Can Financial Innovations Mitigate Civil and Ethnic Conflict?

By Saumitra Jha

The failure to align the incentives of self-interested groups in favor of beneficial reform is often considered a major cause of civil conflict and persistent underdevelopment around the world. However, much less is known about strategies that have been successful at overcoming such challenges. This article discusses the role of financial instruments as a means for fostering broad political coalitions that favor beneficial reform and mitigate social conflict, drawing on historical cases in which innovative financial assets, often introduced by technocratic reformers, have succeeded at making politics less conflictual over time.

It is an all-too familiar story. A new leader assumes authority in a country that has recently discovered that it has fallen behind its neighbours in economic development. He brings in foreign expertise, announcing a series of modernising reforms that adopt what is perceived as best practice and promises much in the way of social benefits. These include the establishment of schools and competitive exams based upon a modern curriculum, the abolition of sinecure positions in government, and the expansion of transportation infrastructure and banks. However the reforms threaten the interests of many among the existing elites. Within four months of the start of the reforms, these elites stage a coup, imprison the executive and rescind the changes. The country faces years of political unrest, civil war and revolution, at great human cost, before reforms occur.

Though the failure of the "Hundred Days Reforms," attempted by the Guangxu Emperor of China in 1898, does not occupy a prominent place in most policy school curricula, the outcome would not come as a surprise to many. In fact, much blame for persistent under-development around the world has been attributed to a failure to align the incentives of potential losers and other disparate interest groups in favour of beneficial reforms and peaceful cooperation. From Latin America, where interests forming around wealth disparities have been blamed for weak contemporary institutions, to African and other developing countries, where polarisation along ethnic lines appears to lead to lower growth and greater civil conflict, to reduced public goods provision in ethnically diverse jurisdictions in the United States; a common theme of recent research by economists and political scientists is that within-society differences in endowed characteristics of wealth, ethnicity or of political rights – can lead to conflicting interests that shape the patterns of economic growth and development we see today.

Furthermore, because, inevitably, some groups are strong today, but would be weakened by disruptive innovation or policies in the future, it is hard to make credible promises to compensate these incumbents out of the social gains from policies that weaken their future bargaining power. Thus a common challenge for innovative firms and policymakers alike is either to fight the often uphill battle towards building broad political support themselves or to make a deal: figure out how to `credibly commit' to compensating incumbents and potential losers out of future gains from innovation or reform, despite the temptation that may be faced down the line to renege and exploit their future weakness.[1]

These problems are tough, but they are also old problems and have been solved in the past. The purpose of this short piece is to highlight one particular set of approaches—the use of financial innovation, often by reformers seeking

explicitly to align political incentives—in doing just that. By allowing individuals with conflicting interests, whether stemming from ethnicity, wealth or simply incumbency advantages, to credibly share in the gains from a common future, financial approaches can and have played a crucial role in solving credible commitment problems that might otherwise stifle innovation and create the conditions for conflict.

Swords into Bank Shares

Take the case of revolutionary Japan in the nineteenth century. Like China twenty years later, Japan faced a crisis when the arrival of the `black ships' of the US Navy in 1853 made clear that it had fallen behind technologically and militarily. Though often considered highly homogeneous today, Japan in the 1860s was divided into feudal domains with strong regional differences and varying degrees of political autonomy. Japan also possessed a hereditary caste

system arguably even more entrenched than that of India, as economic distinctions were enforced by the State. At the bottom of the hierarchy, ritually unclean professions were the exclusive domain of an untouchable caste, while the samurai at the top enjoyed the exclusive right to administrative and military positions in exchange for hereditary stipends of rice. Samurai were legally and custom-bound not to accept other professions or to intermarry with commoners, called *heimin*.

Lower-ranking samurai, once more urban bureaucrats than men-at-arms, had begun to remilitarize in response to the forced opening up by the United States and other countries. A number had returned from action in the Boshin War, in which they had restored the authority of the Emperor of Japan. Instead of being rewarded, however, the 1.8 million samurai would be the likeliest losers of the modernisation of Japan. General conscription of all male Japanese was introduced in 1873, abolishing the exclusive rights of the samurai to the military and to bear arms, leaving large numbers of samurai retainers unemployed and naturally weakening their future bargaining power.

With a large incumbent caste group not only with very different political interests but also the ability to engage in violent resistance to protect it, it seemed the Japan's reforms would fall prey to the same failure as those that would occur twenty years later in China, and time and again in other settings around the world. Indeed, soon afterwards began a series of armed rebellions by samurai, the largest of which, the Satsuma Rebellion of 1877-78, often considered a civil war, cost ¥42 million, or 80% of the government's budget, required the mobilisation of close to 68,000 troops and led to the loss of life of around 20,000 ex-samurai and 6,000 government soldiers.

Despite the presence of a class of elite and militarised potential losers and despite the strong regional cleavages, however, Japan did not disintegrate. Instead, as the historian Marius Jansen concludes: "Japan, which began the Meiji period as one of the modern world's most fractured polities, emerged within a generation as one of its most centralised states".[2] Japan's caste distinctions too rapidly diminished. It is further commonly accepted that the reforms of the early Meiji period – including the abolition of samurai privileges, the development of a modern banking system and introduction of private ownership of land – also laid the basis for Japan's remarkable catch up in economic growth. How then did the administrators of the Meiji era, like Okuma Shigenobu and Matsukata Masayoshi, build support for their reforms?

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My co-authors, Kris Mitchener and Masanori Takashima and I are reconstructing the details of how this coalition was created. However, the broad patterns are themselves illuminating. In 1871, the central government abolished the domains, pensioning of their feudal lords, and took over responsibility for paying the salaries of their retainers. However, these stipends absorbed close to a third of the government's budget. Amidst the period of violent samurai protest, the government responded by an innovative package of reforms, using financial innovations to reduce opposition. First, the samurai's rice stipends were compulsorily commuted into interest-bearing bonds in 1876. 310,971 ex-samurai received public bonds worth ¥113 million. At the same time, the National Bank Regulations were modified so that samurai bonds could be exchanged for stock in newly-opening branches of the National Bank. Bank owners were required to capitalise the bank using 80% government (i.e. samurai) bonds. The remaining 20%, in currency, could come from the commoner class. The change in banking regulations in 1876 led to a dramatic expansion of bank branches, increasing from seven to around 150 new banks within two years – so many, in fact, that the government called a halt to future expansion. In 1878, 29,360 samurai and nobles controlled ¥30, 580, 000 in bank stock, compared to ¥8, 870, 000 held by 4,730 commoners. Though commoners would play an increasing role in the banks, in 1882, samurai still owned three-quarters of the stock of Japan's banks. The successor-organizations of a number of these banks still exist today.

Put in stark terms, the government created an innovative, ethnically-delimited asset – the bonds given to samurai — even while eliminating the privileges and obligations that had made this ethnic group distinct. It then took the ex-samurai, one that was the most likely to engage in violence and enhance political risk, and gave them incentives to become local bankowners- a group with arguably the greatest incentives to *avoid* engaging in violent actions that would raise the political risk of their investments in local ventures (often rice and silk). By aligning the samurai's interests against political risk, these financial innovations aligned their interests with not only the merchants who were their fellow merchant share-holders but society at large. Since all could benefit, and in fact the samurai had explicit stakes, as bankers, in the nation's future, they also meant that the samurai could give up their arms and credibly share the gains that modernisation and reduced political risk provided.

In essence, financial innovators in the Japanese government took swords and made them into bank shares. In fact, as one might expect among a class of newly-minted bankowners, political risk in the form of violent samurai rebellions appear to have also ceased. Instead the ex-samurai played a central role in peaceful political protests in favour of, at first, ex-samurai rights (shizoku minken), but later, popular rights (jiyu minken), that helped propel Japan towards the

framing of a constitution and its first national elections in 1890. Social and political distinctions based upon caste interests appear to have also rapidly eroded. Finance Minister, and later Prime Minister, Matsukata Matsuyoshi was explicitly concerned with mitigating conflict and the threats to law and order the samurai posed. As he noted in 1883, "If the government remained an onlooker to the plight of the samurai, it would have certainly meant that the government did not understand the relationship between peace and rebellion."[3]

Creating a Speculating Phalanx

Financial innovations have played similar roles elsewhere and other times too. Japanese financial innovators, were learning in part on the experiences of Alexander Hamilton's financial reforms in the United States in the 1790s and from the experience of England in the seventeenth and eighteenth centuries. The United States in the 1790s, like Japan in the 1870s, was recovering from a revolutionary war that also brought into question the territorial integrity of the state. Levi Allen, one of the two brothers who helped establish Vermont, sought to make a separate commercial treaty with the British in Canada and to assist in Vermont's secession. There were similarly active discussions by a number of New Englanders who had pre-Revolutionary trading ties with Britain to secede. Spanish attempts to secure the Western hinterland involved closing the Mississippi at New Orleans and offering trade licenses and bribes to settlers in Kentucky and Tennessee. The commander of the US Army, James Wilkinson, was a Spanish spy. Like Japan, the United States also had a militarized group of war veterans that could pose a potential threat of law and order who were owed $25 million of backpay by individual states.

However, Alexander Hamilton, fearing secession and seeking a stronger centralised state, saw an opportunity where many others saw a liability. While the representatives of the main debtor states such as Massachusetts, Connecticut and South Carolina, saw an opportunity to share the burdens of this debt with taxpayers elsewhere, Virginia, Maryland and Georgia had already paid much of their war obligations. Over a famous dinner at Jefferson's in 1790, Hamilton agreed to support the permanent settlement of the capital in the South on the Potomac and compensate for Virginia's additional tax burden in exchange to a weakening of Madison's objections over the `Assumption' of state debt.

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Whether or not the Compromise of 1790 was actually critical to the passage of both bills is subject to some debate. Regardless, it appears that Hamilton's victory on Assumption in 1790 may have created a coalition critical for the success of his further reforms, including the creation of the Bank of the United States. The Bank of the United States and its branches stimulated the competitive chartering of other banks and joint stock companies by the legislatures of individual states. The number of chartered joint stock companies experienced a boom, rising from seven in the entire colonial history of the United States (1607-1776) to 28 between 1781-91 and 295 between 1791-1800. Between 1800 and 1830, the ten northeastern US states alone issued more than 3,500 corporate charters. In New York City, the proportion of households holding stock may have risen from 6% in 1790 to 11% by 1826, despite a period of rapid population growth.

While the empirical link between Assumption and the generation of a coalition of support for Hamilton's other reforms is a subject of ongoing research, it is likely that the Assumption of state debts did create a coalition that provided support for Hamilton's Federalist program. Federal and state war debts totalled $67 million, mostly owed in the form of backpay to war veterans, an important organized group with the geographical coverage and resources to likely to play an important role in the subsequent legislative politics or disunion of the United States. At the same time, speculators had bought up the war bonds from a number of veterans, creating some concentration of ownership of the new US public debt. While both groups previously would have depended on state legislatures for their payments, now many, particularly in the erstwhile debtor states, had an interest in support the funding and the policies of a Federal government that backed (and could also default) on this debt. In particular, it is likely that the interests of the war veterans became aligned in reducing political conflict and in supporting the integrity of the union. Once again, two important but very different constituencies thus gained similar interests. The fact that these debts could be traded in the emergent market for US securities may have expanded these constituencies beyond veterans and first movers.

To Hamilton's legislative opponent, Thomas Jefferson, the causal effect of Assumption was clear. Writing three years after the Compromise, Jefferson argued that Assumption: was unjust in itself, oppressive to the States, and was acquiesced in merely from a fear of discussion. While our government was still in its most infant state, it enabled Hamilton so to strengthen himself by corrupt services to many that he could afterwards carry his Bank scheme, and every measure he proposed in defiance of all opposition. In fact it was the principal ground whereon was reared up that speculating phalanx, in and out of Congress, which has since been able to give laws to change the political complexion of the United States".[4]

Hamilton's innovative use of financial instruments to generate a political constituency for reform arguably had lasting and profound effects on the unity and the financial development

of the United States. The Federalists' control over American government would not last, but Hamilton's change of the "political complexion" of the United States, particularly in the creation of a "speculating phalanx" of financial institutions and interests appears to have persisted, surviving Jefferson's terms as president and even Andrew Jackson's veto of the charter of the Bank of the United States in 1832.

Hamilton's reforms did not result in a dominant central government – in fact the competitive chartering of state banks to compete with the branches of the Bank of the United States may have instead acted ultimately to also strengthen within-state interests. Regardless, like in Japan, what the veterans, speculators and local state elites that became the assetholders of both the Federal and the state banks were likely to share was a natural interest in lowering the threat of local violent conflict and in peaceful, legislative resolution of disagreements between the states.

Modern Approaches

It is useful to contrast the experience of the US and Japan with that of other, more contemporary, attempts to mitigate social conflict by using financial equity to share in the future. In Malaysia, where Malaysians of Chinese ancestry were disproportionately represented in urban and commercial enterprises, two months of violent race riots following the 1969 elections led to a New Economic Policy, with 30 percent of shares in non-ethnic Malay firms slated for acquisition by state enterprises to be held in trust and then redistributed to the `bumiputra' population.

Similarly, in post-apartheid South Africa, Black Economic Empowerment (BEE) policies have provided similarly strong incentives for firms to have at least 20 percent equity ownership by Black South Africans. While in Malaysia, the trust seems to have been relatively successful at redistributing assets to ethnic Malays in a fairly broad manner, in South Africa, criticisms have been leveled that the benefits of BEE policies have been captured by a relatively small segment of the Black population. In both cases, it is hard to gauge how much social resentment and conflict, if any, has been avoided by these policies.

Regardless, it is important to note one key feature distinguishes these policies from the Japanese case: the Malay and South African approaches are explicitly inter-ethnic transfers, and recognize and in fact may reinforce ethnic and social divisions. In Japan, in contrast, though the bonds provided in exchange for samurai stipends were initially `ethnic' in the sense that samurai were owned most of them, they could be sold to non-samurai or used to capitalize banks. Thus, they ceased to be ethnically delineated after their initial distribution. As joint capitalists in cross-ethnic banks, however, the distinction between samurai and non-samurai may have thus been undermined over time.

Conclusion

Our two examples of technocratic leadership using financial innovations to solve political economy problems – the early US republic and Japan – are interesting not just because these became among the fastest growing states of their time following their financial development, but also because they show that financial innovations can work in both a democratic environment, where the challenges faced by technocratic leaders were on building legislative support for reform, and in an emergent caste-ridden dictatorial state, where the threats posed were mainly of violent resistance.

Building on these examples suggests still new approaches. In fact, just as in Japan, it may be the case that there gains from constructing novel financial assets that allow the sharing of risks and returns from endowments – like ethnicity — that are usually considered uninsurable. By allowing individuals to hold common portfolios of new financial assets of this kind, it may just be possible to align interests in new ways in favor of peace and cooperation. Financial innovations, if designed well, may hold much promise in mitigating social and ethnic conflict.

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References

1. This article draws heavily from Saumitra Jha (2011) ``Sharing the Future: Financial Innovations and Innovators in Solving the Political Economy Challenges of Development" in *Institutions and Comparative Economic Development*, edited by Masahiko Aoki, Timur Kuran and Gerard Roland, Volume I of the Proceedings of the 16th World Congress of the International Economic Association, IEA Conference Series 150: Palgrave Macmillan, November 2012, which also contains a complete set of references. An ungated version is available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2001039.

2. Jansen, M. B. (2000): *The Making of Modern Japan*. The Belknap Press of Harvard University, Cambridge. pg. 335

3. Masayoshi, Matsukata (1883) "Memo Explaining the Way to Eliminate Bank Notes", cited in Harootunian, H. D. (1960): "The Economic Rehabilitation of the Samurai Class in the early Meiji Period," *The Journal of Asian Studies*, 19(4), [pg.440].

4. Thomas Jefferson (1793), in Foley (1900) *The Jeffersonian cyclopedia: A comprehensive collection of the views of Thomas Jefferson*. Funk and Wagnalls, New York and London, (page 61). Jefferson would remain convinced of the importance of Assumption, writing near the end of his life:

> . . . and so the Assumption was passed, and twenty millions of stock divided among the favored States, and thrown in as pabulum to the stock-jobbing herd. This added to the number of votaries to the Treasury and made its Chief the master of every vote in the Legislature which might give to the government the directions suited to his political views.– Thomas Jefferson (1818) *The Anas. ix*, 92, Ford edition, i, 161