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## How Entrepreneurs Created the Great Boom That Made Modern Japan

In less than two generations, during the late 19th century, Japan transformed itself from a medieval backwater to a dynamic modern economy. They did it with comparatively little outside capital, public or private. It's probably fair to say that Japan was more successful than any of the nations that, decades later, received government-to-government assistance through the Marshall Plan, the World Bank or the [International](#) Monetary Fund.

Beyond protecting private property, providing an essential legal framework and eliminating many barriers to enterprise, the Japanese government was actually a minor player. There were dozens of government-owned businesses, but almost all of them lost money and were subsequently privatized. Prestigious heavy industries favored by the government never added as much value as humble light industries like textiles that thrived with few subsidies.

Economic historian Frank B. Tipton, Jr. pointed out that "When the central government attempted to introduce new technologies, it generally failed. In fact, monetary and credit policies probably hindered development." Historian Edwin O. Reischauer declared, "It was private initiative that produced the bulk of Japan's economic modernization and growth."

The Tokugawa Shōgunate, as the Japanese military government was called, had virtually cut off Japan from the outside world since Shōgun Ieyasu seized power in 1603. The Shōguns presided over a hereditary caste of feudal lords known as daimyo, below whom were samurai warriors ruling some 260 local jurisdictions. Below the samurai were peasants, then crafts people and finally merchants who were the lowest of the low.

The government enforced suffocating restrictions on economic activity. People weren't free to choose their occupations. [Entrepreneurs](#) were limited to serving local markets. It was illegal for ordinary people to purchase luxuries like silk, which meant that production was always small. Contact with foreigners was banned, except for merchants permitted to see Dutch traders on Dejima, a small island off Nagasaki. Anyone caught trying to leave the country was subject to the death penalty.

Many Japanese, however, were curious about the outside world. A few escaped their country aboard Dutch merchant ships or American whalers. Dutch books were smuggled into Japan. Many samurai sold their precious swords to get Dutch grammars, so they could read Dutch technical books. Relying only on book learning, resourceful Japanese entrepreneurs produced pens, ink, chemicals and medicines.

Meanwhile, the United States turned toward the Pacific Basin. American whaling ships operated in the North Pacific, and American clipper ships worked the China trade. Japan seemed like a logical place for steamships to replenish their coal and other provisions. For many years, Americans had tried to trade with Japan, but the Shōgun insisted on maintaining Japan's isolation.

On July 8, 1853, the American Commodore Matthew Perry appeared in Edo (Tokyo) Bay with four well-armed ships, two of them steam-powered — something few Japanese had ever seen. Perry's cannon could have devastated the city, and because much of the city's food arrived by sea, he could have inflicted a painful blockade. Shōgun Ieyoshi would have been helpless. Perry expressed a desire to begin peaceful relations, then sailed on to China. He returned a year later with eight ships, making clear that the American threat had to be dealt with.

Shōgun Iesada, who succeeded his father after Perry's first visit, reluctantly agreed that (1) Americans could conduct trade not only in Nagasaki like the Dutch but also in Yokohama, Kobe, Niigata, Shimoda and Hakodate; (2) tariffs would be kept at a low 5 percent for the next 40 years; (3) Americans in Japan would be subject to American laws, and violations would be handled by the American embassy, not by Japanese courts. The Shōgun subsequently signed similar treaties with Britain, France and Russia.

These treaties provoked a powerful xenophobic backlash within Japan. The Shōgun lost face for permitting foreign goods into Japanese markets and for agreeing that foreigners would be exempted from Japanese laws. Outraged samurai demanded that the Shōgun "expel the barbarians," but clearly he was unable to do that. Forts controlled by the samurai fired on foreign ships. An American ship responded by sinking two Japanese gunboats, and French soldiers destroyed the forts. They were rebuilt, and again they fired on foreign ships. A fleet of 17 American, British, French and Dutch ships destroyed the forts and extracted an agreement that they wouldn't be rebuilt. The anxious Japanese referred to all unwelcome Western vessels as "black ships."

Rebellious samurai managed to acquire Western ships and rifles for their struggle against the Shōgun Keika, the latest dictator who proved unable to get rid of the foreigners. Japanese scholars portrayed Emperor Kōmei, a ceremonial figure, as the nation's spiritual leader. These scholars called for a revival of Shinto religious doctrines that involved emperor worship. The emperor, in turn, gave his blessing to the samurai. The Shōgun's soldiers were armed only with traditional two-handed swords, and when the samurai overthrew him in 1868, the Japanese could grasp the crucial importance of achieving technological superiority.

The samurai couldn't agree on who would be the next Shōgun. People rallied behind Emperor Kōmei, 36, hoping that he might help Japan avoid becoming a Western colony like much of China. He tried to regain power that had been ceded to the Shōguns over the years, but the Japanese weren't accustomed to taking orders from an emperor. In any case, Emperor Kōmei died suddenly in January 1867, possibly from poisoning. His son ascended to the throne and became Emperor Meiji. A new era became known as the "Meiji Restoration" — the emperor's status if not his power was restored. He moved his residence from Kyoto to Edo and renamed it Tokyo ("Eastern Capital"). But since he was young —

perhaps only 14 – he wasn't able to run the government. Decisions reflected an uneasy consensus among samurai and top government officials.

Although the Shōgun's failure to deal with foreigners had brought him down, the new ruling group realized they didn't have any answers, either. Japanese "learning missions," each consisting of as many as several dozen people, were sent abroad to learn about foreign science, technology, engineering, law, economics and other fields. They reported that Japan was more backward than had been realized, and somehow the country must modernize fast.

The government introduced a number of dramatic reforms that set the stage for economic growth. Feudal domains were abolished. All social classes were to be equal before the law. The government abolished barriers to domestic trade, and as noted, treaties committed Japan to a low-tariff policy for international trade. Guilds were abolished, enabling people to choose occupations freely. Property rights were expanded so that practically anyone could buy land, and farmers could plant whatever they wanted.

With the feudal order gone, the samurai – about 2 million men – lost their jobs. They were a potential source of discontent and revolt. So the government gave them pensions that were between one tenth and one half of their previous feudal stipends. The pensions consumed about a third of the government's budget, and the plan was for them to be converted gradually into lump-sum payments.

The government brought in about 3,000 foreign advisors to help design and implement reforms. Although all the advisors were Western, they represented a range of conflicting views, from English advocates of free markets and peace to Prussian advocates of protectionism and militarism, with other advisors somewhere in between. Japan adopted a parliamentary system based on the experience of Great Britain and Prussia. A compulsory education system was introduced on the French model. Japan looked to Prussia for guidance about reorganizing the army and to Great Britain for guidance about reorganizing the navy.

With tariffs limited to 5 percent, imports surged into Japan, and businesses as well as consumers were free to take advantage of the best deals wherever they might be available. Western goods and ideas appeared all over Tokyo. Emperor Meiji set an example for adopting Western ways. After 1872, he dressed not in traditional Japanese robes but in a Western uniform or a swallowtail coat and silk top hat. He rode about in a Western-style coach rather than the traditional palanquin. Meiji ministers abandoned the traditional practice of shaving their eyebrows and blackening their teeth.

Ordinary people combined Western clothing with traditional clothing; to wear a kimono over slacks, for example, or a frock coat with a sword. Fewer and fewer men continued the traditional hairstyle -- some hair shaved entirely off, the rest long and gathered into a top knot; by the 1880s, some 90 percent of Japanese men favored Western-style "random cropping." Japanese discarded traditional bamboo-and-paper umbrellas and started using imported umbrellas which were dubbed "bat shades." Gold watches became popular. Modern newspapers flourished in Tokyo. Schools began teaching knowledge of the West. Dry goods shops like Daimaru evolved into department stores. Restaurants opened to serve Western-style beef.

Low tariffs meant that Japanese producers could acquire less expensive raw materials, which helped them become more competitive. Sometimes Japanese entrepreneurs could tap foreign investment capital. The British, for example, helped finance a railroad connecting Tokyo and Yokohama (1870).

Amidst the prosperity, many small producers had difficulty adapting to the tumultuous changes, and the government began doing bailouts. For instance, economic historians Johannes Hirschmeier and Tsunehiko Yui reported that “Maritime Insurance Company had to be rescued by the government, yet the company continued its practice of not accumulating reserves, of accepting foreign contracts with only loose checks, and high dividend payments of 10 to 16 percent.”

The government decided to jump-start the economy by “targeting” private firms – giving them subsidies. But officials didn’t do well trying to pick winners. For example, the government helped three merchant houses — Shimoda, Ono and Mitsui. Later, when subsidies were withdrawn, only Mitsui survived. The government subsidized many businesses started by samurai, most of which went bankrupt.

The government awarded contracts, subsidies and monopoly privileges to companies that evolved into the zaibatsu (conglomerates operating a wide range of businesses). For instance, because Minomura Rizaemon, chief executive of the Mitsui money-changing firm, had backed the Meiji Restoration government early on, Mitsui was awarded lucrative contracts to provision the army. The government considered shipbuilding a national security issue and awarded monopoly privileges to the Mitsubishi zaibatsu.

In any case, the zaibatsu didn’t dominate the Japanese economy. At the end of the Meiji period, in 1912, about 60 percent of Japanese people still worked in agriculture. Japan’s biggest exporters were unsubsidized silk and cotton producers. According to economic historian William Lockwood, “it was the expansion of Japan’s basic economy — agriculture and small-scale industry built on traditional foundations -- which accounted for most of the growth of national productivity and income during the Meiji period.”

The government tried starting new businesses. There was a government-owned telegraph system and a rail network. The government pursued shipbuilding, brick production and silk manufacturing. By the mid-1870s, according to an official report, the government owned three shipbuilding yards, 51 merchant ships, 52 civilian factories, two munitions factories and 75 miles of railways.

But almost all these government-owned businesses were a bust. For example:

- \* The government’s Fukugawa cement factory and the Tokyo Gas Company lost money.
- \* Government-owned shipyards in Nagasaki, considered essential for national security, weren’t able to do more than minor repair work.
- \* Government-owned railroads cost twice as much per mile to build as private railroads. By 1892, private companies had built 1,320 miles of railroads, double the mileage of government railroads.

\* In 1870, the government established the Nippon Postal Steamship Company for passengers and cargo. This soon acquired a reputation for inefficiency, and an entrepreneur named Iwasaki Yataro decided he could do a better job. He started the Mitsubishi Company and declared, "While they make use of government protection and are boastful and overbearing, we of the Mitsubishi strengthen our internal controls and go out of the way to please people." Within a few years, Mitsubishi became the leading Japanese steamship line, and the government was among his customers.

\* The government couldn't even turn a profit in a traditional business like silk reeling. The most conspicuous failure was the grandiose Tomioka Filature. It became a make-work scheme for hundreds of samurai daughters. Managers closed the factory to visitors, so they couldn't see how inefficient the place was.

Altogether, losses incurred by Japanese government-run businesses were reported to be ¥69.3 million from 1868 to 1885. This is a big number, compared with Japan's estimated national income of ¥397 million in 1878 (about midway through the period).

The cost of all the failed government-run businesses was borne on the backs of Japanese peasants. The land tax, enacted in 1873, was intended to provide the government with steadier revenues. A peasant's tax bill was based on the assessed value of farm land, not on the value of each year's crop. A peasant had to pay substantially the same tax every year and pay it in money rather than bags of rice (the previous practice). Consequently, the land tax went up as a percentage of a bad harvest – perhaps to as much as 40 percent – and went down as a percentage of a good harvest.

Moreover, spending on government-owned businesses added to inflationary pressures, already serious because the government assumed the cost of what used to be feudal administration, the cost of suppressing the last samurai revolt (1877) and the cost of providing pensions for idle samurai.

Monetary depreciation amounted to a tax on everyone holding cash balances. Government debt soared from ¥55 million in 1876 to ¥254 million by 1878. Rice prices doubled.

Bottom line: far from adding value, government-owned businesses consumed scarce resources. Losses meant that fewer resources were available for more promising agricultural as well as industrial ventures. Government-owned businesses were a drag on the economy.

Even if government-owned businesses had been successful, they weren't big enough to warrant the generous attention they've received in historical accounts of the Meiji period. The government was never a significant employer. Government spending was estimated to be 12 to 14 percent of the economy. Only about one-seventh of the population worked in manufacturing. The great majority of those were in the textile industry.

A turnaround began with the appointment of Count Matsukata Masayoshi as Minister of Finance, October 1881. He decided to embark on radical privatization, not because he embraced capitalism but rather because government-owned businesses didn't work. Nobody running those businesses had a big personal stake in their success or failure. The government policy of subsidizing failure had the perverse effect of encouraging more failure.

Apparently the Japanese government ministries that handed out subsidies didn't provide detailed income statements and balance sheets for each of the government-owned businesses. They reported only aggregate total revenues and expenditures for all government-owned businesses! From a management standpoint, such reports were utterly useless. By insisting on detailed financial reports for each government-owned business, Matsukata made everybody aware how pervasive the chronic losses were, and this knowledge helped generate popular support for privatization.

The first attempted mass privatization was in 1880 when 14 money-losing government-owned businesses were offered for their book value (without a depreciation allowance). But there weren't any takers, a wake-up call that many government-owned businesses weren't worth much, regardless how much money had been poured into them. After that, government-owned businesses were offered to the highest bidder, regardless how low the bids might be. At least future losses wouldn't be on the government's books.

In 1882, Matsukata began selling just about all government-owned businesses except steel and munitions factories. For example:

\* In 1885, Furukawa Ichibei paid ¥338,000 for the Ani Copper Mines on which the government had spent ¥1.7 million.

\* In 1887, Tanaka Chobei paid ¥12,600 for the Kamaishi iron mines. The government had spent ¥2.5 million on the project but couldn't handle technical problems. Only ¥175,126 worth of iron was extracted before the operation was shut down.

\* The government was able to realize only ¥79,950 from the Shinagawa glass factory on which it had spent ¥350,000.

By 1896, 26 large government-owned businesses had been privatized. Matsukata also slashed subsidies for privately-owned businesses as well as government-owned businesses.

He used the money saved or realized to pay off an astounding 97 percent of Japan's national debt. It went from ¥245 million in 1880 to just ¥5 million in 1890. Government interest costs dropped accordingly. National budgets were covered entirely by taxes and fees.

Matsukata encouraged private banking to tap private sector savings. Yokohama Specie Bank, started in 1880, specialized in foreign exchange transactions. It provided financing for the growing export trade. Hypothec Bank (1896) handled agricultural lending. Hokkaido Development Bank (1899) financed enterprises on Japan's northern island. The Industrial Bank of Japan (1900) raised foreign as well as domestic capital for newly-privatized industries.

The number of joint stock companies with at least ¥1,000 of capital soared from 1,298 in 1884 to 4,133 a decade later. John Whitney Hall observed that "It was not the conspicuous heavy industries that accounted for the first statistics of economic growth or gave Japan the base from which to gain its economic security in the world at large. One of the most significant developments at this time was the expansion of silk production for export. Here was an industry that had its roots in the traditional village economy, yet served a growing international need. Once the Japanese were able to modernize the industry and work out the

requirements of quality control sufficient to meet the European market, Japanese silks came into great demand. Japan became the world's largest source."

As commercial centers prospered, they stimulated agriculture where perhaps 80 percent of the Japanese population worked during the early Meiji period. The closer farmers were to a commercial center, the more they specialized in producing cash crops like cotton, silkworms, tea, oil, sugar.

Many Japanese farmers became entrepreneurs who produced cotton textiles, raw silk, paper and tatami. For instance, the most successful Meiji silk reeler was an entrepreneur named Katakura Kentaro who started a small business on his farm. He developed the business gradually, as he acquired machinery and improved his management techniques. Katakura sent his son to the United States so he could study the latest reeling methods first-hand. Katakura might not have attracted as much attention as the government's grandiose Tomioka Filature, but he produced more silk.

Japan prospered with a pro-free market culture. For example, the educator Fukuzawa Yukichi was awed by the material wonders of America and Western Europe. He went on to write *Seiyō Jijō* (Things Western), a book that did much to inform Japanese people about revolutionary economic changes going on. Fukuzawa's best-known work was *Exhortations for Learning* that went through 17 editions and sold over 3 million copies. His opening lines evoked the spirit of Thomas Jefferson: "Heaven did not create one man above another nor one below another."

There were many discussion clubs in Japan, perhaps inspired by Benjamin Franklin's *Junto*, and one of the most influential was the *Meirokusha*. This was a forum where Fukuzawa talked about the ethics of *bunmei kaika* — "civilization and enlightenment." He argued that self-reliance, rational behavior, free trade and entrepreneurial profits were keys to Japan's progress. Fukuzawa started *Keio Gijuku*, a school that encouraged Japanese to become entrepreneurs rather than bureaucrats. *Keio Gijuku* became *Keio University*, one of the most respected universities in Japan. Fukuzawa started *Maruzen*, a trading company that became Japan's biggest book importer. When people are free, Fukuzawa declared, "there is nothing in the world that can withstand man's courage and intellect."

Ukichi Taguchi published *Jiyū Koeki Nihon Kaiza Ron* (A Free Trade Policy For Japan) which, inspired by the great free trade champions Adam Smith and Richard Cobden, explained why government protection of industry undermines crucial incentives to adapt in a changing world. Ukichi's book went through many editions.

Western books about the moral dimension of markets enjoyed startling popularity. *Self-Help*, by the popular English author Samuel Smiles, was translated as *Saikoku-Risshi-Hen* and sold over a million copies. This book was followed by *Smiles' Character* (*Seiyō Hinko Ron*) and *Thrift* (*Seiyō Setsuyo Ron*). Benjamin Franklin's *The Way to Wealth* was published as *Kanetame no Hiden*, and it did well.

According to economist Angus Maddison who spent many years estimating GDP statistics for many countries, between 1870 and the death of Emperor Meiji in 1912, the Japanese economy expanded about 180 percent. By comparison, during this period China expanded about 30 percent, India about 30 percent, France about 100 percent, Great Britain about 130 percent, Germany about 215 percent, and the United States about 400 percent. Japan's

growth was a remarkable performance, thanks to the private entrepreneurs who created wealth and the government officials who got out of their way.

But the Japanese never forgot that their nation was forced open. They came to believe that they needed an overseas empire like the Western nations with their terrifying black ships. That reckless quest, as it turned out, led to death and destruction. A later generation found redemption by again focusing on peaceful markets.

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