FEE Stories

What Caused Japan's Post-War Economic Miracle?

By Lawrence W. Reed

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For a century after his death in 1856, statues of the philosopher and economist Kinjiro Ninomiya adorned public places, especially schools, all over his native Japan. Most of them depicted him as a boy reading a book while walking with a load of firewood strapped on his back. Though he is credited with introducing the concept of compound interest to the peasantry, the statues pay tribute to a broader counsel he championed in Japanese culture: *read, study and work hard as if your life depended on it, because it often does.* He also urged his countrymen to "Save, waste not; otherwise, Heaven will punish you."

Ninomiya's sage and timeless advice surely helped Japan recover from the ravages of World War II. For a full explanation of the remarkable pace and magnitude of the recovery, however, we must identify other factors. How did a nation which had sunk so low undergo such a stupendous economic rebound?

From the Doolittle Raid on Tokyo in April 1942 to the atomic bombs dropped in August 1945, nearly four years of American bombing wiped out a huge swath of Japan's industrial capacity. In his book, *Ashes to Awesome: Japan's 6,000-Day Economic Miracle*, Yoshikawa Hiroshi tells us that 93 percent of Japan's steel production was obliterated. The country's GNP in 1946 stood at just under half its peak before the war. Astronomical hyperinflation nearly destroyed the currency. Living conditions were "wretched" and the caloric intake of the average person was just two-thirds of its pre-war level.

Japan at war's end was a nation defeated, demoralized, devastated, and, until 1952, occupied by almost a million American soldiers. Its major cities, including Tokyo (and of course, Hiroshima and Nagasaki), lay in ashes.

Thirty years later, the Japanese economy ranked second in the world, behind only the United States. From 1950 to 1973, it grew at twice the rate of Western Europe's and more than two and a half times faster than that of the US. During the 1960s, it doubled in size in only seven years. In barely more than one generation, Japan transformed itself from a poor country to a rich one—a feat widely seen as "miraculous." How does such a historically rare development occur?

Did Japan decide to adopt a socialist path to recovery? Silly question. Nobody outside of academia or who understands either economics or history would ever prescribe compulsory wealth redistribution, central planning, massive tax hikes or burdensome bureaucracy as a cure for anything, let alone a half-dead economy. That would simply kill the remaining half. The fact is that Japan's post-war progress owes more to the ideas of Adam Smith and Milton Friedman than to those of John Kenneth Galbraith or Paul Krugman.

The Japanese Economic Miracle is explained by six major factors. Here they are:

1. The Korean War
From 1950 to 1953, the US and allied nations fought the North Koreans and Chinese to a standstill. America bought huge quantities of food and war materials from nearby Japan. This represented a sizable transfer of wealth from American taxpayers to the Japanese economy. This "procurement boom," along with other American aid after 1945, helps explain some Japanese growth early in the country's recovery, but those transfers mostly evaporated when the Korean War ended.

2. Punishment to Growth
US policy in the early months of the Occupation of Japan tended to be punitive, designed to keep the country down and out. But in 1947, as the Cold War with the Soviet Union and Red China worsened, the Truman administration decided that a stronger, freer Japan would help stave off communist advances in Asia and the Pacific.

Among the harsh measures imposed on Japan, based largely on advice from left-wing academics, were monstrously high personal income tax rates that ranged to a high of 86 percent. Alan Reynolds of the Cato Institute writes,

This was a central part of a severe austerity program, not *a plan to promote economic growth. As Edwin Reischauer pointed out at the time, "Steeply graduated income taxes and inheritance taxes have been adopted to prevent in the future the accumulation of … concentrations of wealth." But taxes designed to punish additions to* income *must also punish additions to* output—*economic growth.*

Sky-high taxes kicked in at relatively low-income levels and exemptions were few. Corporate income and "excess profits" were likewise confiscated at high rates. A vast expansion (and higher rates) of excise taxes and a hike in already-high inheritance taxes punished Japanese citizens at all income levels. "Brutal" describes the punitive tax regime imposed on Japan by Americans in the immediate aftermath of the war.

Before economic growth could take off, Japan had to stop punishing its wealth-creating entrepreneurs. As General Douglas MacArthur steered American Occupation toward leniency, that's exactly what Japan did (as you'll read in a moment).

Japan seemed destined to pay heavy reparations to the nations it damaged in the war until America in the late '40s pressed those other nations to back off. Unlike the massive payments the Versailles Treaty obligated Germany to fork over after World War I, and which contributed greatly to another war 20 years later, what Japan was required to pay proved minimal in the end.

By 1949, America was actively encouraging the integration of a depressed and insular Japanese economy into world commerce. Markets opened for the country's exports, which in turn spurred its purchase of imports. In 1955, Japan became a member of the tariff-cutting General Agreement on Trade and Tariffs (GATT).

3. Tax Cuts
Fortunately, the heyday of the left-wing American academics in Japan was short-lived. The changing perspective in Washington from punishment to growth opened the door for tax cuts. To quote Reynolds again,

In late 1950, following a similar policy coup in Germany, Japan's highest individual income tax rate was slashed to 55% from 86%. From 1950 to 1974, Japan cut taxes every year *(except 1960)* *often by greatly increasing the income thresholds at which the higher tax rates applied, or by enlarging deductions and exemptions. The taxable income needed to fall into a 60% tax bracket was raised to 3 million yen by 1953, for example, compared with only 300,000 in 1949. The Shoup Commission's net worth tax was also abolished in 1953. The sting of high tax rates was further neutralized by exemptions for interest income and capital gains, deductions from corporate and individual taxes on dividends, a deduction for earnings, and various other holes in the tax base, legitimate and otherwise.*

Some deductions were far from neutral, and therefore less desirable than lower tax rates would have been. Yet the continual tax reductions from 1950 to 1974 accomplished two things. First, they greatly reduced effective marginal tax rates. Second, they moved the system a long way toward what is sometimes called a "consumed income tax" or "expenditure tax"—that is, a system that taxes income only once, regardless of whether the income is saved or devoted to immediate consumption.

Tax cuts accelerated after the end of American Occupation in 1952. Reductions in levies on savings and investment were especially stimulative. With the baleful influence of left-wing American academics gone, public policy focused on boosting production instead of leveling and equalizing incomes. Success in the marketplace became a virtue instead of a vice. To his credit, Carl Shoup of Columbia University helped immensely to simplify the tax code so that Japanese people could see it as fair and understandable.

Japan also steadily reduced its tariffs (taxes on the purchase of foreign goods). For example: By 1975, Reynolds notes, "the effective tariff on autos fell from 40% to 10%, and the tariff on televisions from 30% to 5%."

4. Economic Freedom

Japan's tax reductions were an important element of a broader liberalization of its economy. Even the World Bank, in a comprehensive 1993 study of the Japanese Economic Miracle, admitted that liberalization was an indispensable factor. It concluded that "the rapid growth was primarily due to the application of a set of common, market-friendly economic policies, leading to both higher accumulation and better allocation of resources."

In explaining the Japanese Economic Miracle, some people suggest that government "industrial policy" agencies such as the Ministry of International Trade and Industry (MITI) were its main architects. But that is belied by the fact that MITI's interventions were neither huge nor effective. They produced more than a few failures. The World Bank's 1993 report dismissed its "contributions" as one of many attempts around the world "to guide resource allocation with nonmarket mechanisms [that] have generally failed to improve economic performance."

At a time when much of the Western world embraced Keynesian economics of higher taxes, spending, budget deficits and debt, Japan's recovery was fueled by lower taxes, less spending, more saving, increasingly secure property rights and conservative fiscal policies. Education, always highly prized in Japan, was kept local with an emphasis on high-quality K-12. Even today, most Japanese people will tell you they studied harder in grade schools than in universities. The result was an explosion in both human and physical capital.

Toshio Murata, a long-time friend of the Foundation for Economic Education (FEE) in America, was a Japanese economist of the "Austrian School." He translated *Human Action* by Ludwig von Mises into Japanese. In 2017, FEE bestowed its "Blinking Lights Award" upon him before his death in 2021 at the age of 97. In an article for FEE in 1994, he explained why the World Bank was correct in its assessment, noting that the favorable tax treatment of savings played a key role in generating a robust capital market for business start-ups and investment:

The true explanation of Japan's successful post-war economic development rests…on good old-fashioned virtues—saving, hard work, reduced government spending, and innovative entrepreneurship—combined with ingenious marketing techniques and relatively free world trade. On the basis of 1971-1991 figures, the average gross saving rate in Japan was twice that in the United States; the saving rate per household in Japan was 2.7 times that in the States.

Industries that had been run or heavily regulated by the old imperial government or by American occupiers were set free. Many of the monopolies *("zaibatsu")* that held sway for generations in Japan, thanks usually to government-granted privileges, were broken up, sold off or deregulated to compete on a more level playing field.

Considerable credit for the advance of economic freedom in Japan goes to Shigeru Yoshida, who served as Prime Minister for most of the period from 1946 to 1954. He spearheaded economic liberalization and, at the same time, successfully resisted American pressure for Japan to spend heavily on the military. At the San Francisco Peace Conference in 1951, he pronounced the treaty formally ending the war as "fair and generous" and "not a treaty of vengeance but an instrument of reconciliation." The following year, Japan once again became an independent nation.

During the four years of Prime Minister Hiyato Ikeda (1960-1964), economic growth and the entrepreneurs who generated it were embraced as keystones of a new and optimistic Japan. Even Ikeda's modest welfare state measures couldn't slow things down (that would happen later as the bills came due).

The spirit of liberalization continued into the 1980s. Under Prime Minister Yasuhiro Nakasone, Japan's national government privatized telecommunications and railways and diminished the influence of MITI in the economy. When the country turned toward bigger government in the 1990s, the growth momentum stopped, as partially explained by economist Hiroshi Yoshida in this recent article for FEE.

Japan never became the libertarian paradise that was Hong Kong (before recent subjugation by Beijing), but it did become far freer economically during the decades of economic liberalization than it perhaps had ever been before. Today, it still ranks an impressive 35th in economic freedom among the world's nearly 200 nations, according to the Heritage Foundation's Index of Economic Freedom

5. Dodge and Deming

While it was fashionable for many governments around the world in the 1940s and 1950s to seek advice from "whiz kids" and "planner" types in the ivory tower, Japan to its credit didn't pay them much attention when they were free to look elsewhere. In fact, by taking advice from two notable men from the entrepreneurial private sector, Japan avoided the stagnation that left-wing academicians usually produced. Their names were Joseph Dodge and W. Edwards Deming.

President Harry Truman dispatched Joe Dodge to Japan from his perch as Chairman of Detroit Bank in 1949. He was to be financial advisor to the Supreme Commander, General Douglas MacArthur, and help the nation emerge from the economic doldrums.

What became known as "The Dodge Line" did the trick. By implementing a balanced national budget and shutting down the printing presses, it ended hyperinflation. It stabilized the exchange rate between the yen and the dollar. It drastically reduced government economic intervention across the board. Dodge's intention was not to "plan" the Japanese economy but rather, to finally leave it alone. He killed every subsidy and price control he could get his hands on, and MacArthur cheered him as he did it. (Truman would later make Dodge his Director of the Budget and in barely a year, he cut the US federal deficit in half.)

W. Edwards Deming was another private sector genius with both feet planted firmly on solid ground. He was an engineer, statistician, and management consultant who introduced quality control techniques to Japanese manufacturing—techniques that achieved previously unheard-of levels of productivity. Toshio Murata writes,

Japanese exports in prewar days were regarded as "cheap, but of poor quality." W. E. Deming, a U.S. professor, played a major role in improving the quality of Japanese goods. A prize established in his honor is awarded to individuals and companies making important contributions to quality control. Today, thanks no doubt to lessons learned from Professor Deming and from taking consumer wishes to heart, Japanese appliances and automobiles are rated among the best in the world.

The Japanese owe these two men a great debt for their important contributions. If the country had followed the prevailing wisdom of left-leaning academics at the time, recovery would likely have been stalled or reversed.

(If my remarks strike you as uncharitable toward leftist academia, please allow me to cite two illuminating comments from economist Thomas Sowell, himself an academic: In 1997 he wrote, "The most fundamental fact about the ideas of the political left is that they do not work. Therefore, we should not be surprised to find the left concentrated in institutions where ideas do not have to work in order to survive." In 2011, Sowell opined, "Socialism in general has a record of failure so blatant that only an intellectual could ignore or evade it.")

6. General MacArthur's Constitution

The sixth factor in Japan's Economic Miracle was by no means the least important. Without the vision and personality of Douglas MacArthur, it's difficult to imagine that either an economic recovery or Japanese-American relations would have emerged as robust.

MacArthur worked so amiably with Japanese leaders, including Emperor Hirohito, that most people in Japan mourned his departure in 1951 as American Occupation neared its end. He personally supervised the writing of a new Constitution that included provisions to ensure a limited, representative government, free and fair elections, private property, and individual liberties. It took effect in May 1947. For seven and a half decades, that Constitution has governed Japan, as one commentator put it, "without the change of a comma."

In April 1951, the general who proved as indispensable to the new, peaceful Japan as he was to winning the war in the Pacific, was able to tell Congress, in person, this good news:

The Japanese people since the war have undergone the greatest reformation recorded in modern history. With a commendable will, eagerness to learn, and marked capacity to understand, they have from the ashes left in war's wake erected in Japan an edifice dedicated to the supremacy of individual liberty and personal dignity, and in the ensuing process there has been created a truly representative government committed to the advance of political morality, freedom of economic enterprise, and social justice.

In 1960, Japan honored General MacArthur with its highest honor, the Grand Cordon of the Order of the Rising Sun. You can see a short video of the official presentation here.

Fortunately for Germany, a similar economic miracle took shape at the same time as Japan’s. There, as I’ve written before, it was largely due to similar free market policies of economist and statesman Ludwig Erhard. Ironic, isn’t it, that two of the nations most responsible for World War II emerged from it as economic miracles because of freedom and free markets. Kinjiro Ninomiya would be most proud.

Freedom works. It's a lesson that needs to be told, re-told, and told again.