gradually. From elementary to high school, students were trained to cooperate, which was the most important principle in Japanese society. This principle was applied to various aspects of Japanese life and the Japanese management is also benefited from such an education. In this sense the Japanese education was successful. But the age is changing and such an education does not necessarily suitable for any time. The Japanese educational system might be suitable only for the age of rapid growth and may not for the coming age.<sup>39</sup>

### Educational Problems

Since the early 1980s the educational problems such as violence to teachers and classmates and refusing to attend school has been increasing and

---

<sup>38</sup> This phenomenon did not occur in Japan in the age of rapid growth because of the Japanese employment system. It is disadvantageous for white-color workers to move to other companies.

<sup>39</sup> This difference is similar to that of growth and development. "Growth" is usually used to indicate the quantitative expansion without qualitative change. On the other hand, "development" accompanies qualitative change such as improvement of quality of life, technology, etc. The age of rapid economic growth is closer to "growth" rather than "development". The problem of Japanese educational system is whether it can cope with the "development".

became a serious social problems in Japan. There are no clear explanation for this problems but it is a sign of deficiency of Japanese educational system. An economic reason may be that people cannot have bright future due to slow economic growth. There may be another non-economic reasons. In this section I would like to discuss the problems of university, which cause the educational problems in lower school.

In Japan, university students are not expected to study, especially for the students of social science like economics. They are just enjoying their university life such as sports. Once they entered university, their future, that is, for which company they may be employed, is almost determined. The knowledge that they learned at university hardly change their chance. Private companies judges students by their universities. In Japan, there is a ranking of universities. The ranking of university was established completely in the early 1980s when the Ministry of Education introduced a national examination for applicants for university entrance examination. When this system was completed and most of the students had to take this examination, students were ranked according to the result. Students are now ranked by the standard deviation. And private education companies officiously ranked universities according to the rank of students. Now a graduate of a university is ranked according to the ranking of universities. Once this ranking is established, it becomes very difficult to change this ranking. For example, a good student of a lower ranked university tends to be ranked lower than a bad student of a higher ranked university.<sup>40</sup>

There is some reason to judge a student by his/her university. When a company recruits a student, they usually lack the information of the student's

---

<sup>40</sup> The fact that Japanese companies do not attach importance to university education can be seen from the fact that the forth grade students have to be absent from university and visit companies to get informal agreement to be employed. Japanese companies have an official agreement that they will not contact students for recruitment before September but informally they contact from April or March of the same year. Even the newspaper companies contact students in a disguised form such as seminar in May, or June. Thus university students must visit companies being absent from class. The problems on the side of university are that university cannot claim that the university education is so important that students should attend the class because they are also feeling that university education may not be important for the student. Another problem is that if a university did not allow its students to be absent from class to visit companies, its students could not find out a good job, which will lower the reputation of the university. The students can graduate university even though he/she did not attend class. If he/she cannot graduate university because of the absence, it will cause a big trouble to the university.

ability. In this situation the background of the students such as the university that they graduate becomes more reliable information rather than examination. Therefore the company attach importance to university.

This explanation assumes that Japanese society lacks mobility between companies. If there is such mobility, the choice become more flexible and need not depend on graduated university. If a company judges that an employee is not suitable for the company, he/she will move to another company. And if an employee judges that his/her company is not suitable for him/her, he/she will move to other company. For the latter, however, their salary will become worse because Japanese salary system does not count their experience in other companies. This indicates that Japanese companies were not willing to mobilize employment. On the other hand, labor unions oppose to mobilize employment because it may bring about unemployment. Thus we know that the Japanese society is too much protected society and that the feeling to be protected leads to royalty to companies.

What will happen if mobility is increased? The Japanese society will become closer to the American-type discussed above. It is another question whether Japanese people will accept this change.

You may expect that Japanese company is not so stupid to choose students by their university. But only recently some Japanese companies began to choose without asking their university. This shows that their choice has been affected by university

## Part II. Economic Development in Lao Style

### Chapter 7. Open Door Policy

#### Japan as a Socialist Country and Planned Economy

In the sense that Japan has economic plan, Japan was a planned economy. However, it was too flexible to call it a plan. The plans were hardly implemented completely. Always the economic situation changes or the target was reached within the plan period and so the plans were replaced by new one. The true role of the Japanese economic plan was to guide the private sector and not to control the economy.

Nowadays, even socialist countries accepted the importance of market mechanism. The failure of planed economy is the lack of incentive. Market mechanism is a more effective incentive system. Market mechanism assumes that people will work according to the profit or income. The higher the profit or income, the harder people will work. This is the essence of the market economy. There are many laws and regulations that restrict the activity of people and therefore the market mechanism. In Japan, people argues deregulation because people need to remove those regulation in order to start new business which is often prohibited by the existing regulations.

#### Corruption

I will show you an argument which may support a kind of corruption, which sometimes troubled me. Of course, I do not recommend corruption but I just show you as an exercise of incentive problem. Imagine a traffic police who catch a driver who does not observe traffic rule. The driver has to pay the fine at a police station which is far away from the spot. He considers which is better, to go to police station to pay the fine or to pay some money to the policeman to overlook his case. The latter is the case of corruption that I want to argue in this section. It is not difficult to expect them to reach to agreement. For the driver, if the amount of the

payment is less than the fine plus inconvenience to go to police station, he will agree to pay. For the policeman, if the risk to be revealed is small enough, he will receive it. If this practice becomes wide-spread, what will happen? There will be to a market price of the corruption. Now we have to think about the incentives of the policemen. Now that policemen receive higher income according to the number of drivers that they catch, policemen will be much more keen in catching the drivers who do not observe rules. This is the incentive to work for the policemen. On the other hand, the drivers will know that policemen is keen in catching and they will observe the traffic rules. This is consistent with the purpose of the traffic rules. If so, does this mean that this kind of corruption is not bad?<sup>1</sup>

If this is possible, we can think about privatization of traffic police. The privatized company will receive the money as their income. The company will try hard to catch as many drivers as possible. If the company succeeds to develop a perfect monitoring system, every driver will observe the traffic rule.<sup>2</sup> As a result the income of the company will decrease to zero. To avoid this case, the company may not catch 100 percent of bad drivers.<sup>3</sup>

I notice again that this argument is not to support corruption but to show the incentive to work. We should not admit corruption in any case. However, where corruption occurs, some of the regulation or incentive system might be wrong. We should improve the regulation to reflect the incentive of people. For example, the policemen may be paid according to the drivers who do not observe the traffic rules.

The essence of Japanese management system such as TOYOTISM is how to make people work harder. It is based on Japanese culture and it is not easy (and

---

<sup>1</sup> There is some difficulty in this argument. One is that for a very rich people, they will not observe the traffic rule because they do not worry to pay small amount of money. A way to solve this problem is to force such a rich driver to pay more. Maybe the amount of money may be changed according to the type of the car.

<sup>2</sup> This may not be true for the rich driver as mentioned in the previous note.

<sup>3</sup> This is possible before the privatization. Policemen may not catch every bad drivers because this might eliminate the chance to receive money.

not clever) to introduce to Laos as it is. It must be adjusted to the situation of Laos. It should be created by yourself. You need not create Lao management system from nothing. It is a result of accumulation of small progress. You should always think about how to improve the situation. If you continue this effort, you will have your own style of management.

### Which Industry should Laos be Specialized?

An orthodox theory of economic development will recommend you that your country should specialize to the industry where your country has comparative advantage. The concept of comparative advantage would be easy to understand if there were only one factor of production such as labor as Ricardo used in explaining the concept. But in the real world it is very difficult to identify which industry has comparative advantage because there are many kinds of factor of production. Furthermore, it is not so simple that this country will develop if industries are correctly selected. This idea is similar to that of economic planning which neglects the efforts of people. This aspect is more important.

Usually it is believed that the comparative advantage exists in a industry which uses the abundant resource of the country. For example, a labor-abundant country is expected to have comparative advantage in labor-intensive industry while a capital-abundant country is expected to have comparative advantage in capital-intensive industry. Laos is not a labor abundant nor capital abundant but natural-resource-rich country and therefore Laos is expected to have comparative advantage in natural-resource-intensive industry such as forestry and hydropower, etc. It is sure that these are very important industries in Laos at present. Is there any other industries that can be established in Laos in the near future? Is it possible for Laos to have the most advanced high-technology industry? There are many cases of failure in the efforts of this direction. The answer will be very pessimistic so long as we believe the old theory of economic development. When Japan tries to establish automobile industry in the 1950s, there were controversy. Those who against the idea insisted that automobile industry was not suitable for

the Japanese resource endowment. This argument neglected the fact that people can change the circumstances, for example, technology or production method. Technology can be adapted according to the situation of the country.

There is a economic theory to which people pay attention recently. It is the evolutionary theory. This theory includes a wide range of economic theory and still not well-organized and it is difficult for me to explain it clearly. But I can point out some characteristics of this theory.

One of the most important characteristics of this theory is that it is not deterministic as the classical theory. As the case of international division of labor shows, the classical theory insists that industries which a country should specialize are determined by the factor endowment and technology. But this idea is too static. Technology can be changed or adapted to different situations. Management system also can be adapted or created. The classical theory did not discuss the efforts of people explicitly and assumed that technological progress is given from outside. In fact the efforts of people and also the government have an important role in this aspect. Schumpeter emphasized the role of entrepreneurs in economic development which is called CREATIVE DESTRUCTION. In this sense, the new theory is Schumpeterian.

Another characteristics of the new theory is PATH DEPENDENCE which means that history or past events have influence on the future path of economic development. In the classical theory, circumstance such as factor endowment and technology determines everything. Economy is changing according to the changes in circumstances. Impact of the past is not taken up explicitly in this theory. If a economy is stable, this might not be so important. But it is sometimes unstable and a very small event in the past could make a big difference in the Future. It is not certain what will make a big difference in the future. The more such small events, the larger the possibility for some of them to develop. Now I want to emphasize the efforts to introduce new technology, information, and innovation which may become a "seed" of future development.

## Cooperation and Competition

When I was in Savannakhet in last January, I met two young Japanese volunteers. One was working at a high school and the other was working at agricultural office. When we had dinner at a restaurant on the bank of Mekong river watching the other side of the river, they told me that even if they become sick, they could not go to the hospital on the Thai side because of the regulation of Japanese side.<sup>4</sup> They said the facility of Thai hospitals is better than Lao hospitals.<sup>5</sup> The reason why they cannot go to the Thai hospital is the regulation of Japanese volunteers, that is, once they delegated to a country, they cannot go out of the country without the permission of their head office. They have to come back to Vientiane if they want to have better medical care than in Savannakhet.

There are other cases that they want to go to Thai side. For example, there is a shop selling automobile parts which is necessary to the class in school, but which is not sold on the Lao side. He, the school teacher, cannot go to Mukdahan and had to order through Vientiane. This procedure, of course, takes much longer time than crossing the river and sometimes more expensive. Anyway, this is very inefficient.

There might be some reasons for such a irrational regulation. One reason is that volunteers may be better to live in the same way as the local people if they want to know the lives of local people. Another reason might be that if they are allowed to go outside the country freely, they may not concentrate on their jobs and traveling the neighboring countries<sup>6</sup>. There may be other reasons but still I think the regulation should be more flexible than this and allow them to go outside the country. Japanese society is full of such regulations and constraints so that the possibility of young people are limited. This kind of regulation which constraints

---

<sup>4</sup> The vice-governor told me that the Lao government allows them to cross the river freely.

<sup>5</sup> Sorry, but for me, it seemed to be so, when I visited to a hospital in Savannakhet.

<sup>6</sup> I think they should have chance to look around the area and learn more. They came to Laos to work for the Lao people and will not neglect their jobs. Some of the Japanese volunteer delegated to foreign countries sometimes have a trouble with local people. In this case, it is a refreshment and mental care for them to travel the neighboring countries.

the activity of young people is a very serious problem in Japan now. This problem will be discussed later in this lecture.

When I heard about the problem of border, I thought about inefficiency. Generally speaking, to restrict the movement of people and also goods is a constraint to the efficient allocation of goods and services. In this sense, the border (in this case between Laos and Thailand) is a constraint to the efficient allocation of goods and services. In terms of economic efficiency, to remove the border is the best way to attain the more efficient situation. This is the basic idea of economics in which the market mechanism functions so as to attain the efficient allocation.

Let's think about the case of hospital. If the Lao people are not allowed to go to Thai hospital<sup>7</sup>, the Lao government has to build a hospital in Savannakhet and actually there is. If there is no border and people can move freely, there is no need to build two hospitals across the river.<sup>8</sup> This means the inefficient allocation of government budget if two hospitals are built on the both sides of the river.<sup>9</sup>

What will be the efficient allocation? Economists are trained to think efficiency and in this case they will answer that only one hospital may be necessary on either side, Laos or Thailand.<sup>10</sup> If the hospital is on the Thai side, the Lao people should cross the river to take medical care while on the other hand if it is located on the Lao side, the Thai people should cross the river. In fact this seems unrealistic because this is related to the matter of security and dignity of a country. When the two countries become hostile to each other, the country which depends on the hospital in the other country will feel dangerous. This is a pessimistic view. But we can think positively that they cannot become hostile to each other if they depend on each other. Thus the mutual dependence is a way for security. In the EU,

---

<sup>7</sup> I do not know this is really the case or not. This is just an example.

<sup>8</sup> There is another constraint of social insurance but I neglect this matter here.

<sup>9</sup> This kind of inefficiency can be happen even within a country. If two provinces want to have their own hospitals, these hospital might be build next to each other on the border of the provinces. This is a coordination problem.

<sup>10</sup> Exactly speaking, this may not be a correct answer because two hospital might be necessary. In this case both sides have their own hospital. But we neglect this case for simplicity.

Germany is willing to depend on the other European countries because it render security to other countries. Is such a relationship possible between Laos and Thailand or between Laos and its neighboring countries?

Now we continue our discussion on hospital. If it is admitted that one country depends on the other, they can establish a relationship of complementarity. Now we assume that Thai hospital is better than Lao hospital.<sup>11</sup> When will the Japanese volunteer go to the hospital in Mukdahan? It is when their sick is serious. If it is not so serious, they will go to a Lao hospital. Now we think about the efficiency of the government budget allocation. This case shows that the Lao hospital can concentrate on basic care and need not to invest in modern technology. This complementarity might result in a efficient allocation of government budget. In other words, maximum result can be achieved with minimum expenditure. In a sense, the Lao people make the best use of the Thai hospital.

You may feel that Laos should have at least the same level of medical care as in Thailand and that to depend on Thailand is not tolerable. If the government budget and personnel are not limited, you can invest in every aspect. If they are limited, something must be surrendered.

Another example of mutual cooperation between Laos and Thailand is printing. When I came to Laos, I thought that it is very difficult to find out bookstores and newsstand. I was looking for a newspaper which reported about my lecture but I could not find out. Then I realized that in Laos even bookstore is also very few. It goes without saying that information is very important for economic development because the more information you have, the more efficient decision making you can make. There might be some reasons for limited supply of books and newspaper. One reason might be that printing cost in Laos is very expensive. Printing industry is an industry of increasing return to scale (or scale merit in other words), which means that average cost of production is decreasing as the amount of products is increasing. For example, academic books whose market is

---

<sup>11</sup> You can assume the opposite if you prefer it. I do not know which is closer to the reality.

usually very limited (for example 1,000 books) must be sold at a very expensive prices (for example US\$50) while essays and novels can be sold at much cheaper prices (for example US\$20) because they may be sold at a much larger number.<sup>12</sup> Unfortunately the Lao population is very small and therefore the number of readers is also limited and as a result printing cost becomes very expensive.

I am wondering the possibility that Lao people read Thai books. Lao language and Thai language are close to each other and many Lao people can read Thai. A question for Lao people is which is cheaper, imported Thai books or translated Lao books. According to the nature of increasing return to scale, imported Thai books may be cheaper. Let's think about a case of university textbook. Suppose that the students can read both English and Thai and that the government will provide the textbook for university students. Then the government compares the cost of imported English book, imported Thai books and translated Lao books. The solution is very simple, just to choose the cheapest one.

But this solution has a very big problem. In a short term, this may be correct but in the long run this is harmful because it becomes an obstacle to develop its own experts. Thus we have to keep both the short-term and long-term objectives in our mind.

We will continue our discussion of cooperation between Laos and Thailand. When I first came to Laos, it seemed very strange for me that we can use kip, baht and US dollar similarly. This situation is the same in Cambodia, Vietnam and Myanmar. I feel very strange because in Japan, we can use only Japanese Yen. I wondered how to measure inflation rate in this country. Do you measure it by kip, by baht, or US dollar? Officially it is measured by kip. But what is its meaning? We can use it so as to control money supply.<sup>13</sup> However, if it were not used widely, it

---

<sup>12</sup> The phenomenon of increasing return to scale is observed in industries where fixed cost is an important factor. Total cost is composed of fixed cost and variable cost. The fixed cost is not changing even though the amount of production may increase while latter increases.

<sup>13</sup> If goods are imported freely, the price level is determined outside the country. Maybe the inflation rate is determined by that of Thailand. If inflation rate in terms of kip is determined by that in Thailand and exchange rate, the Lao government may be able to control the inflation rate by exchange rate only. I suppose, however, the situation is not so simple as this.

has little meaning to the people. My question is whether it is efficient that Laos has its own currency? Does Laos need its own currency? You may answer quickly that you need your own currency because it is a symbol and dignity of an independent country. This is a rather emotional answer. Economically what will be the answer?<sup>14</sup> If you give up your currency and decide to use foreign currencies in Laos, you need not worry about issuing kip, controlling money supply and speculation. In this case, you will depend on foreign countries in the aspect of monetary policy. This is not necessarily unrealistic arguments. The EU is now moving towards abolishing the currency of each country and adopt a common currency. Will ASEAN follow them? Will Laos go ahead of other countries?<sup>15</sup>

We have discussed complementarity in this section. It is a way to save government expenditure and therefore a more efficient allocation of resources. In this sense, it is similar to the idea of division of labor of orthodox economics. However, there is one problem. Once you depend on other country in some aspect, it will become very difficult to recover the previous position. For example, once Laos abolish its own currency, it will lose the knowledge to issue and control money supply and it will take time to prepare to issue its own currency.

On the other hand, the importance of competition is like this. We will discuss tourism industry as an example. Now many countries try to promote tourism industry. "Visit Myanmar Year," "Visit Thailand Year" etc. are the case. In this aspect, Laos cannot depend on other countries. Laos has to promote tourism industry by itself and has to compete with Thailand and other neighboring countries. Laos should offer more attractive tourism spots than neighboring countries. Through this process, these countries can improve the situation of tourism industry as a whole. This is the important effect of competition. We should

---

<sup>14</sup> I am asking in a somewhat provocative manner. I am not insisting to abolish Lao currency but this is just a practice of economics.

<sup>15</sup> I emphasize again that these arguments are mainly for a practice of economics. I am not an expert on financial economics. Please think by yourself.

think about this dynamic aspect of competition. We should distinguish the dynamic aspect and static aspect of competition. Static aspect is that the Lao tourism industry may not be competitive and may lose the competition. This is the argument that less-competitive industries ask the government for protection. And they often became the burden to the people. Let them compete and improve their efficiency. This is what we should learn from economics.<sup>16</sup>

### Globalization and History

Globalization is a phenomenon that goods, services, money, technology, information, etc. move across countries more and more freely. The opening-up of the Lao economy since 1986 is also in this direction. Many other socialist countries also opened up their economies, too, for example, China, Vietnam Myanmar, etc. On the other hand, capitalist countries also deregulated gradually to make its economy more open.<sup>17</sup> All these phenomena are towards free trade. After the end of the Cold War, this trend accelerated. They opened their economy not only because they realized the merit of international trade but also because they have no other choice than to follow this trend. It seems to be evident that a country will be far lag behind in economic development if they keep their country closed.

Now I want to discuss the difference between globalization at present and colonialism in the past. We limit our discussion only at economic aspects. In economic terms, colonialism is an effort to open up the economies (until then many Asian countries closed their economies). This is insisted at least for UK. (For France, their purpose might be a little bit different.) In this sense colonialism is similar to the present globalization. Some scholars even re-evaluate (or sometimes appraise) the economic development under free trade of colonialism. If we accept this idea, it implies that the globalization at present is just a re-emergence of the free trade under colonialism. They argue further that the only way for

---

<sup>16</sup> Exercise: How can Lao TV program improve its quality through competition?

<sup>17</sup> Japan is also the case but delays in deregulation.

development is the market-oriented capitalism and that the efforts of industrialization after the World War II led by the government sector (and socialism) was meaningless. This argument, however, neglects the importance of history. We learned from the evolutionary theory of economic growth that history has an impact on the future path, which is called "path dependence." For example, Thailand which is relatively free economy might be still agricultural economy if the Thai government had not adopted import-substitution industrialization policy because they would have lacked the technological base. If Japan did not promoted heavy industry, it still remain the level of light manufacturing industry by the same reason. The new idea of economics emphasizes the importance of historical events. At a certain time in history, they need import-substitution policy to change the historical path. And we may think that socialism was another way to change the growth path.

### Big Push (Unbalanced Growth)

When the government budget is limited, then how should the government allocate their budget? There are two ways of allocation. One extreme way is to distribute equally to every item of the budget. And the other extreme is to concentrate to limited items, which may be called "strategic sector." We will call them "balanced budget" and "unbalanced budget," respectively. This terminology corresponds to the "balanced growth" and "unbalanced growth" in development economics. Both of them has merit and demerit. The merit of the balanced growth is equality and the demerit is the limited impact to change. Now the Japanese government budget is classified as "balanced" because of vested interests but they try to change to the latter type, emphasizing science and technology because Japan lags behind the U.S. in this field, especially information technology. Thus the merit of unbalanced budget is the opposite of the balanced budget. A problem of unbalanced budget is that the priority sector may not be chosen correctly. Nobody knows which sector is promising a priori. Success and failure of a sector depends on the efforts of the people and also volatile circumstances. The history of

Japanese economic development shows that there were many failures beside the splendid success.<sup>18</sup>

If government indicates the future direction of economic development, general people will also devote their efforts in that direction. The more people devote their efforts, the higher the possibility to success is. In Japan, many people discussed about the future of Japanese economy even while drinking.<sup>19</sup> When Japanese businessmen came to developing countries, they discuss the way of economic development of the country as if it were their own country. In this sense, most of Japanese are thinking as if they were a economic planner of Japan (and sometimes of foreign countries). I think most of their idea is something borrowed from somebody else and often nonsense. But if even a few percent of their idea is realized, it should be considered successful.

This idea is very stochastic and not deterministic. There is a philosophical shift in economics behind this argument. It can be compared to a shift from physics to biology. When economics borrowed the basic idea from physics, it was understood that the circumstances determined everything. For example, gravity determines the path of a throwing ball. In economics, the price level is determined by demand and supply which are given by taste, technology and factor endowment. The level of economic development is also determined by these factors. The level of capital stock determines the level of economic development. The more a country accumulates capital stock, the higher the income level is.<sup>20</sup> What people can do for economic development is just to save, invest and accumulate capital stock. The allocation of investment is according to market mechanism. This is the orthodox idea of economics. Economists have a clear idea to insist and the government and people have nothing to say. But this idea is too static and unrealistic. The government and people have something to determine their economic development

---

<sup>18</sup> The failure of balanced budget is compared to a story of hunter. When he shoot an animal (deer?) running in a group of hundreds, he should target only one. Unless targeting only one, you will miss all even though you are watching hundreds of deer.

<sup>19</sup> This may be true for old generation but not for younger generation.

<sup>20</sup> There are exceptions such as oil-exporting countries.

path. The arguments neglect the efforts of the people to innovate, adapt, reform, etc. These are the role of entrepreneurs of Schumpeter. An idea of evolution emphasizes the role of mutation. Innovation, adaptation, reform, etc. are comparable to mutation in biology. Mutation is stochastic and this idea is different from the determinism of physics, especially classical dynamics.<sup>21</sup> Now economists have less clear idea and less to say but the government and people have more to say and to do.

### University or College ?

Now we will discuss the case of establishing university in Laos as an example of the previous section Laos just established a national university by integrating existing colleges. (Please make clear the difference between college and university. University is a group of college.) The university has eight faculties, such as pedagogy and literature, law, economics and business, agriculture, engineer, medicine and so on.<sup>22</sup> What I want to ask now is which faculty is the most important for Laos and can be up-graded to the international standard or even higher.<sup>23</sup> If such a faculty exists, the government should concentrate its budget and personnel to the faculty. And if this policy is successful, then the faculty will gain international reputation and foreign researchers and students will come to the college to conduct a research or study. Furthermore, research fund may flow to the college, which will improve the facility of the college. This strategy emphasizes college rather than university as a whole. In comparison with the previous section, this strategy is similar to “unbalanced budget” while the other strategy to allocate government budget equally to each faculty is similar to “balanced budget.”

I emphasized the merit of the unbalanced budget but it is unfair not to

---

<sup>21</sup> I am arguing in a very simplified manner. The comparison between physics and biology may not correct if exactly speaking.

<sup>22</sup> I am not sure these are correct or not. Errors should be corrected if there is any but those errors would not affect the meaning of this section.

<sup>23</sup> Please think by yourself which faculty is promising. Many ideas were given in my seminar by the participants such as forestry. Establishing IFRI (International Forest Research Institute) like IRRI (International Rice Research Institute) in the Philippines was also an idea. Those ideas mostly related to the existing industries but we should not limit our possibility to them.

mention the demerit of the strategy. Now Laos needs educated staff to change its social system. The education needed will range over a wide variety of subjects. If the strategy of unbalanced budget is adopted, university would not be able to educate such a wide variety. A realistic solution may lie between the two extreme strategies.<sup>24</sup>

Foreign advisors may recommend the strategy of "balanced budget." They will argue that Laos should bottom-up the educational level in general and need not to have a far-advanced faculty. This idea is similar to the theory of economic development stages. This theory insists that the stages of economic development started from agricultural economy, take-off to industrialization, industrialized country, advanced country, etc.<sup>25</sup> When we learned this theory, we inclined to think that every country should follow the same process. Firstly labor-intensive industry should be developed and then more capital-intensive industry should be developed gradually. But the science developed so fast that the situation becomes more complicated. For example, Laos can establish an entirely new and modern-technology industry by "importing" a whole set of an industry by FDI (foreign direct investment). If the Lao government provides enough privileges to FDI, they may come. But it is not so easy because now many developing countries are competing in receiving FDI and offering tax privileges to attract FDI to Laos. Moreover there are many disadvantages in Laos such as transportation, infrastructure, information.<sup>26</sup> Laos should compensate these disadvantages with tax privileges and other measures.<sup>27</sup>

---

<sup>24</sup> This idea is applicable when a new industry is established.

<sup>25</sup> There is a variety of the theory. This is only one example.

<sup>26</sup> The industrial estate near Chiang Mai in Thailand may be of value for reference because it is also far from seaport.

<sup>27</sup> An idea of making a research institute or college in Laos the most advanced and most famous in the world is to invite the most famous scholars from all over the world by offering high salary. A weak point of this idea is that the character of the institute is not of Laos.

## Chapter 8. Globalization

In the age of globalization the old theory of economic development may not be applicable. One reason is that a country does not necessarily develop gradually from labor-intensive to capital-intensive industries because technology is available outside the country and can be imported by FDI or technology transfer. Technological progress makes the past experience of developed countries obsolete. Country-level analysis is becoming unsuitable in the age of globalization. For example, industrial allocation in a region (such as Asia) is determined geographically. An industry moves searching for the optimal location. This is a process of reallocation of industries and therefore it is not a economic development of an isolated country. In this chapter we will review the past theory of economic development first and then discuss the globalization in Asia.

### A Brief Review of Past Development Theory

In this section we will briefly review two theories of economic development; one is the stages of economic development and the other is the flying geese pattern of economic development. The first is the idea of Rostow and others and insists that an economy passes through several stages from agricultural to industrial economy. It is supposed that every country should pass these stages in order to develop its economy. This theory is lacking in international consideration. The second was originated from a Japanese economist, KOJIMA KIYOSHI, and is called flying geese pattern. The flying geese pattern looks like a wedge shape "<". The most developed country locates at the spearhead and is a front runner. The less developed countries follow them. At the tail of the line is the least developed country. In the case of Asian countries, the front runner is Japan (at least at present. I am not sure whether she can be so in the future, too). The second group which follow Japan is composed of Asian NIEs (Newly Industrialized Economies) such as Singapore, Hong Kong, Taiwan and South Korea. ASEAN countries are the third group and follow Asian NIEs. Laos, China, Vietnam, Myanmar, and

Cambodia are the last group. This idea is better than the former because it takes into consideration the international situation but it still supposes that any country should follow the same pattern of economic development.

The background idea of these theories is that any country should upgrade its technology step by step. This may be suitable when many countries adopted less-open policy where technology, capital, and people are not so movable as at present. However, we have to change this idea for the time being. The current rapid economic growth in Asia is occurred by reallocation of industries.<sup>28</sup> Thus economic development of a country depends on which industry is reallocated to that country. Reallocation period will not be so long, maybe about ten years (unless changes in circumstances occur continuously.) This situation makes the governments of developing countries hasten to obtain FDI. Reallocation of factories is sometimes determined by careful calculations and sometimes by chance such as political stability at the time of decision making, existence of forerunner. These factors are not necessarily related to the level of economic development.

### Economic Development in the Age of Globalization

Globalization is in fact a combination of regionalism. Regionalism is an effort to make a region an economic free area. The examples are EU (European Union), NAFTA (North American Free Trade Area), and AFTA (ASEAN Free Trade Area). There are two contrasting opinions on regionalism. One is pessimistic and considers that regionalism is an economic block and hazardous to free trade. The other is optimistic and considers that regionalism is a first step to global free trade.<sup>29</sup>

In a sense, globalization promoted the movement towards regionalism.

---

<sup>28</sup> In terms of economics it is a movement from one equilibrium to another. When this reallocation comes to an end, the economic growth in Asia also will slow down. This is my understanding of the rapid economic growth in Asia.

<sup>29</sup> It is assumed that free trade bring about efficient allocation of resource and maximize the wealth of people as the classical economics insists.

Regionalism is a way to prepare for the age of globalization. For example, let's think about a case of three regions, that is, America, Europe, and Asia. If globalization is realized without the process of regionalism, every company is exposed to the international competition and the most efficient company in the world, which is often the biggest one, will dominate an industry and become a global monopolist under the condition of increasing-return-to-scale.<sup>30</sup> The country or region in which this company locates will insist to move to globalization as soon as possible. But for the other countries or regions, they will insist regionalism because their companies may lose in the global competition. They intend to improve their competitiveness within a region whose market size is larger than a country and is more suitable for increasing-return-to-scale. After they improve their competitiveness in a regional level, they will open the region to the global competition. Thus, it can be considered that regionalism is a step to globalization and this view is optimistic one.

This case shows how important the process is. Two processes, with and without regionalism, which may be called strategy, will bring about different results. This is path-dependence.

## ASEAN and AFTA

Now we will discuss ASEAN as an extension of the previous argument. ASEAN countries set a target to complete AFTA (ASEAN Free Trade Area) in 2003. AFTA aims to integrate the markets of ASEAN countries into a single market. As discussed above, the efficiency or productivity will increase as the production size increase due to the increasing-return-to-scale. In this process, industries will be reallocated more efficiently. The classical trade theory insists that every country will gain by the more efficient allocation of resource through trade (in other words, by the reallocation of industries). Each country will retain those industries which

---

<sup>30</sup> Increasing-return-to-scale (or scale merit) is a phenomenon that average production cost is decreasing as the volume of production increases. This characteristics is particularly important for modern industries such as automobile.

have comparative advantage and lose those industries which do not have. In this theory, it is not argued which industry leads to economic development and which does not. It is presumed that every country will gain from free trade. This may be true in the short run but may not in the long run. We should be careful for the selection of industries because development path will be affected by the selection. For example, compare between textile industry of Japan and rice industry in Thailand in the latter half of the 19th century.

An illustration of the reallocation of industries is the automobile industry. In most ASEAN countries, automobile industry started as a result of import-substituting industrialization policy in the 1960s. Each country tried to establish their own automobile industry because automobile is a symbol of economic development. When the industry started, the market size was very small and the technological level needed was low because they conducted only the last process of manufacturing, that is assembling the imported parts. This process required only primary level of technology so that even the developing countries can "produced" a car. When this phase was completed, ASEAN countries requested the automobile manufacturers to localize the production of imported parts. This means that the stage of import-substitution proceeded from assembling to the parts production. After negotiations between the government and auto makers, the government set the target and the auto makers began to localize the parts production. Localization took a long time and they repeated negotiations. When this negotiation failed, some companies withdrew from the country. In order to such a case, the government had to be very careful. If the government requires too much, the companies would withdraw. On the contrary, if it requires a little, localization would not proceed. Situation will also change in the phase of business cycle. In the economic boom, it will be easier for the auto makers to accept the request of localization and on the contrary in economic recession, they will not agree the request. This negotiation is similar to a case of game theory. In the game theory, each actor should take into consideration the reaction of the other. The Thai government showed its talent in this negotiation and succeeded to make the auto

manufacturers to localize step by step and Thailand now has a well-developed supporting industries (parts makers). The other ASEAN countries also more or less succeeded in the localization.

When ASEAN countries agreed AFTA, the auto companies began to reallocate their factories established in ASEAN countries during the period of import-substitution. For the last ten years the ASEAN countries adopted BBC (Brand to Brand Complementation) scheme, which offers tariff privilege for the imports from a factory of the same company in other ASEAN countries. Though BBC scheme is replaced by AICO (ASEAN Industrial Cooperation), its effect is the same as before. Under these schemes, the automobile companies are reallocating its factories in ASEAN countries so that the most efficient allocation will be achieved. In this process, the production of a less efficient factory is transferred to the most efficient one and the less efficient one will be closed. To concentrate production to a factory is a way to utilize increasing-return-to-scale. Even though any country will not lose all auto factories due to the agreement, the impact of the reallocation will differ among the countries. For example, the assembling factory can be established for a very small market as the early stage of import-substitution shows and their impact will be very small. On the other hand, if a country succeeded in gathering parts factories, it will have external economy and its growth will become self-sustaining. Thus increasing-return-to-scale and external economy has a the selection of technology will have large impacts on the development path.

### FDI Policy of ASEAN countries

Now almost every country welcomes FDI (Foreign Direct Investment). This is very different from the situation in the 1960s and 70s when the government of developing countries restricted the activity of foreign capital. They were suspicious of their economic power. This might be a reflection of the colonial history. On the contrary, the Thai government welcomed FDI even in the 1960s

maybe because Thailand was not colonized.<sup>31</sup>

The situation changed in the 1980s because it became apparent that FDI had an important role in the economic success of Asian NIES and some ASEAN countries. Those countries succeeded in economic development by introducing foreign technology and investment. In the early 1980s, many developing countries began to reform its institution and improved investment incentive laws. These countries began to offer better conditions for FDI than other countries. This became an competition for acquiring FDI. If a country offer better conditions, another country also offer the same, or better, conditions in order to attract FDI.

To offer better condition is a loss to the government (and domestic businessmen). For example, if the government offer tax reduction, it means a loss to the tax revenue. But the governments have no other choice than to enter this competition. Through this competition, the investment promotion policies of ASEAN countries becomes similar to each other. If Laos want to receive FDI, it must offer better condition because of its locational and other disadvantages.

### ASEAN and Laos

The previous discussions show economic reasons why ASEAN countries want to expand its membership to ten. Then what is the reason for Laos to join ASEAN? I asked many people during I was staying in Laos: "what is the merits and demerits for Laos of joining ASEAN?" The answers can be summarized as follows:

#### [Demerits]

- (1) The government revenue from import tariff and export duty will be decreased because tariff rate should be lowered.
- (2) The government expenditure will be increased to prepare for joining ASEAN and paying "membership fee." (The Lao government should dispatch its staff to ASEAN meeting which will be held several hundreds times a year.)

---

<sup>31</sup> In the 1970s the Thai government also restricted FDI.

(3) Import will increase faster than export and as a result the trade deficit will increase.

[Merits]

(1) Laos will not be isolated.(This answer ranges from very emotional to diplomatic.)

(2) FDI (Foreign Direct Investment) will come to Laos.

(3) Laos can export its products such as maize to Thailand.

(4) Laos can obtain information and modernize its society.

Some of the merits and demerits can be estimated in money term while some of them cannot. The decision of the Lao government to join ASEAN indicates that they estimated the benefit (merits) larger than the cost (demerits).<sup>32</sup> On the other hand, the ASEAN countries also calculated the merits and demerits to accept Laos as a member country and may have concluded that the merits exceeded the demerits.<sup>33</sup>

### Will Japanese FDI come to Laos?

This is the question that many people asked me during I was staying in Laos. They expected Japanese companies will invest to Laos because she opened her economy. This is a very optimistic view. For many Japanese the answer seems to be very pessimistic. We will answer this question by reviewing the factors that make Japanese companies to invest in foreign countries.

The most important factor of Japanese FDI is labor cost. In the latter half of the 1980s, after the appreciation of Yen, it became more and more difficult to export from Japan to other developed countries. Therefore, many Japanese companies transferred their factories to Southeast Asia to use cheap labor in these countries. Unfortunately Laos does not have enough labor, especially those who

---

<sup>32</sup> The merits and demerits cited here may not be complete and some important factors may be missing.

<sup>33</sup> Here we can analyze this situation by game theory. In this framework we can analyze the possibility of negotiation and compromise. The situation depends on the information available to each side. The situation is more advantageous to the side which has more information. Does Laos have enough information?

are trained as a factory worker. Laos is lacking experience in this aspect.

Another factor is the domestic market. If the domestic market is large enough, Japanese companies will invest. This is the case of China. Unfortunately the domestic market of Laos is so small due to small population and low income level that this is not applicable to Laos. Even though the market may be small, FDI may come to Laos if the domestic market is protected. This policy was possible in the 1960s and early 1970s when the import substitution policy was adopted. But such a policy is becoming more and more difficult because the pressure of free trade.

The problem of small domestic market can be avoided if the products are exported. A large part of FDI is targeted to export market. Unfortunately Laos is a land-locked country and has no seaport.

Japanese companies already have a production base in Thailand and to invest in Laos is a duplication of investment and inefficient.

All these factors lead to a pessimistic view. But we should not be too pessimistic. There is a niche of investment which is suitable to the circumstances of Laos. We just need a new idea to attract FDI. Now I mention two cases which may be useful for Laos. One is the case of industrial estate near Chiang Mai and the other is the case of Maquiladora in Mexico.

Chiang Mai is far from seaport in Bangkok and is not so much different from Laos in this aspect. Nevertheless there is an industrial estate in the suburbs of Chiang Mai and Japanese companies invested there. They use transportation by air. Institutions for air transportation and customs check were improved for the industrial estate.

Maquiladora is a bonded industrial estate system of Mexico. Mainly U.S. companies invested in Mexico along the border to make use of this system and cheap labor. Capital, technology, parts, etc. come from U.S. and only cheap labor and land are supplied by Mexico. This kind of investment was accelerated after NAFTA (North American Free Trade Area) was started.

Lao people always complain that Laos is lacking in capital and therefore that they are waiting for FDI. This attitude seems to be too passive. You can borrow money from banks if the project is profitable. The project must be found out by the Lao people by themselves. Do not wait for foreigners to come to find them for you.

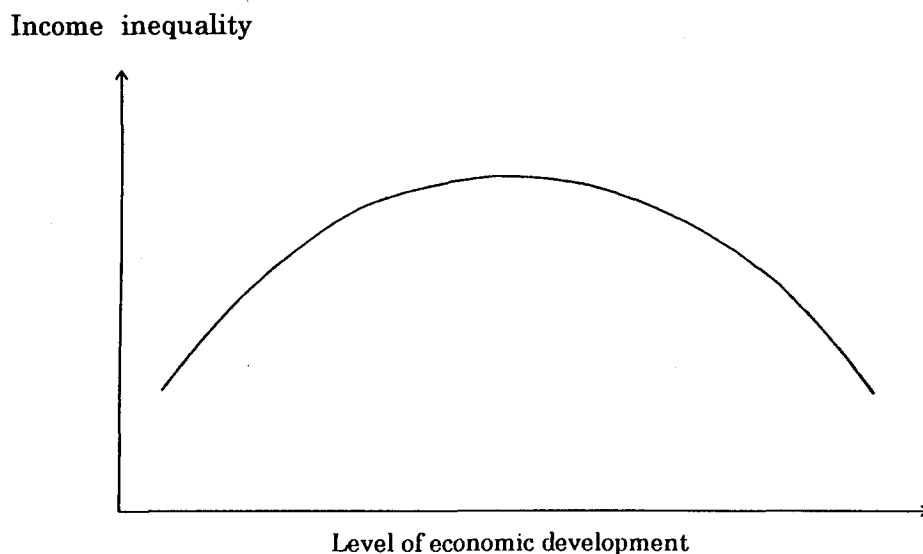
## Chapter 9. Income Inequality and Fairness

It is said that income inequality is increasing in many countries after globalization. In this chapter I will survey the studies of income distribution and changes in income inequality in Asia and then try to explain the causes of recent increase in income inequality and discuss its meaning in economic development.

### Kuznets' Hypothesis

One of the most important topics of income distribution is the relationship between income inequality and economic development. Simon Kuznets found out a relationship as follows: The income inequality increases as an economy begins to develop and the increase continues until the economy reaches to a certain level of development. But after this point the income inequality starts to decrease. A graph of this relationship looks like Figure 1. The shape looks like an inverted U-shape and therefore this hypothesis is also called "Kuznets' inverted U-shape hypothesis."

Figure 1. Kuznets' Curve



An intuitive explanation is as follows: Think about a very extreme case of transforming from a perfectly agrarian economy to a perfectly manufacturing economy. Here we assume that there are only these two sectors. In the agricultural sector, every household receives the same amount of income to each other, which means that there is no income inequality in this sector. On the other hand, we assume again that every household in the manufacturing sector receives the same amount of income to each other but that the income level is higher than that of the agricultural sector.<sup>34</sup> Now we consider the transformation mentioned above. The perfectly agrarian economy is composed of only the agricultural sector while the perfectly manufacturing economy is composed of only the manufacturing sector. At the beginning there is no inequality in the perfectly agrarian economy as assumed. In this process of transformation from agrarian to manufacturing economy, the income gap emerges between the two sectors. When this economy reached to another extreme, the perfectly manufacturing economy, then there is no inequality again as assumed. This is the inverted U-shape curve of income inequality. If we measure this change by some inequality index such as the Gini coefficient, the curve will be drawn as a smooth curve like the above figure.

In a more general terms, it is expressed as follow: Consider a case that a new industry is introduced to an equal economy. The new industry will bring about higher income to those who engage in this industry. As the new industry expands, the income inequality between in the economy as a whole is increasing. But when the new industry becomes dominant in the economy, the income inequality will become smaller.<sup>35</sup>

If we extends this two-sector model to three or more sector model, we can show the turning point will appear later than the two-sector model. If new industries are introduced successively and the newer industry will generate

---

<sup>34</sup> This assumption seems to be unrealistic but it is just for simplicity of explanation. You can find out a more realistic explanation in Ikemoto [1991].

<sup>35</sup> There are many other factors which affect income inequality. For example, when the demand for agricultural products increases as the modern sector expands, the agricultural prices and therefore their income will increase.

higher income, the income inequality will continue to rise. This case may be happening in Thailand now. We will discuss this case later.

### Income Inequality in Asia

Many empirical researches were conducted in the 1970s and 80s to analyze the situation of income distribution and to prove the Kuznets' hypothesis. What we learned from these researches can be summarized as follows:<sup>36</sup>

\*The level of income inequality of East Asian countries such as Japan and Taiwan was much lower than that of Southeast Asian countries.

\*Japan: Income inequality was already very low since the end of the second World War due to the democratic reforms and other social factors. The Gini coefficient was only around 0.3.

\*Taiwan: Income inequality was very low since the 1960s due to the various reforms before and after the War and labor-intensive industrialization. The Gini coefficient was 0.3.

\*Malaysia: In the 1960s the income inequality was increased. After the riot in 1969, the Malaysian government adopted the New Economic Policy (NEP) which aimed to reduce the gap between ethnic groups. In the 1970s, the income inequality was stable and in the 1980s it began to decrease due to labor shortage. This case is typical of the Kuznets' hypothesis.

\*Philippines: The Philippines was the most unequal country in the 1960s. This may be related to the social structure established during the colonial period. The income inequality was stable thereafter and the Gini coefficient remained unchanged until mid 1980s.

\*Thailand: Thailand was a country of relatively lower income inequality in the 1960s, which was between the East Asian countries and Southeast Asian countries.

---

<sup>36</sup> We mainly use the Gini coefficient as inequality index. The Gini coefficient ranges from zero to one. The higher the value of the Gini coefficient, the more unequal the income distribution is. The Gini coefficient is equal to zero when everybody has the same income level, or perfect equality. And it approaches one when the only one person occupies the whole income of the society, or perfect inequality.

Since then, income inequality in Thailand has been increasing until recently, even though there were some fluctuations. A factor of income inequality in Thailand is the gap between rural and urban area, or in other words, between Bangkok and other regions because the urban area is concentrated to Bangkok and other regions are dominated by rural areas.

\*Indonesia: Indonesia is often cited as a country of equal income distribution. But there is some problem because they sometimes refer to the distribution of expenditure instead of income. Usually expenditure is more equally distributed than income because the former excludes saving which makes distribution of income more unequal.

When combined these research results together, the Kuznets' inverted U shape can be found out. In fact, the relationship is not so clear because income distribution was determined by various factors and therefore deviated. Even though this difficulty, it can be said that one of the important factors of determining income inequality is the condition of labor market. The turning point of the income distribution roughly corresponds to the turning point of the labor market. When the labor market turns from labor surplus to shortage, the income inequality also begins to decrease.<sup>37</sup>

### Labor Market, Market Mechanism and Globalization

The importance of the condition of labor market can be seen from the history of Taiwan. Taiwan was successful in reducing income inequality at the earlier period of economic development. And the reason for their success was the development of labor-intensive industrial such as textile. The development of labor-intensive industries increased demand for labor and therefore the turning

---

<sup>37</sup> Labor market is called "surplus" when the demand for labor is less than labor supply, or in other words when there is unemployment and underemployment. On the contrary, the labor market is called "labor shortage" when the demand for labor exceeds labor supply. In this situation wages and salaries will increase and this is the factor to decrease income inequality.

point of labor market also reached at earlier level of development than other countries. Thus a lesson from the Taiwanese experience is that labor-intensive industries should be promoted in order to make income distribution more equal.

This lesson is consistent with the implication of the classical theory of international trade. In the international trade, the specialization depends on the resource endowment.<sup>38</sup> For example, a labor abundant country should be specialized in labor-intensive industries while a capital-abundant country should be specialized in capital-intensive industries. Taiwan was a labor abundant country and one of the factors that Taiwan succeeded in reducing income inequality was just what the classical trade theory insisted. On the contrary, the interventional policies such as import-substituting industrialization was accused to increase income inequality because these policies had a bias toward more capital-intensive technology. These arguments are in line with the appraisal of market mechanism. Thus from the viewpoint of income distribution the market mechanism was considered to be the best way. However, this may not be true in the age of globalization.

Since the 1980s in many countries, both developing and developed, income inequality has been worsening. The common factor of the inequalization is the shift in economic policies towards more market oriented. Reagan, Thatcher, Nakasone were the leaders in developed countries. Their policies are called "Reaganomics" and "Thatcherism" and aimed to activate the private sector. On the other hand, developing countries were forced to change their economic policies in the same direction by the international organizations such as World Bank. Income tax system was changed to bring about more work incentives for the rich class. The income tax rate was reduced for higher income class while consumption tax (or value added tax) was introduced to compensate the reduction of the government revenue from income tax. This affected against the lower income class. This is one

---

<sup>38</sup> Here I use the term "classical" to indicate those theories which attach importance to the market mechanism.

factor to increase income inequality. Developing countries also followed these reforms.

However, in the 1990s it is argued that international trade make income inequality worse. The argument of U.S., especially that of labor union, is as follows: When import tariff is lowered and cheap goods were imported to U.S., the industries which were damaged by imports laid off or fired their employees. The increased number of unemployed workers lowered their salary. If they changed their occupation to service sector, they could earn only lower salary than before. They accused of the cheap imports from developing countries and they argued further that developing countries can export at cheap price by illegal measure and unfair practice such as child labor, prohibiting labor union. By their pressure, U.S. and European countries want to discuss this topic at WTO and other international meeting.

It seems inevitable for the developed countries to lose labor-intensive industries. If they do not want to lose those industries, they have to increase their productivity. Ironically the way to increase productivity is to make the factory more mechanized by introducing factory automation. And this will result in reducing employment.

### Inequalization, Incentive, and Fairness

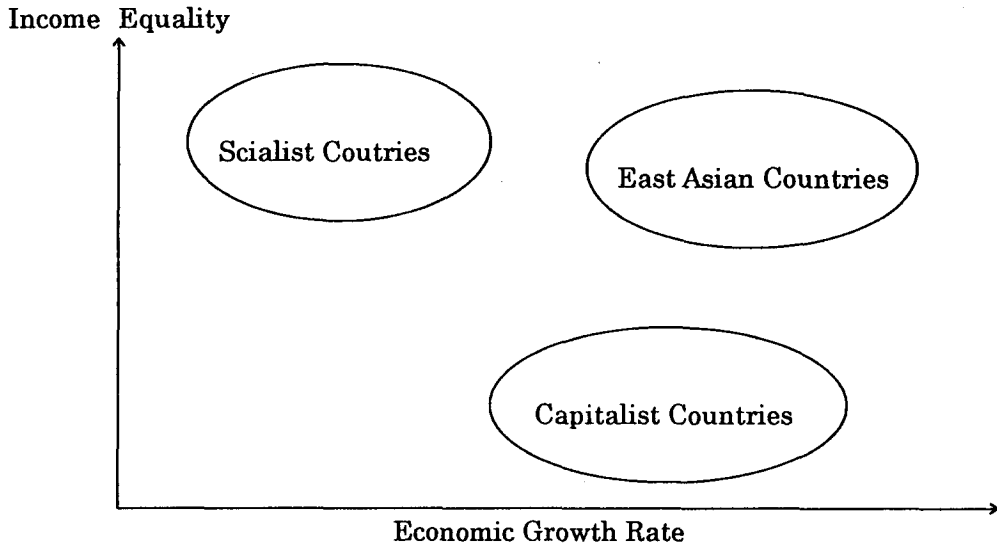
Socialist countries changed economic policies towards market-oriented in the 1980s, being aware of the problems of socialist economic system.<sup>39</sup> The problem is the failure in economic growth. Socialist economic system is usually believed to be equality-oriented and this is supported by statistical analysis.<sup>40</sup> Thus the problem is the trade-off between economic growth and equality. It is very difficult to attain both goals at a time. This relationship may be expressed as Figure 2.

---

<sup>39</sup> At micro level, they were aware of the problem already in the 1970s. For example, when I visited a textile factory of a state enterprise in Vietnam, they explained me their history of reform which started by the end of the 1970s.

<sup>40</sup> The Gini coefficient is extremely low, less than 0.2 for example.

Figure 2. Trade Off between Growth and Equity



The socialist countries are located on the upper left, which means relatively higher equality and lower growth, while capitalist countries are located on the lower right, which means relatively lower equality and higher growth. This is a simplified view and there are many exceptions. The East Asian countries are the exceptions. The East Asian countries could attain both high economic growth and equal distribution of income at a time. Due to this fact, the economic development of these countries are called "East Asian Miracle."

The World Bank report [1993] called these Asian countries "HPAEs" which stands for High Performing Asian Economies. HPAEs includes Japan, Asian four dragons (Hong Kong, Korea, Singapore and Taiwan) and three Southeast Asian countries (Indonesia, Malaysia and Thailand). These eight countries attained average annual growth rate of per capita GDP higher than 5 percent during the period from 1965 to 1990 while other countries attained only around 2 percent. The difference of 2 or 3 percent may be seemed to be small but the small difference for such a long period as 25 years will bring about a large difference. For

example, if 5 percent growth continues for 25 years, the income grows 3.4 times while if the growth rate is 2 percent the income grows only 1.6 times. In terms of percentage growth rate, the former grows 240 percent while the latter grows only 60 percent.<sup>41</sup> "Miracle" was not only the high economic growth rate but these countries attained equal distribution of income, poverty reduction, better health condition and so on. The point is whether the government intervention was effective for these performances. The report accepted partly its effectiveness in promoting economic development so long as economic policy is market-friendly. "Market-friendly" means that economic policies do not distort the market mechanism. By this logic they retained the principle of market mechanism.

The view that these countries attained both economic growth and income equality is too optimistic. For example, income inequality in Thailand has been increasing since the 1960s. And recent phenomena that market-oriented policy reform may have led to income inequality contradicts this optimistic view. The simple model mentioned above, which explains the change in income inequality by the transformation from agricultural to manufacturing economy, may not be applicable for an open economy. For example, in Thailand, this transformation started in the early 1960s and in the early 1980s the GDP of manufacturing sector exceeded that of agricultural sector. Though the employment structure is still dominated by the agricultural sector, the labor market reached the turning point to labor shortage in the early 1990s. Around 1990 the wage rate in rural area already began to increase and it is expected for income inequality to decrease as suggested by the studies on the Kuznets' hypothesis. But the Gini coefficient keep increasing until recently. The Gini coefficient of 1992 reached to a very high level, maybe among the highest in the world.

An explanation of this phenomenon is the continuous inflow of foreign capital or FDI. Now we have to divide the manufacturing industry into domestic

---

<sup>41</sup> If the initial income is  $Y(0)$  and the annual growth rate is  $g$ , the income level at 25 years later  $Y(25)$  is expressed as follows:  $Y(25) = (1+g)^{25} Y(0)$ . The growth rate for the 25 years (not annual growth rate) is:

$(Y(25)-Y(0))/Y(0) = (1+g)^{25} - 1$ . And  $(1.05)^{25} = 3.39$  and  $(1.02)^{25} = 1.64$ .

and FDI-based manufacturing sectors.<sup>42</sup> The simplest model takes into account only the agricultural and domestic manufacturing sectors. Now we have to bring the FDI-based industry into the model. Then what will happen? We should remember the fact that introduction of a new industry into an economy will often increase income inequality. Though it depends on the phase of the Kuznets' curve, the size of the new industry, etc., we can expect that it will affect to increase income inequality, surpassing the effect of decreasing inequality in the second phase of the Kuznets' curve. Thus we expect that continuous inflow of FDI will increase the income inequality.

FDI affects both capitalists and employees favorably but the higher income class is affected more favorably than the lower income class. The former class can be divided into two groups; capitalist and professional workers such as managerial class and engineers. As for the latter their job opportunity is increasing due to the continual inflow of FDI. And they move to a new job whenever the condition is better than before. Every time they change their job, their salary is increasing. As for the capitalist, their investment opportunely is expanding because the foreign companies are looking for partners to invest in Thailand and surrounding countries. The Thai government also supports their investment and BOI (Board of Investment) of Thailand widened its scope. When it was established in the early 1960s, its purpose was to promote the investment in Thailand. Now BOI is promoting Thai capital to invest in surrounding countries and other Asian countries. This idea was started when the former prime minister Chatchai promulgated the idea of "From Battle Field To Market Place." This idea led to "Baht Economic Zone." By the support of the government Thai capitalists could enlarge their investment opportunity. And this affected their income favorably.

Another factor which affects the lower income class adversely is the inflow

---

<sup>42</sup> Domestic manufacturing sector does not necessarily mean that they are owned by only domestic capital. Those companies established by foreign capital in the 1960s and early 70s may be included in this category because they are already "domesticated."

of cheap labor from surrounding countries. It is reported that they are working as unskilled workers and that their number reaches to 500,000 or more in Thailand. These workers are willing to work at lower wage than Thai workers. The companies want to employ workers at lower wage while labor union want to restrict the number of foreign workers. The Thai government seems to be on the side of the companies and decided to admit for the companies to employ the foreign workers on some conditions. Inflow of cheap labor has an effect to decrease wage rate of unskilled workers in Thailand and therefore increase income inequality.<sup>43</sup>

### Open Door Policy and Income Inequality in Socialist Country

Those factors of income inequality we have discussed in the previous section are more or less affecting income inequality in socialist countries. For example, in Vietnam those who are employed by foreign companies receive higher salaries than domestic companies. And FDI generates income in urban area but not in rural area, which will increase the income gap between rural and urban areas. Open door policy usually accompanies increasing income inequality and this phenomenon must have been expected. This point is one of the disputes for shifting to open door policy. Those who were against the open door policy accused the negative impact of income distribution.<sup>44</sup> Laos adopted the New Economic Policy in 1986 and began to open its economy. After a few month, Vietnam also chose the same policy called "*Doi Moi*." When changes are needed, opposition usually comes from the conservatives who are benefited from the current system. They argued the possibility of increasing income inequality and opposed the open door policy. In spite of this opposition the open door policy was adopted and this means that they chose economic growth at the expense of equal income

---

<sup>43</sup> Thai people are becoming richer and richer so that they do not prefer those unskilled jobs that foreign illegal immigrants want to do. This is an factor that eases the income inequality to some extent.

The extension of compulsory education until 15 years old is another factor to make the labor market tighten.

<sup>44</sup> Income distribution has been often a political issue. The opposition party is usually attack the ruling party at this point because its supporters are usually disadvantageous in income distribution and complain the maldistribution of income. Thus the opposition party accused the government for its distribution policy.

distribution.

The purpose to introduce the market mechanism is to bring the work incentive into the society. Failure of the socialist system was the lack of this incentive because people could get equally irrespective of their work in the socialist system.<sup>45</sup> On the other hand, in a market economy, people are paid according to their work and companies are growing according to their profit. Those companies which are making profit will grow faster by reinvesting profits while those which are making loss should improve their productivity or disappear.<sup>46</sup> These forces will increase income inequality at least at the early phase of the transformation and this is the opposite to the goals of socialist countries. Socialist countries cannot choose but adopt market mechanism and accept income inequality. This policy change was also a result of market mechanism. The competitors in the market are socialist countries and capitalist countries and the latter succeeded in production of consumer goods. If there were no capitalist countries at all, the socialist system would have survived longer.

When we think about the income inequality, we have to distinguish between "equality" and "equity". Equality indicates the situation where everybody receives the same amount of income irrespective of their work while equity requires fairness and not necessarily equality. The principle that every body receive according to their work and efforts can be considered fair.<sup>47</sup> A way to maintain fairness is "accountability" which insists that the government has the responsibility to explain and justify its policy to the people. The inequality caused by the type and length of work may be accountable. On the contrary, the inequality caused by corruption is not accountable. The inequality caused by special privilege to which other people are not accessible is not accountable. The chance must be

---

<sup>45</sup> Reality may not be so simple as this.

<sup>46</sup> In Japan, there are many low productivity industries which can survive only by the government protection. Japan is also facing the same problems as socialist countries.

<sup>47</sup> Fairness can be varied from society to society. As the international relationship becomes closer, there will occur the cases often that the difference in the concept of fairness among countries causes friction among them. It will not be fair to force other countries to accept their own fairness.

equal to the people.

It is not difficult to accept the inequality caused by type and length of work. A more important source of inequality in market economy is the risk. The "engine" of market economy is the entrepreneurs which is willing to invest if there is a possibility of profit.<sup>48</sup> Most of their attempts may fail but only one success will compensate all the failures. Thus their investment is very risky and risk taking is characteristic of entrepreneurs. It should be emphasized that their efforts to look for the business chance, introduce new idea and technology, and so on will determine the path of economic development (not government plans). And if they succeed, their profit will be huge and income inequality will be very large.<sup>49</sup> If we take into consideration the important role of entrepreneurs in economic development, the inequality caused by the success of them will be accountable.<sup>50</sup>

---

<sup>48</sup> This is another reason of the failure of socialist economy. Even a good economic plan could not take into consideration of the role of entrepreneurs.

<sup>49</sup> We should not forget their failure. Usually they fail many times before they succeed. If life-time income is measured, their income may not be so large and as a result income inequality also may not be so large.

<sup>50</sup> Of course, this does not mean that they should be allowed to do as they want to do. Their activity should be done under the constraint of the society. The society should be responsible in the direction of development of the society. In this sense, regulation is necessary. For example, if Vientiane wants to preserve the atmosphere of the city, it should regulate the development of the city like Kyoto which had been the capital city of Japan for more than one thousand year and are making efforts to preserve the city. For me the French atmosphere of cities of Laos seems to be worthy to preserve and will become an important resource for tourism.

## Conclusion

Is it useful for Lao people to learn Japanese economic development and management system? This is what I was wondering while I was teaching at NOSPA. These topics may not be applicable directly but I think they are useful. I want to emphasize that the economic development is an accumulation of efforts of the people. Individuals may not know in which way their country should develop their economy. Only as a result of the efforts of the people the development path will be shaped up. This process is similar to the market mechanism which leads to equilibrium. The difference is the role of the government. The government may be able to change (or at least affect) the development path by controlling the direction of the efforts of the people.<sup>51</sup>

Lao people are trying to introduce market mechanism but not used to it and tends to think that a good plan can solve everything. When the economic structure is stable, this method may be useful. But when the structure itself should be changed, this method becomes obstacle. People need the incentive to change the economic structure. We should distinguish between the role of macro policies and individual activities.

During the discussion with the participants of the seminar at NOSPA, I was sometimes asked strange questions and they reminded me that Laos is still a socialist country. I said that the Japanese management system is a device to make people work harder. And some participants replied that it is like a slave with salary. This may be true and it is the decision of Lao people which way to choose, Japanese style or Lao style.

---

<sup>51</sup> Japanese students were taught how important the export is to Japanese economy. They were taught that the Japanese economy is lacking in natural resources and have to depend on imports and that Japan should increase export if she wants to develop because the amount of imports is restricted by the amount export. This education had a deep impact to the Japanese mind.

### [Acknowledgment]

This article is based on the seminars and lectures that the author gave at National Organization for the Studies of Policy and Administration (NOSPA) of Laos. I appreciate the financial support from the Japan Foundation to send me to Laos to give a lecture on Japanese economic development and Japanese management. The author also appreciate the cooperation of NOSPA and Embassy of Japan in Vientiane for their cooperation and the comments and discussions with H.E. Mr. Sakai Hiroomi, Japanese Ambassador to Laos. Dr. Kukeo Akhamontri, director of NOSPA, Dr. Thoongsalith Mangnomek, students of NSAM, and participants to various seminar. Some parts of this paper is owed to their comments and discussions.

I also appreciate the cooperation of Mitsubishi Motors Kyoto, Nishijin-ori Kogyo Kumiai and Kyoto Prefecture for lending me video tapes and some materials to introduce the Japanese industry and culture.

### [Glossary]

|       |                                                                                                                                                                                          |
|-------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| AFTA  | ASEAN Free Trade Area                                                                                                                                                                    |
| COE   | Center of Excellence                                                                                                                                                                     |
| EU    | European Union                                                                                                                                                                           |
| FDI   | Foreign Direct Investment                                                                                                                                                                |
| GATT  | General Agreement on Tariff and Trade                                                                                                                                                    |
| HPAEs | High-performing Asian Economies, which is composed of Japan, Singapore, Hong Kong, Taiwan, South Korea, Malaysia, Thailand, and Indonesia.                                               |
| MITI  | Ministry of International Trade and Industry of Japan, which is believed to have had an important role in Japanese economic development before but now its actual role is controversial. |
| NAFTA | North American Free Trade Area                                                                                                                                                           |

|      |                                                                                                                                                                                                                                                                                  |
|------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| NIES | Newly Industrializing Economies, which is usually used to indicate those countries such as Singapore, Hong Kong, Taiwan, South Korea, Mexico and Brazil but recently it includes those countries which are catching up these countries such as Malaysia, Thailand and Indonesia. |
| WTO  | World Trade Organization                                                                                                                                                                                                                                                         |

[Selected References]

- Ikemoto Yukio [1991], *Income Distribution in Thailand: Its Changes, Causes and Structure*, Institute of Developing Economies, Tokyo.
- Noguchi Yukio [1995], *1940 NEN TAISEI (The 1940 System)*, Toyo Keizai Shinposha, Tokyo.
- Schumpeter, J.A. [1926] *Theorie der Wirtschaftlichen Entwicklung*.
- World Bank [1993], *The East Asian Miracle: Economic Growth and Public Policy*, Oxford University Press.

