

## **PROMOTING INVESTMENT: SOME LESSONS FROM EAST ASIA**

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### **A. Introduction**

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As noted in the previous chapter, accumulation and growth depend largely on the spending behaviour of the classes that take a very large share of national income, particularly the capitalist class. Historical and cultural factors play an important role in the emergence of a dynamic capitalist class with a high propensity to save and invest from profits. It was also noted that income distribution itself can have an important influence on incentives to save and invest. However, experience shows that government policies play a key role in promoting “animal spirits” among business, not only by securing certain basic conditions such as political and economic stability and property rights, but also through appropriate use of fiscal, financial, industrial and trade policy tools and institutional arrangements that enhance the effectiveness of government intervention.

This chapter discusses the key policy instruments and institutions used in the East Asian countries in animating the investment-profits nexus and attaining a rapid pace of growth and industrialization without widening inequality. The next section examines the policies and institutions designed to encourage savings and investment from profits, and is followed by a discussion of specific policies aimed at discouraging luxury consumption, focusing on how trade and development strategies can be designed to link investment and production to exports rather than domestic consumption. The final section examines the role of profit-related pay in reconciling distributional and growth objectives. While the chapter draws primarily on the East Asian experience, comparisons are also made with other countries.

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### **B. Animating the investment-profits nexus**

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All the East Asian governments have generally succeeded in guaranteeing certain basic conditions for investment by maintaining political stability, ensuring the respect of property rights and creating a pro-investment macroeconomic cli-

mate. “Pro-investment” is a better description of East Asian macroeconomic policies than “stable” or “low inflation”, because some of these governments were willing to tolerate a fair degree of inflationary pressure for the sake of boosting in-

vestors' confidence. Moreover, consumption was sacrificed in preference to investment when more restrictive measures were considered necessary for the achievement of national economic goals. However, central to sustaining the momentum of industrialization in the most successful economies in the region has been the pursuit of policies designed to promote profits and to provide incentives to private firms to invest in productive capacity and productivity, and to compete aggressively for a greater market share.<sup>1</sup>

This was done in two major ways. Firstly, fiscal instruments were used to increase corporate profits and to encourage retentions in order to accelerate capital accumulation. Fiscal incentives included specific instruments targeting directly corporate profits and investment, such as tax breaks and special depreciation allowances. Legislation allowed firms to put aside reserve funds against risks and exempted funds from taxation, making it possible to defer tax payments on profits. Such policies also played a catalytic role, since banks were more willing to make loans for investment qualifying for accelerated depreciation allowances.

Secondly, trade, financial and competition policies raised profits above levels that would have been attained under free-market conditions, thus creating rents. State-created rents, indeed, were more vital than fiscal incentives in boosting profits and promoting investment. They were created through a combination of selective protection, controls over interest rates and credit allocation, and managed competition, including the encouragement of mergers, the coordination of capacity expansion, restrictions on entry into specific industries, screening of technology acquisition, and the promotion of cartels for specific purposes such as product standardization, specialization and exports.<sup>2</sup> As a result, domestic prices were allowed to deviate from international ones. This was particularly true in Japan, during the catch-up period, and of the Republic of Korea and Taiwan Province of China - the three economies where the international competitiveness of national firms was steadily built up and industrial deepening proceeded furthest.<sup>3</sup>

The low interest rate policy was particularly important to firms as they built up internal funds. Similarly, the rationing of credit, through such mechanisms as "window guidance" in Japan, also played an important role in raising returns on investment and hence internally generated funds by preventing excessive expansion of productive ca-

capacity.<sup>4</sup> Thus, credit rationing was not just used as an instrument for "picking winners"; it also enabled rent creation and capital accumulation to take place. Together with competition policy, it was also used in the coordination of investment decisions so as to prevent the "investment race" among large oligopolistic firms from going so far as to lead to falling profits and hence falling investment.<sup>5</sup>

Rents were also created by protectionist measures, but an important feature of these rents was that they were often linked to export performance. The most lucrative form of rent provided by the Government of the Republic of Korea consisted of profits from sales on domestic markets made possible by protection that was conditional on export performance. In Taiwan Province of China rent creation was linked to exporting by tying the allocation of import licences to export performance, a practice which ensured that "those getting the windfalls (rents) from importing scarce commodities are at the same time contributing to the economic success of the country by exporting".<sup>6</sup>

Most of the fiscal instruments and rent-creation measures were applied, in a deliberately concerted way, to specific industries at particular moments in time. However, they have not just re-allocated given resources among various sectors, but have also significantly increased the overall rate of accumulation in a number of ways. Firstly, in promoting investment in industries with greater potential for learning, scale economies and productivity growth, the policies served to raise the average rate of return on investment, and hence total profits, thereby stimulating capital accumulation. Secondly, the overall rate of capital accumulation was raised as the result of forward and backward linkage effects that these favoured sectors generated for the rest of the economy. Finally, the policies also contributed to growth by easing key macroeconomic constraints on capital accumulation, including particularly the balance of payments constraint on capital goods imports.

A number of factors account for the successful management of rents in East Asian NIEs in accelerating capital accumulation and growth compared to other developing countries that pursued similar policies. First, the rents were achievable through productive activities which served broad national interests, and governments acted to close off non-productive channels of wealth accumulation. Second, the provision of fiscal subsidies and the realization of rents were related to performance

standards. Significantly, the reciprocity between government support and private sector performance entailed a faster rate of capital accumulation and growth. This was not only because support was often provided in exchange for higher investment, but also because better export performance as a measure of the quality of investment necessitated faster accumulation in order to raise competitiveness through adaptation of new technology, scale economies, learning and productivity growth. By contrast, in many other developing countries where similar policies were pursued, reciprocity between government support and private sector performance was not assured, and earning high incomes did not always depend on productive investment. In such countries the outcome has been a combination of a high share of profits in national income with a low propensity to save and invest from profits, and a highly unequal personal income distribution.

There can be little doubt that the characteristics of the business community as well as government policies play a crucial role in the process of capital accumulation. As one commentator has pointed out describing Japan during the catch-up period, “the success of guidance from above was only made possible by dynamism in industrial circles”.<sup>7</sup> Government policy contributed to that dynamism and accelerated the process of capital accumulation by animating the investment-profits nexus through creating rents and pushing profits and investment beyond what could be attained under free-market conditions.

Effective implementation of such policies in East Asian NIEs depended crucially on building

appropriate public and private institutions.<sup>8</sup> Creation of a strong bureaucracy based on the principles of meritocracy, continuity and insulation from day-to-day political pressures played a major role in establishing an effective government-business network needed to ensure reciprocity. Formal and informal links with peak business organizations, as well as sectoral ties, were instrumental in the design, implementation and coordination of policy measures.

A corporate structure based on large, diversified business groups and concentration of ownership in the hands of a small number of inside investors, together with a close relationship and interlocking ownership with banks, has allowed enterprises to take a long view and hence to establish a pattern of corporate governance which has not been pressured by considerations of short-term profit goals. Such forms of business organization and ownership provided especially effective institutional arrangements under conditions of scarce endowment of capital, entrepreneurship and skill and of inadequate and imperfect information. They helped overcome coordination problems in investment decisions; facilitate exchange of information and reduce risks and uncertainties surrounding investment projects; internalize economies of scope and realize interrelated investment opportunities by encouraging firms to create externalities for each other as well as provide cross subsidies in financing infant industries and R&D.<sup>9</sup> Similarly, the internal capital market organized within banks and firms served to reduce the borrower’s risk and to lower the cost of investment and the rate of return required by investors to undertake investment.<sup>10</sup>

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## C. Control over luxury consumption, trade and industrialization

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### 1. *Luxury consumption*

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Given that the distribution of capital ownership is usually highly unequal, and that savings out of profits take place mainly through corporate retentions, the coexistence of a high share of profits in value added with a highly unequal personal income distribution suggests a low propensity to

save and invest by the rich. This phenomenon is much more widespread in developing countries than the coexistence of high profits with low personal income inequality. There is thus good reason to believe that the rich in developing countries do not always save and invest a large proportion of their incomes, but spend them on goods and services that by many developing country standards can be considered luxury consumption. They also have a

greater tendency to consume goods with high import contents, which, besides emphasizing consumption over savings, has also the effect of leading to a tighter balance of payments constraint on accumulation and growth.

Most countries, whether developing or developed, place few or no constraints on luxury consumption. A policy of controlling luxury consumption has been adopted only by a relatively limited number of countries since the Second World War, and sometimes for only limited periods. Examples include certain restrictions on travel abroad in Western Europe in the immediate postwar years, the efforts of the socialist countries of Eastern Europe to give second place to luxuries in their pursuit of more egalitarian social structures, and the determination of some East Asian economies to increase savings and accelerate capital formation. The corresponding policies have been introduced and subsequently relaxed during various stages of development or, in Western Europe, during the postwar recovery.

There is a popular perception that some countries are more prone to engage in luxury consumption than others, and that this makes a difference to the country's economic performance. These tendencies can be clearly seen from table 45 with respect to passenger car ownership, which is a typical luxury good in the sense that it neither fulfils a basic need nor can be afforded by most people in at least the developing countries. The table provides some snap-shot statistics on car ownership for selected developed and developing countries in mainly the early stages of their development. It shows that some countries had a much smaller fleet of cars in relation to population than others at the same level of development (as denoted by per capita GDP in constant 1985 dollars). For instance, the Republic of Korea in 1984 had one third of the number of cars per 1,000 inhabitants that France had in 1950, although real per capita was roughly the same in both countries at around \$4,000. Likewise, in 1989 it had the same number of cars per 1,000 inhabitants as Turkey in 1992, even though its real per capita income was one and a half times greater than that of Turkey at the time. Germany, Japan and the Republic of Korea stand out as having an exceptionally low level of car consumption compared to that of other countries in their early stages of development or postwar recovery. At the other extreme, there are countries such as South Africa, Brazil and Malaysia where car ownership has been exceptionally high

for their incomes from the very early stages of development.

In some countries car ownership has grown broadly in tandem with per capita income. For example, it has grown fast in Malaysia and Thailand, but so also has per capita real income. In other countries, however, the stock of cars has risen relatively much faster. For example, although Argentina's real per capita income remained unchanged at around \$5,000 during 1965-1989, the number of cars per 1,000 persons rose from 41 to 133 from the beginning to the end of the period. Likewise, Chile, Egypt and Turkey initially had relatively low levels of car consumption, but these levels subsequently increased more rapidly than per capita income. The years of economic crisis of the 1980s only served to brake temporarily the growth of car ownership, which has spiralled in some countries that have recently adopted economic liberalization measures. In the Republic of Korea car ownership rose very slowly until the mid-1980s; the pace accelerated subsequently, but remained slower than that of per capita income growth.

Another indicator of luxury consumption for which international data are readily available is foreign tourism expenditure. Although they cover only the last two decades, they give a similar picture to that of car ownership. It is, however, striking that per capita expenditure on foreign travel in the Republic of Korea has shot up since 1988, when restrictions on such travel were lifted. It therefore seems that underconsumption, at least in foreign travel, had been due as much to restrictive policies as to any intrinsic tendency to save rather than consume by the country's higher-income groups. Import controls were one of the main restrictive measures adopted in that country to discourage or prevent luxury consumption during the initial phase of growth and development. They ranged from outright import bans on goods such as luxury cars or fur coats to a combination of quantitative restrictions, prohibitive tariffs and foreign exchange rationing in which priority was given to importers of capital goods and intermediate inputs. There was a surge in the import especially of luxury goods when controls were relaxed in 1986. Imports of fur-skin products, for example, were 40 times greater in value in 1995 than in 1986 and of tobacco products more than 300 times greater, as opposed to 4.5 times for manufactured imports as a whole.

Both Japan and the Republic of Korea instituted various domestic taxes that discriminated

Table 45

## DIFFERENCES IN CAR OWNERSHIP AT COMPARABLE LEVELS OF PER CAPITA INCOME

(Number of cars per 1,000 of population in year or period specified)

Per capita GDP <sup>a</sup> around	Germany	France	Austria	Italy	Japan	Republic of Korea	Thailand	Malaysia	Indonesia	Turkey	Egypt	Argentina	Brazil	Chile	Mexico	South Africa
\$1,000 Year Cars					1950 <sup>b</sup> < 1	1963-64 1	1962-63 2	1955 <sup>b</sup> < 8		1950 1	1964 3		1950 <sup>b</sup> < 6			
\$2,000 Year Cars					1955 2	1973 2	1979 9	1969-70 22	1990-91 8	1966-67 3	1992 <sup>c</sup> 20		1967-68 20	1950 <sup>b</sup> < 7	1950 <sup>b</sup> < 7	1953 35
\$3,000 Year Cars			1950-51 9	1951-52 10	1960 5	1978 5	1989 21	1977 39		1976-84 12-19			1972-73 29	1961-76 7-27	1963 14	1970-90 65-95
\$4,000 Year Cars	1951 16	1950 36	1956 27	1958 30	1963-64 15	1984 12	1992 <sup>c</sup> 24	1981-87 61-91		1992 <sup>c</sup> 37		1950-54 17-19	1978-91 64-80	1987 49	1970 23	
\$5,000 Year Cars	1954-55 33	1956 69	1960 57	1961 48	1966 29	1987 20		1990 104				1965-89 41-133		1992 <sup>c</sup> 60	1977-78 49	
\$6,000 Year Cars	1958-59 62	1961 133	1964 97	1966 121	1968 52	1989 37									1980-91 63-91	
\$7,000 Year Cars	1962-63 116	1964 182	1968-69 157	1968-69 169	1969-70 76	1990-91 56										
\$8,000 Year Cars	1966-67 175	1967 236	1971-72 186	1972-73 238	1972 118											

**Source:** UNCTAD secretariat estimates, based on national and international sources.

**Note:** It was not always possible to identify a single year as the point when a country reached a given level of income. In some instances an average for two years has been used. In others, where income passed a certain threshold in one year but fell below it subsequently, the number of cars is given as a range for the period between the year when the country first passed the threshold and the year after which per capita income did not fall below the threshold again.

<sup>a</sup> In constant 1985 dollars at purchasing power parities.

<sup>b</sup> The relevant income level was reached before the earliest year for which car data are available.

<sup>c</sup> Income did not reach this threshold until the last year for which the data are available, but was less than 10 per cent below it.

between consumer goods in terms of how “luxurious” they were deemed to be. In Japan 10 adjustments were made to the list of luxury goods during 1945-1987, each reflecting transitions in consumption norms as the country became more prosperous and living standards and expectations rose. Various such adjustments were also made in the Republic of Korea before 1977, when the commodity tax regime based on the Japanese model was replaced by a VAT system that taxed luxury goods far more heavily than other consumer goods.

Credit control was another allocative measure utilized by the Republic of Korea to deter luxury consumption. The loans made by the government-influenced banking system tended to favour production and investment in sectors accorded greater priority. Few, if any, consumer loans were available through the banking system. By the mid-1990s, however, well-established manufacturers themselves began to make credit available to their customers. Car manufacturers, for example, established specialized financing companies for this purpose.

The Governments of the Republic of Korea and other East Asian countries also publicly exhorted wealthy persons to show self-restraint in luxury consumption. The appeals sought to remind them of the harsh working and living conditions that the majority of the population had to endure during those early years of development and growth. These campaigns also had the effect of creating a valuable sense of sharing and solidarity in the population.

## **2. Production and exports**

Many of the goods that are treated in developing countries as luxury items, such as motor cars and consumer durables, are precisely those that have driven, especially through their strong backward linkages, modern industrial development in the advanced economies. They involve industries that typically employ mass production technology based on the use of dedicated capital equipment, where the achievement of scale economy is critical for cost efficiency. This poses an important challenge to developing countries in designing infant industry promotion programmes for such industries.

Typically, the domestic market in developing countries is too small to enable producers to reach

a minimum scale of efficiency. This problem is further exacerbated by the tendency of consumers to want variety in markets such as cars, which leads to a proliferation of models, often produced at below the minimum efficient scale, as in many Latin American countries.<sup>11</sup> At the same time, the scope for exporting is limited by their inability to compete with more efficient producers in the industrial countries. The response to this problem in many developing countries has been to provide trade protection or subsidies to allow them to survive.

Expanding domestic consumption may overcome the problem of minimum efficient scale in countries with relatively large domestic markets, but is not necessarily a solution in the long run. For one thing, expanding the demand for such consumer goods ahead of income would lead to a fall in savings. For another, financing the imports needed for their production would depend on primary export earnings or foreign borrowing, neither of which may increase as fast as domestic production of the goods.

East Asian countries such as Japan and, subsequently, the Republic of Korea have succeeded in resolving this dilemma by focusing on a strategy of export-led growth while at the same time discouraging luxury consumption. In some industries it proved possible to channel domestic production towards exports relatively easily. For instance, during the early 1980s, when the domestic consumption of furs was virtually banned, the Republic of Korea exported fur-skin products on a large scale, becoming one of the world's leading exporters of these luxury goods. In other instances, however, the industries needed to develop first on the basis of domestic markets before they became globally competitive. In some such cases, the consumption of domestically produced luxury goods was initially encouraged in the Republic of Korea in order to enable the infant industries concerned to gain experience and attain minimal scale efficiency on the basis of the relatively large domestic market. To that end, the VAT rate on certain technology-intensive products, such as VCRs, was set at an initially low rate during 1982-1986, with the expressed intention to raise it to 16 per cent in 1986, 28 per cent in 1987 and 40 per cent in 1988.

It was thus a judicious combination of government policies that encouraged producers of luxury goods to export and discouraged domestic consumption of such goods, thereby stimulating domestic capital formation and enabling corpora-

tions to achieve the necessary economies of scale and quality standards to compete globally. Emphasis on exports to advanced country markets has also had the benefits of providing a further spur to domestic producers in respect of productivity and of quality control. Here again the Republic of Korea provides a good illustration. After an initial learning period based on the domestic market, that country's passenger car industry increased exports much faster than production, thanks to its competitiveness in global markets and the adoption of measures to discourage domestic car consumption. As may be seen from table 46, the experience of that country in this respect differed considerably from the more common experience of many other developing countries, where transnational corporations jumped import barriers by establishing local plants to produce for domestic consumption rather than export. Mexico provides an illustration of another sort. There much of the assembly operations is for the export of cars to the United States, but the operations are carried out by subsidiaries of TNCs rather than by domestic firms; moreover, they have a very high import content and low domestic value added.

Entry restrictions were instrumental in the Republic of Korea in encouraging potential investors to build large factories. Other measures for achieving and maintaining sufficient economies of scale included government-induced mergers of firms operating at sub-optimal levels of produc-

tion, forcing firms to withdraw from the market where too many of them were competing in too small a market, and arranging negotiated segmentation of markets to accommodate efficiently two or more producers having distinct comparative advantages.

Since the key to success in solving this dilemma was attaining competitiveness and raising exports rapidly, measures were taken to increase productivity in industries that were regarded as of key importance in the export drive. The measures included the establishment of standards for industries producing parts and components, the provision of fiscal incentives for training and R&D, the suspension of anti-trust legislation where large technological agglomerations were necessary, and the dissemination of information on international "best practice" methods and technologies. Policies were also pursued that facilitated, where their effects were considered beneficial, the operations of TNCs.

Thus, a combination of restrictions on luxury consumption and the promotion of exports was crucial in raising savings, investment and productivity so as to attain rapid industrialization and competitiveness in a variety of technologically advanced product fields. This success was in no small measure made possible by the careful sequencing, phasing and control by government authorities of the pace at which the production, export and domestic consumption of luxury goods occurred.

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## D. Profit-related pay, distribution and accumulation

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A factor that has played a key role in reconciling growth and distributional objectives in East Asia is the bonus system, first adopted in Japan and subsequently in the East Asian NIEs. By linking an important part of labour compensation to company performance and promoting stability of employment, this system has served to attain greater equality in income distribution while at the same time promoting higher savings by workers and higher investment by firms.

### 1. *Extent and nature of the bonus system*

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Profit-related pay is practised in a number of countries both in East Asia and elsewhere under different institutional arrangements. A widely used scheme is profit-sharing, whereby workers receive, in addition to their wages and salaries, a predetermined share of the profits of the enterprise concerned. Such formal profit-sharing arrange-

Table 46

## VEHICLE PRODUCTION AND TRADE: MEXICO, BRAZIL, ARGENTINA AND THE REPUBLIC OF KOREA, 1976-1996

(Thousands of units)

Year	Mexico				Brazil				Argentina				Republic of Korea <sup>a</sup>			
	Total production	of which for export	Imports	Export share (Percent)	Total production	of which for export	Imports	Export share (Percent)	Total production	of which for export	Imports	Export share (Percent)	Total production	of which for export	Imports	Export share (Percent)
1976	..	..	..	..	..	..	..	..	..	..	..	..	27	1	..	2.1
1977	..	..	..	..	..	..	..	..	..	..	..	..	44	5	..	11.5
1978	..	..	..	..	..	..	..	..	..	..	..	..	87	17	..	19.0
1979	..	..	..	..	..	..	..	..	..	..	..	..	114	19	..	16.5
1980	490	18	0	3.7	1165	157	0	13.5	282	4	0	1.3	57	15	0	25.6
1981	597	14	0	2.4	781	213	0	27.2	172	0	0	0.2	69	17	0	25.0
1982	473	16	0	3.3	859	173	0	20.2	132	3	0	2.4	95	14	0	15.0
1983	286	22	0	7.9	896	169	0	18.8	160	5	0	3.3	122	16	0	13.5
1984	358	34	0	9.4	865	197	0	22.7	167	4	0	2.5	159	49	0	30.8
1985	459	58	0	12.7	967	208	0	21.5	138	1	0	0.6	265	119	0	45.1
1986	341	72	0	21.2	1056	183	0	17.3	171	0	0	0.2	457	299	0	65.3
1987	395	163	0	41.2	920	346	0	37.6	193	1	0	0.3	793	535	0	67.5
1988	513	173	0	33.8	1069	320	0	30.0	164	2	0	1.0	872	565	0	64.7
1989	641	196	0	30.6	1013	254	0	25.0	128	2	0	1.4	872	347	0	39.8
1990	821	277	0	33.7	914	187	3	20.5	100	1	0	1.1	897	340	0	37.9
1991	989	351	0	35.4	960	193	28	20.1	139	5	17	3.7	1158	379	0	32.7
1992	1081	383	6	35.4	1074	342	45	31.8	262	17	65	6.3	1307	428	0	32.7
1993	1080	472	3	43.7	1391	332	97	23.8	342	30	65	8.8	1593	573	0	36.0
1994	1097	575	56	52.4	1581	378	218	23.9	409	38	72	9.4	1806	648	0	35.9
1995	931	779	17	83.6	1629	263	369	16.1	285	48	134	16.7	2086	944	0	45.3
1996	1211	971	30	80.2	1813	306	224	16.9	313	109	134	34.8				

Source: M. Mortimore, "Dimensions of Latin American Integration: the NAFTA and MERCOSUR Automobile Industries" (mimeo), ECLAC, Santiago, Chile, 1997; and K.H. Lee, *Hankook Jadongcha Sanup ul Baijun Kwajung* (The Development Process of the Korean Automobile Industry) (in Korean), Seoul, Kia Economic Research Institute, 1995.

<sup>a</sup> No data are available for imports.



ments are typical of the profit-related pay schemes in developed countries, in particular those of OECD.<sup>12</sup> They are often encouraged by tax concessions, and applied after a threshold level of profits. Payment may be made in cash or shares. When in cash, the payment may be made immediately or after a certain period. A special instance of deferred payment is where profit-sharing is used to allow workers to accumulate retirement funds, as in North America. In the share-based system employees acquire shares in the company free or on preferential terms. These are often company-wide incentive schemes which do not depend on individual performance, although eligibility to participate usually varies with length of service.

In East Asia profit- and performance-related pay is particularly widespread in Japan, where the tax and social security systems encourage bonus payments. While the law requires such payments to be made with an interval of at least three months between them, in practice bonuses are paid twice a year. The Republic of Korea has an almost equally developed bonus system, where such payments are encouraged by favourable treatment in the social security system. The payments are made four times a year, and consequently the amounts can be altered more rapidly according to business conditions. In other economies, such as China, Taiwan Province of China and Singapore, the bonus system is also widely practised, although its importance in terms of workers covered and the share of such payments in total remuneration in the latter two appears to be somewhat more limited than in Japan and the Republic of Korea.

The bonus system in Asia differs from profit-sharing schemes in North America and Europe in a number of important respects. First, formal agreements for the distribution of a pre-determined portion of profits are much less common, and there is often an important discretionary component, particularly in Japan. According to a survey made by the Ministry of Labour in 1983, only one third of all firms in Japan paying bonuses had formal arrangements. Moreover, only three quarters of such arrangements were linked to profits, and the rest were payments made on the basis of value added or the volume of production or sales. Even formal profit-sharing agreements often include provisions for discretionary payments. Similarly, enterprises have been given considerable freedom in the implementation of the incentive pay system in China since it was introduced in the mid-1980s. Detailed information is not available for other

Asian countries, but formal agreements seem to be more common in the Republic of Korea, although not to the same extent as in the profit-sharing schemes of OECD countries. However, there appears to be a move in the region towards the kind of flexible pay system practised in Japan.<sup>13</sup>

While the discretionary component of the bonus system weakens the sensitivity of bonus payments to changes in profits, it introduces considerable flexibility into corporate management and promotes greater interaction between labour and capital, which often leads to cooperative arrangements. In Japan, for instance, in unionized firms negotiations over bonus payments are conducted separately during *Shunto* (Spring Wage Offensive) and on the basis of a different set of considerations. While the current level of profits is an important element in setting bonuses, other factors are also important, including firms' plans for expansion or job creation. This appears to be the case in the Republic of Korea, too. For instance, the labour union at Daweoo Electronics recently announced that it would voluntarily give up part of the bonus payments, amounting to half a month's wage, and accept a wage freeze for the year, in order to help the company expand investment in new areas of business and stabilize employment.<sup>14</sup>

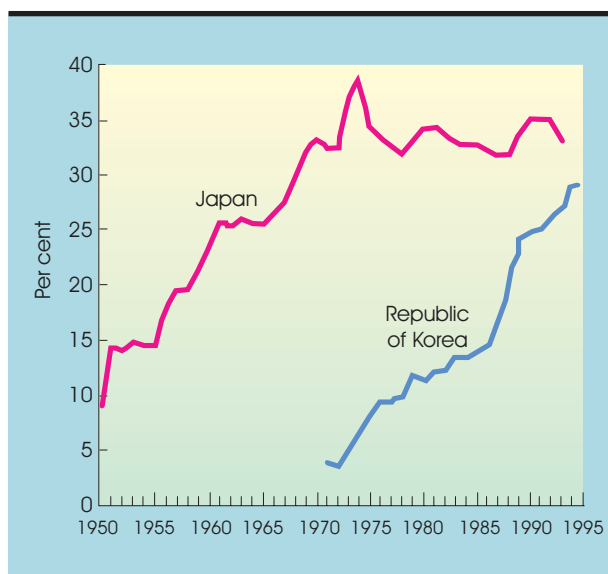
Thus, the bonus system in East Asia does not simply provide a rule for labour compensation, but is a component of a broader labour-capital interaction whereby the interests of the workers are reflected in company decisions. This is certainly an important reason for greater corporate loyalty in East Asia. Bonuses also provide an important incentive for work effort and have been shown to have a significant positive effect on productivity in the Republic of Korea.<sup>15</sup> Although bonuses are determined by the collective performance at the firm level, social ostracism and peer pressure help to solve the individual incentive problem, since co-workers can easily monitor each other's efforts.<sup>16</sup>

A second important difference is that, while the overall significance of profit-sharing schemes in labour compensation is fairly limited in most industrialized countries, the bonus system in many East Asian countries has a wider coverage and accounts for a substantial part of total pay. In Japan it was initially limited to white-collar workers in large firms, but since the 1950s it has spread widely to cover blue-collar workers and has begun to account for a growing portion of total pay.<sup>17</sup> By the early 1980s, almost all workers in firms with

Chart 17

### BONUSES AS A PERCENTAGE OF WAGES IN JAPAN AND THE REPUBLIC OF KOREA

(Percentage)



**Source:** Ministry of Labour, Republic of Korea, *Occupational Wage Survey*. Ministry of Labour, Japan, *Monthly Labour Statistics*.

at least 30 employees were receiving bonuses. The bonus/wage ratio rose from about 10 per cent in 1950 to over 40 per cent in the mid-1970s, declining somewhat and stabilizing at around 33 per cent thereafter; thus, in the early 1980s about a quarter of total labour remuneration took the form of bonuses. In the Republic of Korea the bonus system also covers almost all workers in firms with 30 employees or more. Its development was started later than in Japan; the bonus/wage ratio rose from around 5 per cent in the early 1970s to 15 per cent in the mid-1980s. There has been a further sharp increase since the late 1980s, and the ratio has now reached a level similar to that in Japan (see chart 17).

There are no systematic data for other countries in the region. In China, the share of bonus payments in total labour compensation appears to have increased considerably after the mid-1980s, and this may have been a key factor in the rise of the share of labour in total factor payments in various branches of industry. Available evidence suggests that in Taiwan Province of China bonus payments amounted to some 15 per cent of total

labour compensation in the 1970s, and it seems that this proportion has been maintained in more recent years.<sup>18</sup> In Singapore the system includes annual bonus and annual wage supplements; in 1989 about 90 per cent of workers seem to have received some form of bonus. In manufacturing, such payments represented about 11 per cent of wages in 1988.

## 2. The bonus system, distribution and accumulation

The bonus system clearly has implications for income distribution both among workers and between labour and capital, as well as for savings and capital accumulation. However, these implications have been little explored in studies on the bonus system, and empirical evidence is scarce. What follows is a brief description and discussion of various characteristics of the system and their relevance to distribution and growth.

A number of features of the bonus system in East Asia appear to widen, rather than narrow, income differentials among workers. In Japan the share of bonus in total remuneration tends to be higher for workers who receive higher wages; bonuses account for a greater proportion of pay for white-collar than for blue-collar workers. The share is also positively correlated with the size of firm and the length of continuous service, factors that play a major role in wage determination in Japan (see table 47). In the Republic of Korea, too, the share of bonus in total pay is higher in larger than in smaller firms, for white-collar workers than blue-collar workers, and for male workers than female workers (see table 48). The variation of bonuses with firm size appears to be responsible for the large inter-industry wage differences in Japan and the Republic of Korea by international standards.<sup>19</sup>

While the bonus systems in Japan and the Republic of Korea tend to widen earnings differentials in some respects, they tend to promote equality in others. Despite the large inequalities among different groups of workers noted above, wages are much the same for all workers within the same gender and age groups, irrespective of education and occupation. The close correlation between the share of bonus in total pay and length of service suggests that bonuses promote skills based on learning-by-doing, as well as corporate

Table 47

**SHARE OF BONUS IN TOTAL LABOUR COMPENSATION IN JAPAN IN 1983, BY SIZE OF FIRM,  
LENGTH OF EMPLOYMENT AND TYPE OF OCCUPATION**

(Percentage)

Years of service <sup>a</sup>	Size of firm (number of employees)							
	10-99		100-999		1,000 or more		All firms <sup>b</sup>	
	White- collar	Blue- collar	White- collar	Blue- collar	White- collar	Blue- collar	White- collar	Blue- collar
1-9	17.5	15.3	21.6	19.3	24.1	21.4	21.3	17.9
10-19	20.8	18.1	25.5	22.3	27.8	23.5	26.0	21.8
20-29	20.7	18.7	27.4	23.0	31.2	24.8	29.1	23.1
30 and more	20.4	18.7	28.1	23.4	31.1	26.0	29.2	24.0
All workers	18.8	15.8	24.7	20.6	28.6	23.4	25.7	20.2

**Source:** J. Suruga, "Bonus system and flexible wages" (in Japanese), *Nihon Rodo Kyoukai Zashi*, March 1987.

**Note:** White-collar: administrative, office, technical workers; blue-collar: production workers.

**a** Years of continued employment in the firm.

**b** With at least 10 employees.

loyalty. Development of such skills is certainly conducive to better income distribution when opportunities to develop such skills are widely available.

In one important respect the bonus system promotes greater equality among workers since, in as much as it imparts intra-firm wage flexibility, it stabilizes employment at the firm level. This result is attained through an internally organized labour market within firms and by linking pay to firm-specific conditions, rather than to market-clearing wage formation based on the kind of "flexible labour market" advocated by orthodox analysis. Consequently, its implications for the distribution of income and jobs among workers are quite different from a system where wages and employment change in response to labour market conditions.

In a system where hiring and firing is relatively costless, contraction in business activity often results in workers being laid off. Consequently, while some workers are fully employed and earn going wages, others are without jobs or

pay. By contrast, the bonus system rations work more or less uniformly at times of contraction. Indeed, one of the main features of the Japanese labour market is the flexibility of working hours. Compared to the other major developed economies, the market is characterized by considerable fluctuations in working hours and very little fluctuation in the number of people employed.<sup>20</sup> Japanese firms tend to vary working hours and with them overall pay, rather than employment, when adjusting to demand fluctuations, promoting what is known as "life-time" employment. When obliged nevertheless to reduce employment, they tend first to cut down on fresh recruitment, then send existing workers to subsidiary firms in the business group, call for voluntary resignations after that, and discharge and lay off workers only as a last resort and with great reluctance. This certainly leads to a better income distribution among workers than a system where part of the labour force is unemployed and part is gainfully employed.

Until the mid-1980s adjustment of employment to variations in business conditions was more widespread in the Republic of Korea than in Japan,

Table 48

**SHARE OF BONUS IN TOTAL LABOUR COMPENSATION IN THE REPUBLIC OF KOREA  
IN 1995, BY SIZE OF FIRM, TYPE OF OCCUPATION AND GENDER**

(Percentage)

Firm size (Number of employees)	White-collar workers		Blue-collar workers		All workers
	Male	Female	Male	Female	
10-99	15.9	14.7	11.7	9.8	13.0
100-299	24.0	20.6	19.0	16.4	20.6
300-499	27.4	24.9	23.7	21.1	24.8
500 or more	33.6	31.9	31.6	28.9	32.0
All firms <sup>a</sup>	24.9	20.8	21.8	18.0	22.4

**Source:** Ministry of Labour, *Monthly Labour Statistics* (various issues).

<sup>a</sup> With at least 10 employees.

but less than in other developed economies. Despite similarities with Japan in the bonus system, variable working hours and permanent employment were not important features of the Republic of Korea, where the average length of continuous employment was only four years in 1989, compared to almost 11 years in Japan. Although in the previous decade aggregate employment was fairly stable in the economy as a whole, the employment pattern has become more like that of Japan; since 1987, adjustment of employment has become more rigid, while working hours have become more flexible. It is also notable that increased stability of employment has coincided with a steep rise in real wages and increased power of the unions.<sup>21</sup>

The wage flexibility brought about by the bonus system is crucially different from the labour market flexibility underlying the conventional analysis. As discussed in greater detail in *TDR 1995*, when there is a chronic demand deficiency and structural unemployment, greater labour market flexibility simply turns open unemployment into disguised unemployment, characterized by low-pay, low-productivity occupations, particularly in the services sector, and leading to wide earnings differentials, as has been observed in some industrial countries since the early 1980s. Intra-firm flexibility not only helps to maintain a high level of employment in high-productivity jobs by promoting investment through the channels explained

below, but also allows firms to adjust to shocks such as loss of international competitiveness due to currency appreciations or the emergence of low-cost producers, without creating hysteresis in the labour market whereby unemployment leads to a deterioration of skills, rendering workers increasingly less employable. Indeed, intra-firm wage flexibility has certainly played an important role in the Japanese adjustment to shifts in international competitiveness since the mid-1980s without triggering massive unemployment. Under such a system, a persistent excess supply of labour may at least partly be absorbed by intra-firm work-sharing arrangements through cuts in working hours. Such a response is certainly more equitable than leaving some workers without jobs and pay and consigning others to low-wage occupations.

More importantly, the bonus system contributes to high employment and better income distribution through its effect on productivity and investment. As noted above, this system tends to raise productivity by promoting incentives for greater work effort and corporate loyalty. Bonus payments from increased corporate revenues not only serve to stabilize the distribution of value added between labour and capital incomes, but also raise profits and corporate investment. Higher investment, in turn, helps to maintain a high level of employment, contributing to a better income distribution.

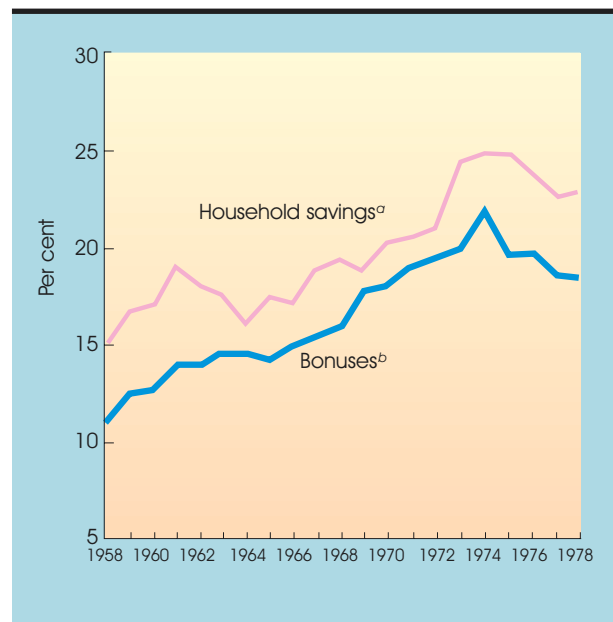
Chart 18

The bonus system promotes higher employment and better income distribution also by increasing the propensity to save from personal income. There is, indeed, a striking correlation between the household savings rate and the bonus/wage ratio in Japan (chart 18).<sup>22</sup> The correlation is somewhat weaker in the Republic of Korea, but bonuses are an important element in household savings in that country too.<sup>23</sup>

Since bonuses are paid as a lump sum at periodic intervals, they are at the disposal of firms in the interim as interest-free funds. From the workers' point of view such suspended payments may constitute involuntary savings and involuntary deferred consumption, in view of their limited access to consumer credit. In any event, the propensity to save from such temporary and transitory incomes tends to be higher than for regular incomes. Similarly, consumption decisions are often the creatures of habit, and change only slowly in response to changing incomes. Evidence suggests that in Japan household consumption has a stable relationship to wage income, while the bonuses are considered a convenient supplementary source of savings. Thus, the marginal propensity to consume bonus income during 1969-1980 was estimated to be about 0.5, compared to that for regular income of about 0.7.<sup>24</sup> The bonus system accordingly appears to be one of the reasons why household savings have been relatively high and rising in the East Asian NIEs.

It was noted above that even if corporations in the major East Asian economies retain a large proportion of their profits, their investment still exceeds their savings by a large margin because of high "animal spirits". If household savings were not sufficient to close the corporate savings gap, the outcome would be inflation. The result would

### LABOUR BONUSES AND HOUSEHOLD SAVINGS IN JAPAN, 1958-1978



Source: Ishikawa and Ueda, *op. cit.* (see text, note 17).

a As a percentage of disposable household income.

b As a percentage of total labour compensation (wage plus bonus).

be to reduce the corporate savings gap by generating forced savings through a redistribution of income from wages to profits, with attendant consequences for income distribution, as well as by reducing corporate investment. Thus, high household savings promoted by the bonus system help reconcile greater equality with rapid growth by reducing the inflationary pressures that are usually associated with a process of rapid accumulation. ■

## Notes

- 1 Certain aspects of these policies were discussed briefly in *TDR 1994*, Part Two, chap. I, sect. G.
- 2 See A. Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (New York: Oxford University Press, 1989); A. Amsden and A. Singh, "Concurrence dirigée et efficacité dynamique en

Asie: Japon, Corée du Sud, Taiwan", *Revue Tiers-Monde*, Vol. 35, No. 139, July-September, 1994; M.J. Peck and S. Tamura, "Technology", in H. Patrick and H. Rosovsky (eds.), *Asia's New Giant: How the Japanese Economy Works* (Washington, D.C.: The Brookings Institution, 1976); and R. Wade, *Govern-*

- ing the Market: Economic Theory and The Role of Government in East Asian Industrialization (Princeton, NJ: Princeton University Press, 1990).
- 3 This has also been demonstrated by the World Bank in *The East Asian Miracle ...*. In respect of the conformity of national prices with international prices, the study shows that Taiwan Province of China, the Republic of Korea and Japan fall within the fifth and sixth deciles of a sample of developing countries, with a greater degree of price distortion than Brazil, India, Mexico, Pakistan and Venezuela (p.301).
- 4 See G. Ackley and H. Ishi, "Fiscal, monetary and related policies", in H. Patrick and H. Rosovsky (eds.), *op. cit.*, p. 205.
- 5 See K. Yamamura, "Caveat Emptor: The Industrial Policy of Japan", in P. Krugman (ed.), *Strategic Trade Policy and the New International Economics* (Cambridge, MA: The MIT Press, 1988).
- 6 R. Wade, *op. cit.*, p. 129.
- 7 M. Shinohara, *Industrial Growth, Trade and Dynamic Patterns in the Japanese Economy* (Tokyo: University of Tokyo Press, 1982), p. 23.
- 8 These have been examined in detail in a number of studies for the UNCTAD project on *East Asian Development: Lessons for a New Global Environment*, sponsored by the Government of Japan (Geneva: United Nations, March 1996). See in particular study No. 2, by Tun-jen Cheng, S. Haggard and D. Kang, "Institutions, economic policy and growth in the Republic of Korea and Taiwan Province of China"; study No. 9, by A. Singh, "Savings, investment and the corporation in the East Asian Miracle"; and study No. 10, the report by the UNCTAD secretariat to the Kuala Lumpur Conference.
- 9 See T. Yanagihara, "Economic System Approach and its Applicability" in T. Yanagihara and S. Sambommatsu (eds.), *East Asian Development Experience* (Tokyo: Institute of Developing Economies, 1997).
- 10 See A. Singh, *op. cit.*; and Y. Akyüz, "Financial Liberalization: The Key Issues", in Y. Akyüz and G. Held (eds.), *Finance and the Real Economy*, ECLAC, Santiago, Chile, 1993.
- 11 See M. Mortimore, "Dimensions of Latin American Integration: the NAFTA and MERCOSUR Automobile Industries", (mimeo), CEPAL, Santiago, Chile, 1997.
- 12 For a survey of these schemes see *OECD Employment Outlook* (Paris: OECD, July 1995), chap. 4 - "Profit-sharing in OECD countries".
- 13 See ILO, *World Labour Report 1992* (Geneva: ILO, 1992), pp. 64-65.
- 14 *Chosun Ilbo*, 7 March 1997.
- 15 B. Lee and Y. Rhee, "Bonuses, unions and labour productivity in South Korea", *Journal of Labour Research*, Vol. 17, No. 2, 1996.
- 16 See M. Okuno, "Corporate loyalty and bonus payments : an analysis of work incentives in Japan", in M. Aoki (ed.), *The economic Analysis of the Japanese Firm* (Amsterdam: North Holland, 1984).
- 17 T. Ishikawa and K. Ueda, "The bonus payment system and Japanese personal savings", in M. Aoki (ed.) *The Economic Analysis of the Japanese Firm* (Amsterdam: North Holland, 1984).
- 18 M. Shinohara, *Industrial Growth, Trade and Dynamic Patterns in the Japanese Economy* (Tokyo: University of Tokyo Press, 1982).
- 19 See A. Krueger and L. Summers, "Efficiency wages and inter-industry wage structure", *Econometrica*, Vol. 56, 1988.
- 20 See T. Tachibanaki, *Wage Determination and Distribution in Japan* (Oxford: Clarendon Press, 1996). It is estimated that, over 1970-1983, the variability of employment, as measured by the standard deviation, was more than twice as high in the United States as in Japan, while variability of working hours was lower by 25 per cent (p. 225).
- 21 See J.-I. You, "Changing capital-labour relations in South Korea", in J. Schor and J-I. You (eds.), *Capital, the State and Labour: A Global Perspective* (Aldershot: Edward Elgar, 1995); and J-H. Lee, "Ways to improve wage structure in order to increase wage flexibility" (in Korean), *Korea Development Research*, Vol. 16, No. 1, 1994.
- 22 See also M. Shinohara, *Industrial Growth, Trade and Dynamic Patterns in the Japanese Economy* (Tokyo: University of Tokyo Press, 1982).
- 23 See T. Mizoguchi, *A Statistical Analysis of the Consumption Function* (Tokyo: Iwanami, 1964); M. Shinohara, "The puzzles of savings rate" (in Japanese), *Chochiku Jiho*, No. 127, 1981; and *Industrial Growth, Trade and Dynamic Patterns ...*. See also Ishikawa and Ueda, *op. cit.*
- 24 Ishikawa and Ueda, *op. cit.*