
Japan, Germany, and the End of the Third Way

BY NORMAN BARRY

Last year's election results in Japan and Germany are not only important for those countries but also have wider lessons, for they herald a decisive defeat for a once-fashionable doctrine—the Third Way. This was adopted by socialists in despair of the abject failure of “really existing socialism” but desirous to preserve their anti-capitalist credentials. They assumed we could secure all the benefits of the free market, in terms of its higher productivity and liberal social framework, without its unpleasant concomitants—excessive individualism, companies' concern with shareholder value, the use of the takeover mechanism for industrial reorganization—all summed up by the morally loaded term “greed.” Fortunately for Third Wayers there were two economies that apparently evinced different virtues and were highly successful, the second and third biggest economies in the world, Japan and Germany. Indeed, at one time all America was frightened of Japan's stupendous economic virility. The Japanese car industry, spearheaded by Toyota, Nissan, and Honda, was on the brink of taking over from Detroit, and although the Japanese were not great innovators, they could copy and make cars, washing machines, and computers more efficiently than the West. And Germany was the dominant economic power in Europe, whose industries, like Japan's, were heavily geared toward exports. In both countries the shareholders were squeezed out of running companies they nominally owned and industry was geared toward serving the community more than the owners' interests. Thus the

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huge Japanese corporations played a significant welfare role, and nobody ever lost his job. Even though private ownership was sedulously maintained, Germany and Japan did not have Anglo-American capitalism as exemplified on Wall Street and in the City of London.

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results, Japan more than Germany. What went wrong? Briefly, both countries became dominated by interest groups that used the political system to divert income created by others to themselves (“rent-seeking”); both had too much state welfare; and neither economy was flexible enough to cope with the demands of globalization. Overall, Japan and Germany have political systems that offer every incentive for political parties to preserve the current inefficient system and none for anyone who tried to break out of it.

It was a classic “social dilemma”: everybody knew they would all eventually be better off if they dumped the obstructive labor laws, cramping regulations, and costly welfare, but political parties were beholden to interest groups that benefited from the preservation, indeed expansion, of the prevailing system. Mancur Olson, who analyzed the dilemma in immense detail and sophistica-

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tion once suggested that it could only be overcome by a national catastrophe such as defeat in a major war.¹ And Japan and Germany had their economies devastated by defeat in World War II yet managed to make amazing recoveries in the early postwar years, while among the victors Britain languished until Margaret Thatcher. Britain, of course, was dominated by interest groups, especially trade unions.² I shall look at Japan first, and in more detail, because it appears as if it is getting over the aforementioned social dilemma better than Germany.

Japan has had a dominant party, the Liberal Democrats (LDP), which has been out of power only once since 1955, briefly in the 1990s. Yet it has no coherent program. It is really a bunch of pressure groups that profit from the burgeoning state. There is no serious socialism in Japan, and it still has a relatively small public sector, but the Democratic Party of Japan, formed by disenchanted LDP members, is slightly more left-wing and under the influence of trade unions. They know where the rents are.

Japan has always had a market economy, but it was not Anglo-American. Shareholders were paid derisory dividends and kept out of annual meetings; companies were run by “stakeholders,” that is, managers and banks. Firms were also more interested in market share than profit, and the whole nation was mobilized to promote exports, not consumption. Companies themselves, if not socialistic, were certainly communitarian: they provided welfare benefits and lifetime employment. It was a rigid and inflexible system, but it worked well enough to make Japan the second biggest economy in the world—until 1990, when the stock market began to fall—from a high of 39,000 on the Nikkei to below 10,000, its nadir. The real economy went into a steady relative decline. Investors originally benefited from capital gains, but millions of Japanese housewives, who had spent the family income buying up stocks, were badly hit by the fall in the 1990s. The country was at the same time building up a huge government debt—now 160 percent of GDP.

Prime Minister Junichiro Koizumi although from an establishment Japanese political family, knew something had to be done if the country were to get out of the stagnation of the 1990s. Japan had been very good at copying Western electronics, but he realized it would have to copy Western economic models too. Elected in 2001, he set his sights on the Japanese postal system. It is not only important in itself, but is also indicative of the Japanese malaise. He wanted to privatize it. His plan was defeated by the upper house of the Japanese Diet (Parliament) early in the summer of 2005 (the lower house had barely approved it), which was the immediate cause of the election.



Prime Minister Junichiro Koizumi of Japan

Privatization was not to improve the delivery of letters and parcels. I can speak from extensive personal experience that, despite being state-run, the postal system is efficient. The real reason for privatizing the post office is that it is also a huge savings bank and provider of nationalized insurance. The Japanese have a legendary propensity to save, and they tend to put their savings in the post office—at present it controls assets of \$3 trillion. And where does that money go? It funds huge and mainly unnecessary public works. There is a medium-sized town near Tokyo that has two airports, which together have ten flights a day.

All this is a gift to the LDP, which benefits from the useless jobs and wheels out the votes at election time. The post office has 400,000 employees. What Koizumi wants to do is to free up all this capital to be invested in the still-productive private sector.

Of course, all this upset the LDP establishment, and it defeated Koizumi's first attempt at privatization. But he daringly called an election last September, fired dissident LDP members, and sent in “assassins,” handpicked glamorous media personnel, to fight them at the election. He won an overwhelming victory: even if the upper house continues to oppose post-office privatization, he has enough votes from the lower house, with his coalition partners, the Komei, to use the constitution and override it.

Public Choice Defied

Koizumi's victory was remarkable because it defied the lessons of Public Choice theory: it is normally impossible to defy an electorate that consists largely of rent-seekers. The future benefits of necessary reform are insufficient to compete with the attractions of short-term advantage. But Koizumi is an astute, possibly honest, politician, and he campaigned as if the election were a referendum on the privatization. If he had run on a regular manifesto it is almost certain his opponents could have defeated him on a rent-seeker's program. He also has some charisma, unusual in Japanese politics.

But progress is likely to be slow in Japan—the privatization is not scheduled for completion until 2017. And the rent-seekers are likely to defeat him if he tries to reform the costly welfare system. The immediate problem is that Japan has an aging population and a declining workforce. That will also bring forth the need for increased health expenditure. Furthermore, Koizumi has to leave his post by next September; the LDP rules limit the leadership of the party to two terms, and there does not seem to be anybody with the drive and commitment to reform to take his place. However, there are already moves underfoot to persuade him to carry on. If Japan is to continue to defy the well-established theorems of Public Choice, the country will need somebody of his determination.

Germany

Germany has the world's third biggest economy, and it has gone through an experience not unlike Japan's. From being the powerhouse of Europe the economy is now almost shrinking, with over 11 percent unemployment. After World War II Germany established the "social market economy" under Ludwig Erhard, first as finance minister, then (unsuccessfully) as chancellor.³ The "social market economy" seemed to combine market-led economic progress with compassionate welfare policies, though in the last 30 years the social element has inexorably displaced the economic element in the model. (It is not at all clear that Erhard himself would

have approved of this.) The original Bismarckian welfare state was extended, first to expanded pensions (unfunded and dependent on a rising birth rate) and then to conditions of employment. But the German birth rate has dramatically fallen; private pensions are virtually nonexistent; and rising nonwage labor expenses have made the costs of doing business unsustainable—much German capital is leaving the country. This can only worsen under globalization. German business is like Japan's, with powerless shareholders. Takeovers are rare.

All this has been known for a long time, but entrenched interest groups made the political system more or less immobile. No political party dare risk offending these groups with serious reform. The parties are in an unconscious cartel, but while cartels are normally overcome in private competitive

markets, it is not so easy in the ersatz competition of representative democracy. Germany is in an insoluble social dilemma, and Erhard has been virtually forgotten.

Some progress was made, however, with the emergence of Angela Merkel as leader of the Christian Democratic Union (CDU). Unable to form even a tiny majority in alliance with the small but more free-market Liberal Democratic party, Merkel has been forced into a "grand coalition" with the Social Democrats. That means the same interest-group immobility will continue for

some time. A good example is tax reform. Merkel's projected finance minister is an obscure academic, Paul Kirchhof, who achieved notoriety by suggesting replacement of the complex German tax system, with its myriad exemptions, with a lowish flat tax of 25 percent. Immediately all those groups that benefited from the prevailing system protested and the scheme was quietly forgotten during the campaign. No German commentator seemed to realize that a carefully designed flat tax will actually increase government revenue through less tax avoidance and tax evasion, and the operation of the Laffer curve. A flat tax is not just for the rich, but benefits everybody, except tax accountants. It is a way of getting over the social dilemma.



Ludwig Erhard (1897–1977)

Frau Merkel has suggested that laws on hiring and firing will be relaxed so that it will be easier to dismiss redundant workers, and her welfare reforms would remove the temptation not to work, the bane of German welfare policy. However, even the Social Democrats under Gerhard Schroeder offered tame versions of these policies, only to water them down even further after relentless opposition from Germany's still powerful trade-union movement. Of course, Germany has certain unique problems, especially the cost of reunification, but this should not distract us from the fact that the country illustrates all too well the universal problems of representative democracy, especially the ability of entrenched groups to prevent the pursuit of the genuine public good.

The experience of both Japan and Germany should alert us to the seductive but ultimately lethal properties of the Third Way. By locking ever more people into the state, especially through generous welfare policies, it only strengthens powerful interest groups and makes reform almost impossible. Perhaps only by the Swiss system of referenda on particular issues can the dilemma be got

round. Indeed, the fact that Koizumi almost turned the Japanese election into a referendum on the post-office privatization supports this position. It is possible that if the flat tax were put to a referendum in Germany it would be approved.

And by restricting the power of shareholders the Third Way weakens the corrective mechanisms of the market and strengthens the managements of companies and banks, neither good defenders of free markets. There is only one form of successful capitalism, that is free-market exchange with a very limited state. As the president of the Czech Republic, Václav Klaus, once famously said: "The Third Way is the Third World." Japan, which is on its

way to recovery, might have resisted Public Choice temporarily, but Germany certainly has not.



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1. See Mancur Olson, *The Rise And Decline of Nations* (New Haven, Conn.: Yale University Press, 1982).

2. See Norman Barry, "What Kind of Conservatism?" *Margaret Thatcher's Revolution*, ed. Subroto Roy and John Clarke (New York: Continuity Books, 2005).

3. See Norman Barry, "The Social Market Economy," *Social Philosophy*, vol. 10, 1992.

The Price of Security

The desire for security, while in itself natural and legitimate, can become an obsession which ultimately must be paid for by the loss of freedom and human dignity—whether people realize it or not. In the end, it is clear that whoever is prepared to pay this price is left neither with freedom and dignity nor with security, for there can be no security without freedom and protection from arbitrary power. To this exorbitant price must be added another . . . namely, the steady diminution of the value of money. Surely, every single one of us must then realize that security is one of those things which recede further and further away the more unrestrainedly and violently we desire it.

—Wilhelm Röpke, *A Humane Economy*