

## SOCIAL CAPABILITY AND ECONOMIC GROWTH

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### ABSTRACT

*İktisadi büyüme açısından ülkeler arasındaki uzun dönem performans farklılıklarının nedenleri öteden beri iktisatçıların üzerinde durduğu bir problemdir. Bu çalışmada Solow'un teknolojik gelişme ve büyüme analizlerinde çözümsüz olarak bıraktığı "artık" (residual) kavramından hareketle, yeni sanayileşen Doğu Asya ülkelerinde toplumsal yetenek olgusunun büyümeyi nasıl etkilediği sorusu üzerinde durulacaktır.*

### I. Introduction

When we examine the growth performance of developing countries during the last three or four decades, we can see several stylised patterns emerging. First, a half dozen or so countries, which we now call newly industrializing economies (NIEs), were able to grow at very fast rate for more than three decades, transforming their economies from a backward one to an industrialized economy.

A second group mostly consisting of Latin American economies, had a stop and go pattern of growth performance in the last several decades. Some good performance for several years was interrupted by several years of bad performance, but these countries were never able to achieve rapid and sustained long term growth as shown by the first group countries. This despite the fact that many of the second group had started their modern growth path well ahead of current NIEs.

The third group of countries represents those labelled as "socialist" economies. These performed pretty well in early period of their catch-up process, and then stagnation and collapse of the socialist system followed. The final group includes many countries in Sub-Saharan Africa which have not even started the path of sustained growth. They are still busy with nation-building and it seems that substantial preparation for growth have not yet been completed.

The diverse performance record of these groups of economies is quite striking. Some of the Asian NIEs, for instance, were transformed into industrial economies from poor agrarian economies during the last three decades, while others either experienced stagnation in the growth of Per capita income or even decline.

How can explain the difference in long term growth performance of these economies? Conventional

theories in neo-classical paradigm using capital and labour as major inputs (e.g., Solow type model. Solow, 1956) can only explain a part. We tend to get large unexplained residuals from such explanations. Other specifications including a separate human capital variable in addition to "raw" labour were tried. Bu still significant unexplained residuals as large as one third were left to be explained.

For a long time students of economic growth apparently knew that differences in growth performance could not simply be explained in terms of the differences in factor supplies. How these given factors are managed and utilised may be as important or even more so than differences in factors inputs. The concept of social capability comes from the notion that there are certain elements in a society to make scarce factors more productive at given level of supplies. The observation that certain elements in a society have significant impact on productivity of factors is certainly no new. J.S.Mill, G. Myrdall, S. Kuznets and more recently all those concerned about institutional economics have argued this point for a long time.

Neo-classical theorists, however, did not embrace the notion readily in their models. In a standard neo-classical world, with perfect market, perfect information, etc. These institutions and social elements do not have roles to play. Either they are external, or can be ignored. They say that these cannot even be measured easily for empirical testing.

The main purpose of this paper is the following: First, we would like to explore the elements of these unexplained "residuals", which we call social capability, so that we will be able to contribute a small part in building a hypothesis to explain why certain economies maintain sustained growth for a long time and succeed in transforming their economies into advanced one, whereas others fail to do so; Second, we would like to use Japan and Korea, which have demonstrated the record of sustained long term growth in the last three or four decades, and shown relatively large residuals, as examples.<sup>2</sup>

<sup>2</sup> The residuals, frequently referred to as total factor productivity, were measured with many different specifications by students of economic growth in recent years. A. Young (1994) came up with the models which could reduce the residuals significantly by using different labour and capital stock data. The study showed that much of the growth of the NIEs in East Asia can be explained in terms of factor inputs (capital and labour), rather

## II. Social Capability: Understanding The Concept

Let us begin with some examples.

Students of economic development learned that human capital is a critical ingredient in economic development. In the last several decades countries such as Asian NIEs were able to have sustained growth despite the fact that they initially did not have enough capital, natural resources, and technology, with only human capital. However, they were also puzzled by the fact that many countries with respectable human capital stock, such as Philippines, Argentina and India were not able to experience sustained long term growth. More recently, the experiences of Russia and other socialist economies, which have failed in sustained economic growth with a large pool of well trained engineers and skilled workers, tell us that the factor supply is not a sufficient condition for sustained growth. The capability to utilize and manage these scarce factors seems to be even more critical.

The second example, with the implication of our search of explaining the differences in long term performance of economic development. Some years ago when a South Korean economist met a high level government official from the US., who also an excellent economist, the latter asked the Korean economist to explain how Korea could produce steel most competitively in the world. And export to the US market and other countries, although she had to borrow capital, import technology and all major raw materials, such as iron ore and cooking coals. The Korean economist's answer was swift and simple. It is because of the

"people". To be more precise, human and their managerial capability.

Considering the fact that certain factors of production such as capital and technology can cross borders, as in the anecdote just cited, students who are searching for explanations for sustained long term growth began to look at factors which can not move easily, such as labour and socio-economic environment in which economic development must take place, including policies and institutions.

It is important to notice that, while the availability of physical and human capital are undoubtedly key factors in explaining the varied performance of developing economies in the last several decades, it is not mainly the scarcity of these factors which is at issue. Rather, the issue is capability of the country to manage and utilise the physical and human capital to make them more productive. To put it differently, that capability is why some economies can build and maintain a system which attracts physical and human capital and utilize them efficiently, while others experience capital flights and brain drains.

Also we need to see why some economic systems can create positive externality, for instance, through appropriate specialization, communication and social interaction of specialists which are all important for productivity growth, while other systems fail to do so. The former USSR or India must have much more well trained and skilled manpower than Singapore or Hong Kong. But the management and utilization of these scarce human resources in this two regions differ greatly so different. Engineers in Silicon Valley, and some well-run industrial and science parks in market economies where engineers work, interact and communicate freely with other fellows, and those in rigid socialist economies who could not show good contrast.

Neo-classical economists neglected the analysis of environment in which production and exchange takes place for a good reason. They conveniently assumed that agents, individuals, firms and government, have perfect information concerning products and markets which is complete and perfect, and there was no uncertainty. Hence, in that environment buyers and sellers will produce and exchange smoothly and no transaction cost are involved. There is no need to think about the economic and social milieu in which production and exchange take place.

We hypothesise that a variable, which we call social capability, is another critical factor in explaining long term performance difference in economic growth, in addition to such factors as capital and labour. Social capability is defined here, as already noted, as the capability of a society to manage scarce resources.

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than total factor productivity as previously suggested. P. Krugman, in his recent Foreign Affairs article (Nov.-Dec., 1994), compared and pointed out the similarities of the performance of Asian NIEs and that of former USSR during the 1950s and 1960s, since both regions' high growth performance was due to continuous mobilization of factor inputs rather than due to total factor productivity growth, citing Young's study. His argument implied that unless these high performance countries in Asia can change the sources of growth from the mobilization of capital and labour to innovation and efficiency improvement, which will be shown in their growth of total factor productivity, the continuous growth of these economies may not be possible. Krugman's comparison, however, does not appear to be able reasonable, considering significant differences in economic systems of Asian NIEs and former USSR. For instance, whereas the Soviet economy was a completely planned and closed economy, and mobilization and allocation of resources were done by government, the Asian NIEs relied on market mechanisms to mobilize and allocate resources efficiently, whereas Asian NIEs did, as indicated by continuous high rates of return on factor inputs.

In addition, it has to be considered that an important source of Asian NIEs' sustained growth has been their ability to compete in international markets (namely, outward oriented growth strategy). They had to compete fiercely with producers from industrial and developing countries in the world market. The high rates of real interest, high rates of investment, and high rates of return on investment, which Asian NIEs have experienced, are all consistent with high productivity growth in these economies. (\*\* A. Young's different results about the measures of total factor productivity appears to be related to his using different labour inputs, among other things) The capability to manage their economies, so that they could continue to attract high level of investment, while going through rapid structural changes and moving up ladder in terms of industrialization and technological catch-up is indeed remarkable. How they could manage their economies and resources as they did remains to be "explained", so that other countries can replicate their performance.

What do we mean by the capability of a society to manage scarce resources? When we try to develop an economy, the availability of factor inputs, such as labour and capital are important. However, the critical thing is just the level of factor supplies, but how these given factor inputs can be utilized, organized and managed efficiently for economic growth. This is the key issue in consideration of social capability in economic development. Social capability means that certain social systems and critical features of a society make scarce factors more productive. It can be said that it is too broad concept. However, an important point here is that we deliberately selected the managerial capability of an economy as a key explanatory variable in accounting for the significant differences in long term economic growth among nations.

We assume that social capability is made up, first, with certain elements such as social norms, values and networks which works in relationship among economic agents. "to improve efficiency of a society by facilitating co-ordinated action" ( Putnam, 1993); second that it is made up of the systems that are developed to maintain a viable society, such as education, innovation, health, financial and legal systems. The key common characteristics of these ingredients of social capability are that: First, they are relatively indigenous to the society, not easy to bring in from abroad; Second, it influences the behaviour of all economic agents, people, firms and government. Third, it can be nurtured and developed and subject to change, but takes time to learn and to change. It also related to culture and history (path dependence). When neglected, it can be weakened and destroyed. It has a tendency to make a virtuous circle, when nurtured, and vicious circle when neglected. Fourth, it carries the characteristics of public good.

Before we discuss the salient elements of social capability, we need to briefly review certain similar concepts which have been developed to explain related economic activities. They are social capital, social overhead capital, and institution.

### **Social Capital**

In recent years some sociologists, economists and political scientists began to develop the concept of social capital in order to explain certain economic activities of agents. (Coleman, 1988, 1993; Frank, 1992), The concept of social capital is somewhat novel for economists in neo-classical tradition. According to Coleman, "Social capital is not a single entity but a variety of different entities, with two elements in common: they all consist of some aspect of social structure. Like other forms of capital, social capital is productive, making possible the achievement of certain ends that in its absence would not be possible.....Unlike

other forms of capital, social capital inherent in the structure of relations among actors." (Coleman, 1988) It is consist of certain social values and norms, such as expectations, trust and social networks. There is no questions that social capital, as defined, will facilitate economic activities by reducing the cost of transaction and information collection.<sup>3</sup>

Our concept of social capability includes the social capital defined here, but it also includes certain social systems and institutions.

### **Social Overhead Capital (SOC)**

Economists used the concept of social overhead capital (SOC) for long time to indicate certain forms of capital that renders services to all agents, such as roads, utilities, communication facilities, etc. More recently, economists (Uzawa, 1992) included certain economic organizations and institutions as a part of invisible, or non-physical, such as financial and education system.

### **Institutions**

Institutional economics are concerned about two kinds of issue: According to Williamson (1994) first, the institutional environment which " is the set of fundamental political, social and legal ground rules that establishes the basis for production, exchange and distribution. Rules governing election, property rights, rights of contracts, etc. (Davis and North, 1971); Second, an institutional arrangement, "which is an arrangement between economic units that governs the ways in which this units can cooperate and/or compete".

Institutions issues including governance, rules and contracts are analyzed mainly using two approaches, namely that of transaction costs and collective action. Although the issues dealing with institutional economics is closer to our concern, the social capability approach embraces such issues as social norms, networks and values more readily. Also whereas institutional economics deals with these issues more generally to explain various activities of economic agents including certain aspects of economic development, our concern is much more specific to efficiency in factor utilization in the context of economic growth and development.

### **III. Elements of Social Capability**

The concept of social capability is wide in scope and its elements are diverse. In principle, it may be said that all the elements, ranging from institutions to social norms and value system, which are related to the capability of society to manage scarce resources are the

<sup>3</sup> R. Putnam (1993) in his elaborate in his study of Italian regional governance points out that, despite the fact that northern and southern Italy shared the same government institutions, the performance in terms of economic development, civic and social development was so different in these two regions, because of the large difference in stock of social capital.

subjects of our concern. However, in our effort to build the hypothesis to relate social capability and growth, we will concentrate on the following aspects.

In this paper, our discussion of social capability is divided into several levels. First, we need to discuss certain preconditions or background factors for sociality to function as a unit, namely nation building. Evidence suggested that when nation building has not been completed, social capability to manage scarce resources is weak.

At second level, our analysis of the elements of social capability will be directed to institutions and systems that are necessary in managing resources at a societal level, such as education, health, legal system and financial system. Some of these systems such as education and health are elements of human development as they are related to individual human beings as well as human in a society. The others are related to the development of market mechanism. At the third level the role and capability of government (state) and firms will be discussed. These two organizations are the prime institutions which embody managerial capability of a society in terms of managing resource for economic development.

Finally, we need to discuss social norms and values and networks. In particular, those values which are closely identified with the economic development such as third and future orientation, co-operation and hard work, and equity. In discussing these values and norms, we are very conscious of possible objections of economists in including these elements to explain economic development. It is frequently good that these should be excluded in the analysis because social norms and value systems do not change easily and therefore, should be regarded as given. However, we have evidence to suggest that these norms and values play a critical role in shaping individual behaviour and hands in formulating social capability, and that they are amenable to changed over time.

There are important common characteristics of various elements of social capability. First, it is assumed that social capability is embodied in humans and also in institutions such as firms and government that work for economic development. Therefore, it is not visible in physical forms. We only see the consequences of social capability manifested in the indicators of economic development. Second, social capability has the characteristic of public goods. The management of such a socio-economic system (education, health, financial and legal system, etc.) including ownership should not mainly be relegated to the market mechanism.

### **Nation Building and Equity As a Background Factor**

Despite a long history of building nation-state in many parts of the world, we also have a significant number of countries, where the task of building nation state has not been quite completed. In those countries tribal politics often dominate in major economic policy decision making. Nationalism has not been developed well. Under such a condition, managerial capability of society will be difficult to develop. It does not mean, however, that social capability at a regional (tribal) level can not be developed. Only means that tribal and regional rivalries can cause significant damage and cost in social capability building.

In a different context, countries with serious racial and ethnic conflicts, or severe inequities will also suffer from developing social capability.

The relationship between equity and growth has been discussed widely without reaching a unified view. From our point of view in relating long term growth with social capability, equity is an important variable. Equity and growth may not have a one - to one - relationship as some economists tried to prove (or disprove). But several inequity observed in some developing countries was the cause of social disintegration, had negative effect on socio-economic environment, and tended to destroy their social capability. Landless poor tenants, compared with those farmers who work on their own farms, would not have incentive to work hard or to save for the future; they would not trust government or their employers; labour-management relationship would be difficult to manage; access to social services, such as education, finance, legal service, tend to be unequal in those societies for rich and for poor; chronically poor people would not have high hopes for the future. All these factors work negatively for building social capability and long term economic growth. The comparison between Asian NIEs and Latin American countries in terms of equity and long term growth performance makes this point clear. (F. Fajnzylber, 1995)

Nation building in context of discussing social capability also implies that the leaders and people of a nation state should have urges to build a nation with the socio-economic environment in which people, organizations and firms are encouraged to participate, encouraged to realize their potentials fully, encouraged to enter the market freely and to compete, encouraged to observe laws and regulations for public encouraged to innovate, and encouraged to invest in the future: in short, a nation under a good governance.

## **Systematic and Institutional Elements of Social Capability**

### **Education System:**

The importance of educated and trained human resources ( human capital ) for economic development is well documented. Education is one of the most critical elements in social capability and the key factor in sustained long term growth. Through education and training, knowledge, technology and skills that are essential for high quality human capital for sustained growth are embodied in labour, and capability to absorb foreign technology and know-how grows.

It is, however, important to recognize that education is not simply a tool for economic development, but it has more broad and fundamental function to develop intellectual, physical and artistic potential of human beings along with the development of moral and ethical character and integrity. Through education at home and at school, children develop attitudes about how to cooperate with others, how to contribute to a society, and gain knowledge and skill. Therefore, a good education system is essential in social integration and social mobility, and hence social capability building.

### **Innovation System:**

It is well known that technology development and innovation is one of the key factors for productivity growth. In the neoclassical paradigm, innovation and technology are related as exogenous. In our discussion, the innovation system is one of the main ingredients of social capability in managing scarce resources efficiently. In the developing country context the notion of innovation implies something more than inventiveness. Since, developing countries as late comer economies can be more efficient by learning technology from and catching up with the developed countries, than trying to "re-invent the wheel", it is important to know how to make late comers, acquire, adapt and internalize technologies and managerial know-how from advanced ones most efficiently. Even though this is learning rather than invention, the absorption of technologies and know-how from advanced countries is never easy. They have to be adapted and internalized for absorbing countries to utilize them. In this process of adaptation and internalization, significant innovation is involved, without which successful absorption is not possible.

In promoting innovation, creation of competitive environment is critical, both internationally and locally. The motivation to innovate can be dissipated with a lack of healthy competition. The role of government, due to its externality effect, in promoting technological capability seems to be quite important. However, a critical element is not just government resource allocated to public

laboratories, but also to develop an incentive system for the private sector to engage in innovation actively.

### **Financial System:**

Efficient financial intermediaries are essential in capital mobilization and resource allocation. Although most developing countries have had traditional intermediaries, sustained economic development and industrialization demand the development of modernized capital markets. Financial systems developed by advanced countries, after having been adapted to the needs and capability of absorbing developing country, can be utilized.

When it is well developed, the banking sector for instance can play an important role in monitoring and supporting industrial firms (e.g. Japan's main bank system). In the developing country context, government's role in repressing the financial system can be quite serious, resulting in the underdevelopment of the financial market, under the pretext of promoting industries (i.e., industrial policy). It often happens in the countries which traditionally view financial intermediation as parasitic rather than legitimate value added activities for the development of society, compared with the manufacturing activities.

In designing and operating the financial system it is important to allow the interest rates to move relatively easily to clear the markets, so that the market will not suffer from chronic excessive demand. In that situation, entry of new firms would be difficult and small and medium sized firms would suffer in financing their activities.

### **Legal and Regulatory System:**

An efficient and effective legal and regulatory system is another important ingredient in social capability. Without an effective legal system, contract enforcement can not be accomplished, which would have a serious negative effect on economic growth. Dealing with corruption and illegal rent seekers are also critical in an effective legal system.

Many of these problems are prevalent in "soft state," where credible sanction does not exist, and effective monitoring and law enforcement is weak. An effective legal and regulatory system will protect those law abiding firms and individuals from illegal actions of rent seekers and even bureaucrats.

### **Firms and Government, and Social Capability**

As noted above, in the context of economic growth, the activities of firms and government are very critical. It is our hypothesis that the performance of firms and government is closely related to the social capabilities embodied in them.

### **Firms:**

In a market economy firms are a basic unit which are engaged in production, exchange and distribution of goods and services. How to make firms engage in these activities and perform efficiently are major concerns of a country that needs to have sustained long term growth. Firms must be able to attract highly qualified manpower and they should enjoy an environment which support them to complete and grow, and in which entry into new market is easy.

One of the most critical elements in firm performance is good interaction and communication among peer employees and between management and employees. The way that information flows and is shared among members of a firm is important in firm performance. Many studies showed that it generates positive externalities.

As discussed below in more detail, small employee groups in firms play a critical role in process innovation and quality control. This is possible, because of the prevalent environment ( or culture ) of peer support, close interaction and communication and trust among the members. This practice, originated from Japanese firms, now well spread to other countries and showing the same good results.

### **Government:**

The role of government in economic development is a controversial subject. Some argue that government can lead economic growth and development, whereas others insist that less government involvement and intervention in the market is the best for economic growth.

In the developing country context which typically shows under-development of market mechanism and a weak private sector, government role seems to be essential in developing market mechanism and efficient resource allocation. History of economic development shows often that government could push economy from low ( trapped ) equilibrium to higher equilibrium. It is to be noted, however, that government should not be seen as always benevolent, as many studies have shown. It appears that good governance is closely related to the existence of division of power among administration, judiciary and legislature, as well as strong public minded civic groups and media.

Despite the limits of government's role, it is still critical in correcting market failures. The government's power to sanction, to establish institutions and arrangements, to tax, can reduce transaction costs and information costs for firms and individuals and address market failures.

We also know that government can fail. Interest group politics, lack of competition, or weak competition in public sector, " soft-state " problems, all contribute to the government failures.

For our purpose, an important issue is the relationship between government and private sector in promoting economic development. It is often seen that the interaction between these two sectors as zero-sum game, and seen as two rival entities for competition. In the context of developing countries, we have seen that government and private sector can work together for common objective, economic growth and development, to remedy market failure and support a weak and under-developed private sector. This co-operation can reduce uncertainty and transaction costs and information costs for both government and private sector, and hence contribute to sustained economic growth.

Finally, it should be noted that, the model of co-operation between government and private sector works best when government is capable of helping a weak and under-developed private sector to develop. It suggests that as the private sector become strong and mature and the market mechanism developed, the role of government must recede. This is apparently not easy, as many tales of de-regulation efforts in many countries are telling us.

The prime goal of government is good governance. How can achieve that? in a way it is a fundamental question. Experience show that leadership quality is critical, and government must have legitimacy, which will allow her the capability to enforce rules and regulations with credible sanctions. Also a good balance of power among the administration, the judiciary and the legislature, as well as active civic organizations and media seems to be critical. As discussed in the section of nation building above, good governance implies that people observe rules, have equitable basic services, and are free to pursue economic activities one chooses.

### **Social Norms, Values and Networks**

It is well documented in a number of recent studies how certain social norms and values as well as socio-economic networks help to develop community and economy. ( Putnam, 1993, 1994; Inglehart, 1995 ) Among the social norms and values those which are related to co-operation with others, thrift and future orientation, hard work and achievement mentality, honesty and entrepreneurship are shown to be important in this respect.

This norms and values reduce transaction and information costs through building trust between individuals and groups. They generate important positive externalities. (Stiglitz, 1995) by influencing behaviour of others. The recent discussion on network externalities can

be understood in the same way. It is important to recognize that institutions and networks may be efficient in solving "local/regional problems." but that does not guarantee efficiency of global/national problem solutions.

#### **IV. Social Capability and Economic Growth of Japan and Korea**

In this chapter we would like to use Japan and Korea as examples to show how social capability of these economies has helped them to achieve sustained long term growth in the post-war period. As already noted in the introduction, this is not a full fledged case study for Japan and Korea, but rather the presentation of them as examples to show how various ingredients of social capability played a role in the process of sustained long term growth of these two economies, beyond the well known role of such factor inputs as capital and labour. The reasons why we chose these two are that they have experienced rapid growth for several decades in the post-war period and they also had relatively distinct elements of social capability that we are interested in using to explain sustained long term growth.

##### **Nation Building and Equity: background factor**

##### **Nation Building and Equity in Japan:**

Japan's nation building process was begun a long ago, even before modern times. As a nation of relatively homogeneous people, she did not have serious problems in this effort. Good administration and market systems were developed before the Meiji restoration. Beginning in mid-19th century she stepped up efforts to build a nation-state by adopting and reforming administrative, legal, financial and managerial systems through learning and adapting Western systems to its own needs.

The reforms measures which Japan undertook after World War I, under American occupation were very critical indeed to transform Japan into a modern democratic nation with a market economy. In particular, land reform, which virtually abolished landlords and tenants, and resolution of the Zaibatsu, ( large Japanese conglomerates ) were important for the stable growth of the Japanese post-war economy.

As for the equity issue, Japan has been known as a model country among advanced industrial economists for her relatively equal income distribution ( Sawyer, 1976 ), despite some concern that the income distribution recent years worsened. ( Ishikawa, 1995 ) The main reasons why Japan could have fairly equal income distribution were as follows: first, the postwar land distribution and ensuing inflation almost wiped out rich landlords and tenants. The rapid growth of the economy, which has grown at an average real rate of growth of 8-9 percent per annum until 1973, began with labour intensive

industries and enlarged employment. Until now, even when growth rate was down nearly half, Japan still maintains a high employment rate. The excellent labour-management relations, and low wage level gap between workers and relatively efficient labour market practice all help to explain equitable income distribution in the post-war period. ( On the negative side, the wage differential between men and women, and land price inflation in urban area in the late 1980s also had negative effect on equitable income distribution. )

##### **Nation Building and Equity in Korea:**

Korea's nation building effort has also been evident in her long history. It has maintained a fairly well run central government with good administrative system. However, in the wake of 19<sup>th</sup> century imperialism, Korea, a small and weak country in East Asia, became a war zone among the world powers, and finally in 1910, when the modern system of nation building, including administrative, education, financial system, began to take root. Korea was annexed to Japan until 1945. Korea's nation building effort was distorted under the colonial government. Despite the colonial legacy, Korea adopted Western systems of administration, judiciary, education, finance, etc. All of which imitated the Japanese versions.

Beginning in 1945, Korea began a series of reforms in government and the private sector under the supervision of U.S. military government until 1948 including a major land reform. The land reform and ensuing inflation almost abolished the fortunes of the landed class and tenants also became land owners. The Korean war of 1950-1953 completely devastated its economy and made virtually all people poor. Despite the poor living condition, people did not neglect to send their children to school and support them in high schools with their meagre savings. The rapid and sustained growth of Korean economy since early 1960s started with this kind background.

The subsequent growth strategy based on export-led growth specializing on labour intensive industry products enlarged employment opportunities and through this period of rapid expansion income distribution became more equitable. This sustained growth from the impoverished situation helped Korean people to have confidence in managing their own future and led them to future orientation. It produced positive feed back system which show that the harder they work now and save, the better off they will be for the future. It also helped government and private sector through higher productivity and increased savings. The role of government was important during this process, because people expected that government should lead in the nation building and economic development.

## **Institutions**

### **Japanese Education and Learning System:**

It is well recognized that the rapid catch-up of Japan with the advanced countries and its sustained long term growth owe a lot to the Japanese education and learning system. Even before the advent of the modern system of learning in mid 19<sup>th</sup> century Japan, a fine tradition of learning was established. Japan has shown its particular capacity for learning in the area of borrowing and adapting foreign technology, accumulation and efficient diffusion of knowledge, and continuous learning, all of which have had important roles in the rapid industrialization of Japan. ( Rohlen, 1992 )

The development of the Japanese education and learning system was influenced a great deal by cultural factors. In Japanese society where competition to succeed is very strong, education and learning is one of the most important ways of upward social mobility. The active government policy and public investment in education assumed that education and learning were vital to economic development. By 1950 virtually all new entrants to the labour force graduated from middle school ( 9<sup>th</sup> grade ) and above. By 1975 more than 90 percent of all new work forces graduated from high school ( 12<sup>th</sup> grade ) and above.

Formal education in Japanese education learning system represents only a part of this effort. The informal learning system, starting from learning by doing on the job training to formal company training, is another vital part of Japanese human capital formation. Companies constantly provide opportunities for its employees to learn every day. Quality control circles and other small group activities are also geared to this purpose. Japanese system of life time employment implies that the company's investment in the education and training of its employees will here a good rate of return in the long run. Despite some recent concern about the adequacy of the current Japanese education and learning system to produce a good number of " creative " people to lead the world in innovation and invention, it seems to be certain that the Japanese system of learning enabled them to achieve the current level of economic development.

### **Korean Education and Learning System:**

If we were to choose one country which relied heavily on human capital and its good utilization for its sustained long term growth, it would be Korea. As noted above, Korea in the 1960s was a poor country ( per capita income less than \$ 100 ), with very little capital and technology ( the export of manufactured goods were less than 3 percent in 1960 ). But Korea had educated human resources. By 1960 nearly all children of primary school age attended primary schools. By 1970 43 % of all

secondary school ( 7th to 12 Th. grade ) age group attended secondary school. By 1985 35 % of all tertiary school age children attended universities and colleges in Korea. Usually, investment in education is explained in terms of the level of income, but Korean education expenditure, formal and informal, is much greater than countries with similar income groups. It means that even when they were poor as in 1950s and 1960s, they invested heavily in the future of their children.

How can we explain this. A part of it is due to cultural factor. This reflects a long tradition of meritocracy which regards education as an important route to upward social mobility as in the case of Japan.

Importance of learning in work organizations is similar to the case of Japan, since a lot of the practice in this area Koreans learned from Japan, including learning activities of quality control circles. Just as in Japan, there is currently a serious national debate in Korea concerning Korea's education and learning system to meet the challenges Korea will face in the next century. Few people doubt that Korea's investment in education and learning so far has not paid her handsomely.

## **Firms and Government and Social Capability**

### **Japanese Firms and Social Capability:**

Despite recent doubts concerning the wisdom of Japanese management practices, Japanese management practice which embodied her social capability served Japan well in her rapid catch-up and sustained economic growth. In this process of catching up Japanese firms performed well. We need to discuss a few salient aspects to understand why Japanese firms performed efficiently.

(1) Information processing and monitoring in Japanese organizations: According to Aoki, ( Aoki, 1988, 1992, 1995 ) one of the reasons why Japanese firms performed efficiently in the last few decades is because of its typical information processing and monitoring approach. A typical Japanese firm is organized in such a way that information processing is decentralized, so that information sharing is done more efficiently, but monitoring is done hierarchically. Tendency toward decentralized information processing is reflected in the development of team work at a firm level in which individual capabilities are well integrated.

(2) Innovation, quality control and learning approach in Japanese firms: Studies on Japanese firm revealed that an important competitive advantage of Japanese firms comes from learning and process innovation arrangements of Japanese workers at a shop floor. In typical Japanese firms there many small sized group of workers, often called quality control circles. They have group discussion meetings several times a week to discuss ways to reduce defects, learn from each other and



make suggestions for process innovation to the management. According to these studies, these innovation, quality control and learning arrangements contribute to reduced the cost of production and defects. The remarkable thing is that this is a continuing process. The key factors for this successful arrangement include such social norms as teamwork and co-operation, value placed on continuous learning, and good management-labour relations.

(3) Japanese labour-management relations: Japan, different from other industrial countries has enterprise union. Japanese labour-management relationship is more co-operative and conciliatory than the practices of other countries. Japan in the 1940s and 1950s had its own share of serious confrontational labour-management relations until even 1960, when the Mitsui mining strike which lasted more than 300 days took place. Both management and labour came to the conclusion that co-operative relations between labour and management under enterprised based union system would serve both parties better.

Life time employment practice accepted by both parties was also an important factor in establishing the co-operative, non-confrontational relationship. Workers and employees were encouraged to see their long term vested interests in the performance of the company. The long term relationship is their investment in the company.

#### **Korean Firms and Social Capability:**

In discussing the performance of Korean firms and social capability, we see a lot of similarities between Korean and Japanese firm organization. This is in part due to the common cultural factor and to Japanese influence in shaping Korean firms' management practice.

Korea's competitive advantage at a firm level seems to come from several sources in relating to social capability. First, Korean firms have excellent capability to absorb foreign technology and know-how. After they import them, then adapt them to fit Korean environment and needs, and finally internalize them, so that the borrowed technology and know-how would become the stepping stone for innovation of their own. This absorption capability is based on good education and training on the part of employees, and the managerial capability of firms. Second, as in the case of Japanese firms, Korean firms also developed the arrangements for workers' learning, innovating and controlling quality through activities of small quality control circles. They have learned it from Japanese firms and adapted it to fit their own needs.

#### **Japanese Government and Social Capability:**

After the Meji Revolution of 1968, Japanese government played a key role in Japan's development and industrialization. Government designed institutions and helped to develop private sector. This tendency continued until the early post-war period, when Japanese economy after the defeat had a difficult time recovering from its destruction during the war. Japanese government planned its development course and intervened in the economy when necessary. The role of the Ministry of International Trade and Industry in developing industrial policy has been important. Ministry of Finance's role in controlling financial institutions through its monetary policy and power to monitor and supervise them was powerful. This was possible, partly due to the fact that Japanese government could attract best of brains from Japanese elite for its professional staff, and also due to the cultural and traditional factor in perceiving government as entity to lead.

However, in the 1950s and early 1960s as the private sector's role and capability developed further, active role of government began to recede. The scope of government intervention in the economy became limited. The role of government moved to the direction toward that of monitor, co-ordinator and institution designer, enforcer of the rules and caretaker of the issues that market is not well suited to solve, including certain type of R & D and provision of social overhead capital. It is interesting to note the transition in Japan which has taken place for a long time under the legacy of strong government.

#### **Role of Government and Social Capability in Korea:**

In the post-war period when Korea started reconstruction from the aftermath of Korean War, government had to take a stronger role. The markets were under-developed, and private sector was very weak. Important part of this result is colonial legacy. How was the Korean model of development in which government took an active role different from the development model of socialist economies?

First of all, Korea adopted market mechanism in which private sector is to lead. Korea never envisioned an economic system in which government planned, produced and distributed goods and services. Second, when government had economic development planning, it was not a government plan, but the joint plan between the private sector and the government. The planning exercise helped private sector in a number of ways. It reduced uncertainty. It also set certain goals which private sector striped to achieve. This is one way of pushing private sector from low equilibrium to higher equilibrium. Third, government actively helped to develop market mechanism

as a designer of institutions, and to support the development of private sector through privatization scheme.

It is important for us to look at so called "authoritarian" model of Korean development in the context of social capability. It is often argued that sustained long term growth of Korea and other NIEs in Asia was possible because of authoritarian rule, in which labour rights and human rights were sacrificed. In our view, although we agree that government under President Park in Korea, for example, cannot be regarded as a model of democracy and political activities of oppositions were restricted, the argument of authoritarian model is misleading. The sustained growth was not due to the suppression of human rights, but the suppression of rent seeking behaviours and bureaucratic red-tape and inefficiencies, and to the capability to implement policies efficiently.

Since the early 1980s the role of government has been visibly changing. As the private sector's capability to develop the economy grew rapidly, the role and capability of government showed its limits. Liberalization and deregulation were important tools to have sustained growth of the economy. The role of government moved toward reform of systems (institution designer), promotion of competition, building social overhead capital, promoting R & D and education. Despite all these efforts to move toward small government, it does not seem to be an easy job, as the current government's reform agenda has indicated.

#### **Social Norms, Values and Networks in Japan and Korea:**

In both countries future orientation in their value system, which is shown in their high savings rates and their desire to invest heavily in the education of their children, played a significant role in the sustained growth of both economies, enabling them to mobilize domestic savings and provision of good human capital.

Both countries also have good social customs to cooperate closely among members of organization. Anthropologists showed that this social norm originated from traditional rice farming activities in the rural area which required a lot of co-operative works. This norm of close co-operation was essential in building small financial intermediaries and co-operatives as well as successful organizations of small group activities for quality control and learning at firms.

In the case of network building Japan seems to be doing far more successfully than Korea. The network of subcontracting between suppliers of parts and components and assembling firms in Japan and their efficiency has been well documented. In both countries

various type of organizations and networks were developed for serving diverse purposes. (These networks may be useful for solving some local problems they face, but it does not necessarily guarantee that these solutions may be globally efficient.) These network activities seem to generate externalities through close interactions, communications and mutual learning.

It is not easy to determine to what extent these social norms, values and network helped Japan and Korea to have sustained long term growth. It is well demonstrated that such activities as high savings rate, high investment in education, and successful small group activities at firm level have contributed significantly for their rapid and sustained growth in the post-war period.

#### **V. Development of Social Capability**

It is not difficult to see that the ingredients of social capability are not those which can change and develop quickly and easily. However, it is important to recognize that social capability can be developed, and we should not regard it as given. The question is how we can develop social capability.

For one component of social capability, namely, social norms, values and network, the basic strategy to develop is through education at home and at school. Children can be taught the values of co-operation, trust, importance of public mind, thrift, honesty, efficiency, future orientation, hardwork, fair competition, accountability. It is also important for the leaders and social elite's to practice these social norms and values. Because children will not just learn from word but from observation. The role of public media is very critical in this respect.

As for the institutional aspect of social capability, we need to go back to basics: namely, good governance, reform, and development of competitive market. On the one hand, they have to free, emancipate, motivate and empower people, and develop market mechanism fully, and on the other hand, they have to deal with rent seekers and law breakers with credible sanctions. The good balance between administration, independent judiciary and legislature as well as the role of active civic organizations and public media seems to be indispensable for good governance. Finally, one thing we should note is that utilization of social capability has positive feedback mechanism. Therefore, the good utilization of social capital itself will develop social capability further. In the following some concluding remarks are in order.

In this paper I tried to point out that availability of key factors of production (capital, labour, human capital, etc.) and institutions are not enough to get an economy to have sustained long term growth. They are necessary, but not sufficient. The critical issue is how to manage these

scarce resources efficiently. This managerial capability is the key for a country to enjoy sustained economic growth.

Our understanding of this managerial capability of society is still imperfect. However, we do understand certain ingredients which consist of this social capability, including certain social norms and values and networks, such as attitude of future orientation, thrift, education, co-operation, trust, as well as socio-economic organizations and institutions, that give rise to good governance, social interaction and communication to generate positive externalities.

For a long time, neoclassical economists did not pay attention to this managerial capability, holding on to unrealistic assumptions of perfect competitive market and perfect information. Furthermore, these ingredients of social capability were assumed to be given and not to subject to change. As already discussed, these ingredients can be developed and change.

In modern economy the role of firms and government is critical in economic growth. The social capability is embodied in the firms and government. The performance of firms and government will reflect the degree of social capability which is embodied in them. Firms and government will participate in economic activities under a certain socio-economic environment. This environment will influence their behaviour, but firms and government will also influence the environment through creation of institutions, hence participate in the development process of social capability. The social capability has a tendency to give positive feedback; the more a society develops and uses it, the more it will generate; if a society neglects and does not use it, it will degenerate. A critical question is how members of a society to work together to develop and use the social capability more.

Although we still need to go a long way in understanding the long growth process more adequately, we can utilize what we already know, and try to develop social capability.

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