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Institutional Change in Japan: Theory, Evidence, and Reflections

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Institutional Change in Japan: Theory, Evidence, and Reflections

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June 27, 2005

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I. Introduction

I Love You, You're Perfect, Now Change is the title of a long-running off-Broadway musical in New York City that chronicles the course of love and marriage. One could forgive Japanese visitors if they surmised from the title that the show was actually about the changing perception of Japan in Europe and North America. In the 1980s, the Japanese economy registered strong income growth; the yen soared in value; high domestic savings rates allowed massive investments overseas; soaring equity and land values commanded daily media attention; and Japanese economic institutions and business practices were lavished with praise (and sometimes vilified) by the Western media. North American and European firms and governments studied the Japanese experience closely to see what aspects of Japanese business practices and institutions they could adopt to improve their own performances. In the 1990s, the love affair with Japanese institutions was shaken when Japan's economic bubble burst. Land and stock market prices began a precipitous fall in 1990 that has only leveled off in the 2003-2005 period; real income growth was low and volatile for over a decade (1991-2003); deflation in consumer prices from 1995 raised anxiety among foreign and domestic observers that the economy was on the verge of collapse; and massive losses on overseas investments, e.g. in Hawaii and New York City, sullied Japan's image as an economic superpower with a uniquely long vision in making investments. Calls of *Now Change!* began to resound both inside and outside of Japan after 1995. Yet within just a few years the academic and media chorus began to repeat a new refrain: *Why Doesn't Japan Change?* Why doesn't Japan reform its unique economic and political institutions, remolding them around the successful models observed in Great Britain and the United States?

Our challenge in this essay is three-fold. First, we provide a brief overview of the theory of institutions and institutional change, with considerable emphasis placed on Douglass North's recent formulation of these issues in his book, *Understanding the Process of Economic Change* (2005). In particular, we spend considerable space discussing the concept of "path dependence" as we believe that it is critical to an understanding of Japan's contemporary institutions.

Second, we closely examine the assumptions underlying the initial calls for institutional change and set forth the process by which such change would proceed. We identify four critical assumptions: (1) the underlying reason for Japan's economic stagnation is that its economic institutions had become obsolete and were no longer capable of generating efficient outcomes; (2) large-scale rather than incremental institutional change was required; (3) the institutional changes could be proposed, enacted, and implemented relatively quickly; and (4) the new institutions would quickly become effective, raising GDP growth within a relatively short period of time. Our analysis critically examines these assumptions and finds that many of them are highly problematic, even in a highly idealized setting. We briefly ponder whether major institutional changes could have been carried out successfully if there had been strong leadership in political, business, and labor arenas pushing for the changes.

Third, we analyze the question, *Why Doesn't Japan Change?*, from a number of critical perspectives. We begin by critiquing the conventional wisdom, that a coalition of powerful, political interest groups is blocking critically needed reforms because these groups would lose wealth and power. Because the current system is so cozy and inflexible, it is commonly argued

that reformers have been and will be unable to muster sufficient political power to force change until the system is confronted with a major crisis. We argue that the conventional wisdom captures essential elements of an answer to the question, yet also provides a far too simplistic portrayal of the determinants of institutional change in Japan in the first decade of the twenty-first century.

We then question the basic premise behind the question, Why *Doesn't Japan Change?*, and consider whether there really has been little or no institutional change in Japan. As do several other authors in this volume, we argue that Japan has been undergoing incremental change since the early 1980s and that such change is harder to discern and evaluate because of its incremental nature, slow pace, and the continuing economic stagnation. Rather than only asking why Japan does not change, we should also be examining how Japan is changing and whether these changes are likely to be sufficient to generate a new set of social institutions that will be flexible enough to allow Japan to weather and adapt to its current pressing challenges: The shocks of globalization, the dramatic demographic shift in the age structure and size of its population, and the meteoric rise of two new Asian giants, China and India. We analyze several strategies that the Japanese government has been using to trigger institutional change and reflect on why several institutional changes, considered by many analysts to be critical components of stimulating economic growth in Japan have not been implemented.

We proceed as follows. Section II provides a brief survey of the theory of institutions and an overview of a variety of different analyses of Japan's unique institutions. Section III focuses more specifically on the theory of institutional change and confronts the questions of whether these theories are likely to be applicable to Japan. Section IV concludes.

II. Institutions: Theory and Applications to Japan

The New Institutional Economics: An Introduction

"Institution" is a commonly used word that could refer to an organization that plays a prominent role in society, e.g. Sony Corporation, the Japanese Diet, Tokyo University, or it could refer to the sets of rules, norms and expectations which guide our behavior. In the New Institutional Economics, it is the second use of the word that dominates, although there are significant variations in its usage by its practitioners. One group, which includes Douglass North and Leon Hurwicz, defines institutions as

> The humanly devised constraints that structure human interaction. They are made up of formal constraints (e.g., rules, laws, constitutions), informal constraints (e.g., norms of behavior, conventions, self-imposed codes of conduct), and their enforcement characteristics (North, 1994, 360).

A second group, which includes Andrew Schotter, Avner Greif, and Masahiko Aoki, considers institutions to be the equilibrium outcome of a game. Aoki (2001) defines an institution as a shared, self-sustainable, summary expectation held by agents of the way in which a game is repeatedly played in a certain domain.

Regardless of which definition we adopt, institutions arise because individuals face an environment with multiple sources of uncertainty, and they have an "ubiquitous drive to make their environment more predictable" (North 2005, 14). Ronald Coase (1937, 1960) made this point in a more limited context in his seminal articles on the relationship between markets, firms, and legal rules, arguing that in a world with zero information and transaction costs, there would be little need for firms or for legal rules to structure transactions. In a world with imperfect and asymmetric information, environmental shocks, e.g., floods, earthquakes, droughts, etc., and technological innovations, humans construct institutions to structure their responses to these events and with each other. By structuring the way the game is played among human beings, institutions allow individuals to face a more secure environment, albeit at the cost of encountering a more complex human environment.

North (2005, 49) sets forth a concise representation of the broad scaffolding that constitutes the institutional framework of modern societies:

> The institutional framework consists of the political structure that specifies the way we develop and aggregate political choices, the property rights structure that defines the formal economic incentives, and the social structure—norms and conventions that defines the information incentives in the economy. The institutional structure reflects the accumulated beliefs of the society over time, and change in the institutional framework is usually an incremental process reflecting the constraints that the past imposes on the present and the future. All this—and more—makes up the structure that humans erect to deal with the human landscape.

North (p. 60) makes a sharp distinction between institutions and organizations, with organizations being "groups of individuals bound together by some common objectives." Arising as an endogenous response to incentives provided by the institutional structure, organizations compete to earn rents within the existing institutional structure and to change the institutional structure to their advantage. To gain an advantage in both types of competition, organizations invest in skills and knowledge. This accumulated human capital leads to two critical results: (1) it allows some organizations to be successful in their initiatives to change the institutional structure; and (2) it changes the way in which organizations and their members perceive and evaluate the institutional framework.

The second point is critical, as much institutional change can only move forward when it is approved by legislators, judges, regulators, or the executive. They, in turn, must be convinced that existing institutions have become inefficient; that there is a better alternative which can be implemented in a timely fashion; and that they will be able to convince constituents of the these points. A number of factors—specific investments by organizations in the existing institutional framework; interlocking institutions; uncertainty concerning how alternative institutions might work; and the transaction costs associated with the process of institutional change—combine to ensure that in most cases, institutional change is incremental, proceeds at an uneven pace, and is path dependent (North 2005, 62).

The basic theory of group adaptation and environmental selection is compelling in the context of a free and open civil society, but one can surely question how easy it is in many

countries for new groups, particularly splinter groups, to enter civil society and prosper therein. Governments typically treat various groups in civil society very differently, thereby raising significant barriers to entry. Existing groups frequently take action to raise costs for potential new rivals. Network externalities may mandate that a new group enter civil society at a very large scale if it is to be effective. In general, all of the factors that lead to restricted competition in product markets are also present in civil society. And, as in product markets, the presence of barriers to entry and externalities eliminates the standard result that competition will necessarily lead to an efficient allocation of resources.

Path dependence is a much debated and controversial concept. In economic history, the concept usually refers to the remarkable durability of past institutional choices; it is encapsulated in the proposition that current choices "are constrained by the heritage of institutions accumulated from the past". North (2005, 51) maintains that path dependence stems from the presence of numerous organizations "whose survival depends on the perpetuation of those institutions and which hence will devote resources to preventing any alteration that threatens their survival."

The original debate over whether path dependence "mattered" centered around the evolution of technological standards within the marketplace. Paul David (1985) argued that the QWERTY layout seen on almost all typing keyboards had become the standard layout despite strong evidence that other layouts would raise the productivity of typists. David asserts that the only reason why young typists learn to type on QWERTY keyboards is because most keyboards they are likely to use have the QWERTY layout. Stan Leibowitz and Stephen Margolis have questioned the quality of the evidence showing that non-QWERTY keyboard layouts are more productive, and David (1997) has responded by defending and extending his original analysis.[1] While one may or may not be fully persuaded by the Leibowitz and Margolis defense of the productivity of the QWERTY standard, they also provide several clear-cut examples showing that other industry standards have quickly faded when consumers are presented with new, more preferred technological standards despite the presence of an extensive stock of capital embodying a different standard. Examples include the rapid replacement of Beta tape players with VHS tape players in the late 1980s; the rise of IBM-type PCs in the mid-1980s despite the dominance of Apple PCs with a different operating system; and the rapid transition from the "WordPerfect" word processor to the Micosoft Word word processor.

Path dependence may, however, have more currency when it is applied to the institutional framework rather than to technological standards, as competing institutional standards cannot just enter the "market" and compete with existing institutions. In many cases, changes must be approved by one or more political entities, providing losing organizations with opportunities to block the changes. We illustrate with two well-known examples of path dependence from North (2005) and Daron Acemoglu, Simon Johnson, and James Robinson (2001).

North (2005, 144) uses the concept of path dependence to analyze the source of Spain's long decline from the seventeenth century into the second half of the twentieth century. Spain was formed when two previously independent kingdoms, Castille and Aragon, united in the late fifteenth century under Queen Isabella and King Ferdinand. Aragon had a strong Cortes with

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[1] The Leibowitz and Margolis articles on path dependence are collected in Lewin (2002).

significant representation from merchant groups, while Castile had a weak Cortes, no "heritage of strong merchant groups", and had been engaged in prolonged internal and external warfare. Without strong interests to counter Queen Isabella's consolidation of authority, it is unsurprising that Castile emerged as a bureaucratic, centralized monarchy. North argues that the centralized monarchy was the major factor behind Spain's decline and that Spain's use of centralized, bureaucratic institutions in South America played a central role in its institutional evolution.

Acemoglu, Johnson, and Robinson (2001) have argued that contemporary political and economic institutions in countries previously colonized by Europeans frequently retain the broad features of the original institutions established in the country. Their hypothesis is that the type of institution established in each country was broadly related to settler mortality in those countries. In colonies with high settler mortality, e.g. West Africa, Indonesia, and South Asia, institutions were put in place to extract the wealth of the colony rather than to maximize the welfare of the host population. By contrast, in colonies with low settler mortality, e.g. New Zealand, North America, institutions were put in place by European governments that facilitated wealth creation by the European settlers.[2] A sophisticated (albeit much criticized) econometric analysis supports their hypothesis.[3]

Path dependence has implication for analysis of contemporary institutions, as it carries with it the possibility that the dead hand of institutions—designed and evolved to serve a past society—may be impairing the functioning of contemporary institutions. It is not surprising that notions of path dependence are raised during times of rapid social and economic change, as slow institutional change and consequent sluggish economic performance leaves observers searching for their sources.

Path dependence occurs because transaction costs—the costs of defining, measuring, and enforcing a transaction—associated with institutional change are nontrivial and typically serve as impediments to rapid or jolting change. Transaction costs play a significant role in three different varieties of institutional analysis, all of which begin by placing the transaction at the center of their analysis. The three perspectives are differentiated by their treatment of government and the potential for welfare losses within the system. The first perspective, *exchange-supporting institutional analysis*, finds its fullest expression in Oliver Williamson's pathbreaking 1985 book, *The Economic Institutions of Capitalism.* It contained the fundamental insight that as transactions grow in complexity, additional resources must be devoted to *ex ante* contracting and to *ex post* governance. It lays the basis for the insight that high-income economies will devote a higher percentage of their income to the contracting process and in most cases will lead to growth in the resources allocated to government. Wallis and North (1989) provided empirical foundations by estimating the percentage of U.S. national income devoted to

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[2] Low mortality rates of settlers were often correlated with high mortality rates of the indigenous population.

[3] By contrast, Engerman and Sokoloff (1998) argued that the type of crop suitable for cultivation in a particular environment was a major determinant of institutional choice. For example, in environments suitable for wheat, smallholder cultivation was the norm, while in environments suitable for sugar, slave cultivation was the norm.

supporting transactions. Their finding that it had increased rapidly in the twentieth century was consonant with other emerging theories arguing that growing transaction complexity required an expanding government to define and enforce the new nexus of property rights and contracts. Economists writing in this tradition also see the potential for welfare losses from misguided policies and obsolete institutions, which can be corrected if individuals are made aware of the losses and the gains from alternative arrangements.

A second, closely related perspective, *constrained efficiency analysis*, developed in the 1970s and the 1980s at the University of Chicago and University of Washington also places the transaction at center stage and spends considerable effort to show that institutions and government policies typically evolve to minimize deadweight losses in the system. Economists writing in this tradition [Becker 1983; Stigler 1975; and Barzel 1997] have emphasized that rules formulated by government tend to be efficient once we have carefully taken all constraints into account. For example, Gary Becker and George Stigler have emphasized that economic policies and institutions which are seemingly inefficient at first glance often must be re-evaluated once we take into account a second objective: Transferring income. For example, a minimum wage both generates deadweight losses and transfers income to certain groups of low-income workers. They assert that once we take into account the deadweight losses from alternative methods for transferring income (increases in the marginal income tax rate, social welfare programs, etc.), the policymakers' choice of a minimum wage is efficient. If this choice were actually inefficient, i.e., a more efficient policy can be implemented with the welfare gains greater than the costs of implementation, then, in Mancur Olson's words, there would be "money left on the table" and organizations would have incentives to strike bargains to appropriate these rents.

A third perspective, *public choice analysis,* also places the transaction front and center, but has a much more harsh view of government (Buchanan and Tullock 1962; Rowley, Tollison, and Tullock 1988). It models the decision-making process of government officials and representatives and finds that they make decisions which maximize their own utility rather than the overall welfare of society. Rules are promulgated which, rather than supporting exchange, constitute barriers to exchange and create rents for particular organizations competing within the institutional structure and for some in government. High transaction costs of understanding the implications of the rules, monitoring government officials, and organizing political support for the alternatives prevent clearly superior alternative rules from being implemented. Economists writing in this tradition argue that this process could be short-circuited by constitutional requirements restricting the power of governments to engage in such actions.

Applications to Japan

From 1953-1972, Japan's economy grew at an average annual rate of 8.2 percent, rising from the ashes of wartime defeat into the elite group of developed countries. This performance occurred within an institutional framework that coalesced between 1952 and 1962 and would remain in place for another 25 years. The framework included lifetime employment for male workers at major manufacturing and service corporations (Ono and Moriguchi, ch 5); corporate governance institutions that emphasized the role of main bank monitoring of managerial performance and deemphasized monitoring by equity holders (Milhaupt, ch. 6); cross-shareholding to prevent hostile takeovers; extensive government intervention in the financial

sector to ensure that capital was allocated to infrastructure projects and industries favored by the government (Cargill, ch 7; Hoshi, 2003); technology policies designed to ensure that technology is broadly distributed within Japanese industries; and close cooperation between industry associations and the government bureaucracy.

Complementarity of Institutions. One characteristic of the Japanese institution that is crucial in the assessment of potential for its change is complementarity among its various sub-components. Osano and Serita (1994) offer a model that incorporates strategic complementarity in the choice of financial and employment contracts. Their discussion emphasizes that Japanese industrial relations include life-time employment contracts with deferred compensation plans and investment in the firm-specific human capital of workers that would be sunk should the employees leave the company. The main bank provides insurance to workers that the implicit agreement on their deferred payments will be honored by increasing the probability of firm's survival. Corporate governance institutions reduce monitoring of management by shareholders and prevent them from breaking the wage bargain.

Aoki (2001) presents a comprehensive account of Japanese economic institutions. Aoki argues that diversity in economic systems is natural due to the bounded rationality of economic agents, the asymmetric distribution of information among agents, incomplete markets, and different environmental characteristics. In this context, there cannot be any single ideal economic system holding over time and space. Aoki's models typically generate multiple equilibria; history and the institutional environment surrounding the domain of the game often dictate which of the equilibria will actually be observed. Institutional complementarity plays a central role in his theory of Japanese economic institutions, with lifetime employment, the main bank system, and government regulation being closely interrelated. His models generally are designed to highlight the incentives of economic actors within economic institutions and usually do not incorporate political economy considerations explicitly.

Aoki believes that the Japanese economic system encourages investment in "contextual skills" that are useful in the context of a particular organization; their value cannot be assessed in the external market. Further, in these firms with an assimilated or shared information structure, teamwork is the typical mode of operation and no individual's contribution to the organization can be clearly identified. On the other hand, the American system emphasizes functional skills determined by the market and thus can be assessed in the external market. Aoki's models thus lend room for institutional diversity across economies and institutional specialization. The institutional diversity could, however, be upset by increased market integration, technological change, or reductions in the costs of monitoring worker effort.

Consider a marriage between Aoki's theory with the gradual reduction of global trade barriers over the last 50 years. Suppose that Japan also possesses some industries that would be best organized under the American system but are forced by Japan's overarching economic institutions to be organized under Japan's system. In many cases, these industries would not survive international competition but for protection. As trade barriers have fallen and more goods and services have become tradable over the last 30 years, many of these industries have faced increased competition from developing countries in Asia and have rapidly declined. With their decline and the slow movement of resources to other industries in which Japan has a

comparative advantage, Japan's growth rate declines. This theory would note the close correspondence between Japan's slowdown and the rapid import of low-cost goods from Southeast Asia, many from transplant firms.

Path dependence. Robert Higgs (1987) studied the growth of government in the United States during the nineteenth and twentieth centuries and concluded that a major source of this growth was the expansion and exercise of emergency powers during wartime. Higgs places particular emphasis on World War I, the subsequent Red Scare, the Great Depression, World War II, and the Cold War as critical episodes leading to expansions of emergency powers. While the federal government typically gave back some powers in the aftermath of its wars, Higgs concluded that each succeeding peacetime period experienced a overall ratcheting-up in the scope and scale of government power compared to prior peacetime periods. Higgs argued that this increase in government regulation had the effect of reducing both economic growth and economic freedom. In sum, Higgs believes that path dependence is particularly important in understanding institutional change in countries experiencing frequent, deep national crises.

Can some of the growth in government and regulation in Japan be attributed to Higgs' ratchet effect? At first glance, the application of Higgs's ratchet theory to Japan is somewhat problematic, as Article 9 of Japan's "Peace" constitution renounces "war as a sovereign right of the nation and the threat or use of force as means of settling international disputes." While Japan maintains "self-defense" forces and has sent military personnel to peace-keeping operations in Cambodia, Rwanda, Afghanistan, and Iraq, it has not been explicitly involved in any wars since World War II.

A closer look shows, however, that the ratchet effect may have some application to Japan. Noguchi (1995, 1998) and Ozaki and Okuno-Fujimura (1999) have emphasized the persistence of the wartime institutions put in place to mobilize domestic resources for war production. Noguchi catalogued the reasons for the survival of the "1940 System" into the 1990s as well as the problems caused by its persistence.[4] Among the wartime changes which had a long post-war life were limitations on dividend payments by corporations; the extensive system of subcontracting used by manufacturing firms; the rise of major corporations; tax reforms designed to increase national government revenues; subsidies to rural prefectures; and the consolidation of powers within the national government. With the end of WWII and the ensuing American occupation of Japan, it appeared as if the rachet effect was in full operation, as the American occupiers orchestrated the writing and adoption of a new Japanese constitution, dissolved the *zaibatsu* (Japan's large, highly-integrated conglomerates), purged some members of the bureaucracy directly associated with the war, instituted new labor and education laws, and implemented extensive agricultural land reform. The American program to dismantle wartime institutions was interrupted by the outbreak of the Korean War in June 1950. When Japan regained its sovereignty in September 1951, many of the wartime institutions were still in place. For example, the 1942 law providing the institutional foundations of the Bank of Japan was

[4] Okazaki and Okuno-Fujiwara (1999) offer a detailed illustration of the historical events that led to transformation of the Japanese economy away from the orthodox capitalist, market-oriented system that existed until the mid-1930s.

modeled after the German Reichsbank law of 1939. Both were designed to mobilize resources for the national government in wartime. The Diet left the Central Bank law intact until 1990.

Institutional Schlerosis. Mancur Olson (1982) in his classic treatise, *The Rise and Decline of Nations*, argued that established interest groups typically become more powerful over time. They learn how to reward individuals who cooperate with the interest group and punish those who defect. When economic conditions change, thereby increasing potential gains for a new coalition, the old coalition frequently persists in its position because of its superior organizing abilities and the relatively poor organizing abilities of "new" competing interest groups. The increasingly long and strong protection for (outdated) established interests means that productivity growth would decline over time. If, however, a shock eliminates or disrupts the coalition of established interest groups, then government action would be less likely to disrupt productivity-enhancing changes by the private sector. Olson used the severe disruptions of World War II on German and Japanese civil society to illustrate his point, arguing that the special interest groups took considerable time to reorganize and become effective, particularly in light of the new governance institutions established by the post-war constitution. As evidence he observed that Japan's economy not only caught up to its previous growth path but greatly surpassed previous growth rates for another 25 years.

Mancur Olson's explanation for the high post-war economic growth in Japan essentially combines the effects of the severe disruption of Japanese civil society with the persistence of wartime institutions for resource mobilization. The argument is that the disruption of civil society in Japan left space for nationalistic bureaucrats to implement policies designed to reconstruct the economy without significant opposition from losing organizations.[5] As old and new interest groups began to organize more effectively, they gradually gained more influence and, Olson presciently argued, would ultimately produce less institutional change and lower rates of economic growth. His analysis, conducted in the late 1970s and early 1980s, represents a remarkably accurate forecast of the "lost decade" of the 1990s.

Developmental State. Olson's explanation is somewhat agnostic as to whether the high economic growth in Japan emerged because the disruptions in civil society allowed effective market adjustments to changes in relative prices and endowments of technology, human capital, and physical capital or whether the disruptions allowed for bureaucrats to redesign and implement policies and institutions that facilitated the society's adjustments to the rapid structural changes. Among many political scientists, the emerging conventional wisdom for Japan's spectacular growth and subsequent slow-down is that Japan experienced difficulties in transiting between institutions that facilitate rapid catch-up growth by encouraging technology transfer and capital accumulation and those that facilitate growth once the frontier of production and organizational technology has been reached by encouraging development of new technologies (Hayami, 1998; Hayami and Ogasawara, 1999). In these scenarios, Japan used command-and-control style regulation to facilitate resource allocation to industries that could

[5] Ed Lincoln's book, *Arthritic Japan* (2003) and Richard Katz's two books, *Japan: The System that Soured* (1998) and *Japanese Phoenix: The Long Road to Economic Revival* (2003), are in this Olsonian tradition.

imitate and improve frontier technologies and thereby compete on world export markets (Johnson, 1982; Hayami, 1996).[6]

These theories suffer from the presumption that the developmental state has been a highly effective institution in Japan—a notion that David Weinstein's work has gravely undermined. Weinstein analyzed the effects of providing industries with special privileges: trade protection, subsidies, special corporate tax breaks, and government loans. His econometric analysis found that that not only was there no systematic distribution of these privileges, but that industries receiving them typically grew slower than other industries. Weinstein and Beeson (1995, p. 85) concluded that "Japanese industrial policy very like its French and American counterparts over the past four decades [has been] politically driven, favor-based, non-helpful to the nation's overall functioning." If the developmental state has been ineffective, then stagnation may have been the result of growing deadweight losses ensuing from its ineffective industrial policies; as the economy became more complex and more integrated with a rapidly changing global economy, the losses from misplaced regulations are likely to become larger.

There was, however, more to the apparatus of the developmental state in Japan than just the provision of special privileges to targeted industries. The institutions and organizations put in place in the 1930s and early 1940s to direct resources to the war machine were also used by the Japanese government to mobilize resources for the reconstruction and modernization of Japan's infrastructure (highways, ports, railways, airports, power, telecommunications, and water) and housing stock for three decades following World War II. While it is still an open question as to how well the channeling of savings from the Postal Savings Bank to the quasi-public FILP (Fiscal Investment Loan Program) corporations facilitated the rebuilding of infrastructure, bureaucrats and politicians increasingly realized, particularly after the second oil price shock (1978-1981), that a program of privatization and deregulation was necessary both to bring the government budget back into balance and to promote economic growth. A program of privatization and deregulation had considerable success in some sectors (see Section IV below) but left government ownership and regulation in other sectors relatively untouched.

A number of recent researchers (including contributors to Blomström, Hayashi, Kashyap, and Corbett 2003; and Cargill and Yoshino 2001) have bypassed the question of whether the extensive government involvement in infrastructure provision and the financial system was effective and have instead focused on measuring the burdens which these institutional arrangements currently impose on the economy. Particular attention has been paid to constructing estimates of the financial positions of private and public financial organizations, semi-public corporations, and —including the Postal Saving Bank, the largest public and private banks and insurance companies, the semi-public FILP corporations, and prefectural and local

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[6] T.J. Pempel's 1998 book, *Regime Shift*, offers an explanation based on the political dominance of the LDP through the 1970s. The lack of political competition enabled the party to implement economically rational policies that allowed for broad-based economic growth. With the rise of multiple political parties and the decline of the LDP, he argues that policy making became more politicized. In many ways, Pempel's explanation of Japanese growth and stagnation is Olsonian in its basic outlines, with political parties added as intermediary organizations. See also an intriguing book by Bai Gao (2001) which emphasizes how strategic political decisions led to economic growth in the 1951-1973 period but also created later problems of path dependence.

governments. Careful estimates of the on- and off-book debts accumulated by these organizations—summarized concisely in Hoshi and Kashyap (2004)—provide overwhelming factual support to reforms efforts to stem future losses and to efforts to address the untenable debt burdens accumulated. These contributions oscillate between the public choice tradition—in which bureaucrats following their own interest bring about inefficient arrangements—and the constrained efficiency tradition, in which institutional change is moving as fast as it can, given the constraints on choices by elected representatives and bureaucrats.

LDP Legislators: In Control or Bureaucratic Puppets? Japanese institutions are surely the product of the electoral system and the interactions between legislators, bureaucrats, and their constituents. Japan's multi-member electoral districts and the dominance of Japan's "umbrella" political party, the LDP, have been at the center stage of most analyses of the electoral system. Mark Ramseyer and Frances Rosenbluth (1993) argued that Japan's multi-member districts have forced the LDP to offer multiple candidates in each district, with politicians focusing on votes from specific interest groups. The factional organization of the LDP provides a decentralized mechanism for identifying relevant interest groups and developing innovative policies to serve them. These "particularistic" Diet members then have strong incentives to reward their interest groups with desired regulatory policies. Ramseyer and Rosenbluth argued that as the Japanese polity changed, the LDP regularly changed its organization and policy stances to remain in power.

A 1993 electoral reform eliminated the multi-member districts, replacing them with 300 single-member districts and 200 representatives elected from proportional lists in eleven different-sized districts with 7-33 representatives elected per district. The new electoral system provides incentives for smaller parties to merge or cooperate to field single candidates against LDP candidates in the single-member districts, but also provides incentives for small parties to remain independent due to their prospects for gaining Diet seats via the proportional representation list. Over the last decade, support for the LDP has fallen—as one might expect given Japan's stagnant economic performance, and it has been forced into coalitions with smaller parties to stay in power. Opposition to the LDP remained relatively fragmented through 2004, with grand opposition ventures such as the defunct New Frontier Party achieving little success. Whether the consolidation of the opposition around the Democratic Party of Japan in the 2004 elections represents a move towards a two-party system has yet to be seen.

Throughout, Ramseyer and Rosenbluth take the controversial view that the relationship between Japanese bureaucrats and LDP bureaucrats is best analyzed as a well-functioning principal-agent relationship in which bureaucrat agents effectively carry out policies desired by LDP Diet members—the principals—which are designed to keep them in power. This constrained efficiency approach differs greatly from the one chosen by Gerald Curtis (1999) and many other commentators. They hold that bureaucrats have a great deal of independent authority, some informational advantages, and are not always well monitored by Diet members. In this world, bureaucrats are an independent force to be reckoned with, and political maneuvering among politicians and factions also helps to determine the outcome.

III. Institutional Change in Japan: The Lost Decade and Its Aftermath

Determinants of Institutional Change

In North's framework (2005), the interaction between institutions and organizations is a critical determinant of institutional change. Individuals and organizations compete to take advantage of opportunities presented under the given institutional structure. If organizations perceive that they have better opportunities under a different set of rules, then they will devote resources to changing rules if they perceive reasonable possibilities of success. North (2005, 59-61) argues that vigorous competition among organizations is likely to lead to rapid institutional change, while muted competition will lead to a more stable institutional environment. In this competitive environment, organizational survival depends on making productive innovations or being able to adapt well to changes in the environment, e.g. changes in relative prices. For an organization to engage in either innovation or adaptation, the individuals associated with the organization must invest in skills and knowledge. Investment in human capital depends heavily on the incentives posed by the society's institutions, and the type of human capital acquired shapes individuals' belief structures and their perceptions of the opportunities presented by the society.

Some institutional changes will occur in a Hayekian fashion, as the combination of investment in knowledge and competition among individuals and organizations alters the informal norms which serve as the primary constraints on individual behavior in many situations. Hiroshi's Ono's analysis of marriage in Japan (this volume, chapter 9) relies heavily upon changes in informal norms as the economic environment rapidly changed in post-WWII Japan. Other changes in the institution of marriage were, however, effected by changes in the legal environment concerning divorce and care of elderly parents. With respect to institutional changes which require assent by the polity, individuals typically need to understand how the environment has changed, thereby increasing the gains from adopting alternative institutions; they need to perceive that superior, alternative institutions exist; they need to understand how the new institutional arrangements will affect their welfare; and there need to be incentives for political entrepreneurs to act to overcome free-riding problems. Most importantly, in most cases there will be organizations and individuals that will lose from the changes, and in some instances they will have incentives to engage in action to stop change or to push for alternatives which are less beneficial for the overall society. Because political institutions are not and cannot be organized as markets, there is no guarantee that the political process will generate efficient instiutitonal change.

North places special emphasis on how "economies of scope, complementarities, and network externalities of an institutional matrix make institutional change overwhelmingly incremental and path dependent" (North 2005, 5). Change will usually be incremental (and therefore slow) because "large-scale change will create too many opponents among existing organizations that will be harmed and therefore oppose such change." Path dependence occurs "because the direction of the incremental institutional change will be broadly consistent with the existing institutional matrix … and will be governed by the kinds of knowledge and skills that that the entrepreneurs and members of organizations have invested in" (North 2005, 62).

North and Barry Weingast (1989) and Gary Libecap (1989) have emphasized that those in power will change institutional arrangements to secure their own wealth rather than the wealth

of the overall society. For example, Avner Greif, Paul Milgrom, and Barry Weingast (1994) constructed a repeated-game model to analyze the emergence of merchant guilds during the late medieval period in Europe. They argued that merchant guilds were a mechanism to secure merchants' property rights in foreign cities and were, therefore, an institution that extended rather than restricted trade. In their view the guild "functioned as a nexus of contracts, weaving separate agreements with the individual merchants and the cities in which its members traded into a system whose parts were mutually supporting" (p. 772). With the rise of the centralized nation-state in Europe, political entities began to assume the functions previously carried out by the merchant guilds. Greif, et al. observed that the merchant guilds did not fade away (as an efficiency theory of group selection would dictate), but instead "some guilds became fiscal instruments that hindered trade expansion in the emerging states. Other guilds consolidated their political power and, after securing their members' rights, turned to limit the rights of their competitors." (p. 773) Thus, rather than change their internal institutions to better facilitate exchange in the new contracting environment, guilds chose instead to use this machinery to raise rivals' costs of facilitating exchange.

Greif's study (1994) of two differently organized pre-modern societies—the Maghribi traders of the eleventh-century Muslim world and the Genoese traders of the twelfth-century Latin world—carefully examined how two different groups of merchants adapted to changes in the contracting environment. Greif observed that the two groups faced similar contracting environments, yet chose very different societal organizations to support long-distance exchange of merchant goods. The Maghribi traders formed an insider trading group with a structure closely resembling the stylized model for trading groups outlined in Yarbrough and Yarbrough (1999) and Landa (1994). Their common social and religious ties enabled them to support the requisite institutions for information exchange and collective punishment. By contrast, the Genoese traders were more individualistic. They did not share information among themselves, did not restrict certain trading networks to other Genoese, and relied on state enforcement of contracts rather than collective punishment by the group of Genoese traders.

Grief's game-theoretic analysis of the two societies came to a striking result: The use of insider groups to facilitate exchange is more efficient in supporting intra-economy trade but is less efficient than a system of contract law in supporting inter-economy trade. As trade expands and the size of the market increases, inter-economy trade becomes more lucrative and the gains from switching from insider groups to the impersonal system of contract law increase. Thus, insider groups have advantages when they function relatively autonomously but encounter problems when they have to contract with other groups. While the historical record is insufficient to compare the relative efficiency of the Genoese and Maghribi traders, it is notable that in the long run Italian traders thrived and the Maghribi traders disappeared from the Mediterranean trading world. Potential applications to modern Japan arise from the perception that Japan's unique institutions are more suited to intra-economy than inter-economy trade. If globalization requires that Japan standardize its institutions with the rest of the world, both import- and export-competing businesses will suffer until institutional changes have been completed.

Institutional Change in Japan

Incremental reform. The premise that the Japanese government has done nothing to reform its economy over the last two decades is just plain wrong. To name just a few prominent examples:

- Japan engaged in a wave of privatization in the mid-1980s, privatizing its national railroad (JNR) in 1987, its flagship air carrier (JAL) in 1985, and its telephone carrier (NTT) in 1985.

- During the 1990s, major deregulation initiatives were undertaken in the trucking, airlines, taxi, telecommunications, and electricity industries.

- In 1997 Japan repealed its Large-Scale Retail Store Law, returning limited regulatory powers over construction of large retail stores to provincial and local governments.

- The "Big Bang" financial reforms, implemented between 1998 and 2001, were just the latest steps in a long string of deregulatory measures in finance and banking.[7]

- In April 2001, there was a reform of the Fiscal Loan and Investment Program (FILP), which channels funds from Postal Savings to public corporations and local governments.[8] FILP corporations are forced to raise funds directly from financial markets; their bonds are not guaranteed by the national government; and the Postal Savings Bank does not have to purchase FILP bonds.

- In 2004, the post office was corporatized, and in 2005 there has been extensive debate in the Diet over its privatization.

Despite these changes, it is important to also analyze the view that change in Japan has been slow.

Japan has a tradition of slow change. One should not conclude from Japan's recent performance that it is incapable of carrying out necessary institutional reforms. Change is a tradition in Japan. The historical record since Commodore Mathew Perry's black ships first appeared in Yokohama Bay serves as a vivid reminder that Japan has constantly changed over the last 150 years.[9] The successful borrowing and transplantation of foreign political and economic institutions during the 1870s and 1880s serves as a reminder of Japanese willingness to borrow organizational as well as production technology from overseas and to adapt them to Japanese circumstances. Japan's slow response to its depressed economy also has precedents in its own modern history. During two long periods, 1895-1914 and 1919-1932, Japanese per capita income growth rates averaged less than 0.6 percent, slow growth rates for a developing

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[7] See Hoshi and Kashyap (2001) for a magisterial discussion of the evolution of the Japanese banking and financial system.

[8] See Doi and Hoshi (2001) for a full discussion of FILP reforms.

[9] See Weinstein (2001) for an excellent discussion of Japan's experience with stagnation and reform.

country. Both long periods of stagnation were, however, followed by robust economic growth, albeit in wartime environments (Weinstein 2001).

Institutional change carried out during the post-WWII occupation and embedded in the post-war constitution quickly became part of the fabric of Japanese life. Labor unrest during the 1950s gave way to new labor market institutions, including lifetime employment. As in Italy, parliamentary democracy coalesced around one party—the LDP—and lively policy debates ensued inside the LDP. Unwanted institutional change imposed during the post-war occupation was quickly reversed, the most prominent example being the re-centralization of education in the national government.

Japan's ability to engage in structural reform during its four decades of high growth after WWII has been a central feature of its economy. From initial specialization in coal, silk and cotton textiles, processed foods, and toys came the transition in the 1970s and 1980s to cars, electronics, steel, and semiconductors. Today's critical question is whether Japan can make the next shift to finance, insurance, computer software, and telecommunications.[10] Studies of productivity in these sectors during the 1990s show them lagging far behind the United States. Yet institutional change that facilitates adoption of the latest organizational technologies by Japanese firms could push these industries to the forefront and produce a sustained phase of economic growth.

Japan is not unique in its slow response to crisis. The widespread assertion that Japan's decade-long economic crisis is unprecedented among industrialized countries in the post-WWII period is false. Timothy Kehoe and Edward Prescott (2002) have studied economic depressions in both developing and developed countries and have established a useful benchmark for categorizing depressions. They defined an economy as in depression if there is a time period when output per working-age person falls 20 percent below the trend growth path <u>and</u> at least 15 percent of that decline occurs over a ten-year period.[11] Japan's current economic crisis fits the Kehoe-Prescott criteria for a depression, as over the 1991-2001 period, the gap between actual and trend output was approximately 20 percent.

Kehoe and Prescott also found that two other industrialized countries have experienced depressions since WWII: Switzerland (1973-2000; 30 percent drop) and New Zealand (1974-1992; 32 percent drop). At the start of their crises, both countries had high per capita incomes, long experience with market institutions, and rich traditions of democracy. Both countries were also slow to initiate major economic reforms. New Zealand did not embark on major reforms until 1984—ten years into its depression. The impact of New Zealand's microeconomic reforms was dampened by a poorly designed monetary policy, and their implementation took well over a decade.[12] The New Zealand change in policy was precipitated by a balance of payment crisis and by a radical change in the policy stance of the Labor Party. Swiss policymakers reacted even

[10] Weinstein (2001), 37.

[11] Kehoe and Prescott (2002) adopt an annual per capita growth rate of 2 percent as the trend growth path for all countries in their study.

[12] See Evans, Grimes, and Wilkinson (1996) for an extensive analysis of New Zealand's reforms.

slower than in New Zealand, waiting almost two decades to mount major policy responses to their economic stagnation. The slow Swiss response may have been due to Switzerland's high per capita income; its ability to expel guest workers during times of crisis; and the difficulty in gaining consensus in such a linguistically and culturally heterogeneous nation.[13] Given New Zealand's and Switzerland's slow responses to their depressions, Japan's response appears more typical—the usual case rather than the outlier.

Reform in Rich Countries. Why do rich countries in depression wait so long to undertake reforms? One obvious reason is that their wealth and high per capita income provide individuals and firms with a hedge against hard times. This means that prolonged economic stagnation is less likely to cause a precipitous crisis that could force policymakers to undertake major reforms. With its high household savings rates and high incomes, Japan fits this model well. The absence of a major crisis in the 1990s that could have forced reform was a major factor in turning stagnation into depression.[14]

New Zealand, by contrast, was forced by an exchange rate crisis to begin implementing reforms in 1984. Blomström (2002) has argued that Sweden implemented swift reforms to its banking system in 1992 due to an exchange rate crisis and a desire to meet the conditions necessary for entry to the European Union. Japan has not faced such a crisis, as it has run balance of trade surpluses throughout the 1980s and 1990s.[15]

A second reason is that by their very nature institutions cannot be too pliant. Institutions are a set of shared expectations about how individuals interact in a society, i.e., the shared perceptions of the rules of the game. Japan has grown rich because its institutions functioned well, and individuals will resist changing them until enough pressure arises to force change.

A third reason is that most rich countries became rich because their governments had ongoing commitments to economic reform. Thus, when stagnation appears, policymakers reasonably believe that they are already undertaking extensive reform measures. They view most downturns as the product of unexpected, temporary, negative shocks—such as higher oil prices—and believe their impact can be minimized with timely, expansionary monetary and fiscal policies. In this environment, policymakers are unlikely to initiate extensive reform programs.

[13] See OECD (2001) for a discussion of Switzerland's economic reforms and ongoing problems.

[14] In 1997, there were two major financial crises: the liquidation of Yamaichi Securities (one of the Big Four securities houses) and the collapse of Hokkaido-Takushoku Bank (one of the City Banks that the Ministry of Finance had openly promised to defend). While both crises had the potential to trigger major banking reforms and were accompanied by a yen depreciation, there was never any sense that they were likely to generate a currency crisis or a balance of payments crisis. Japan's high level of international currency reserves made a balance of payment crisis extremely unlikely.

[15] Japan ran balance of payment deficits during the Gulf War years.

The above explanations fit well Japan's experience with its first two periods of economic stagnation after growth resumed in the early 1950s—the first (1973-1975) and second (1979-1981) OPEC oil shocks. During both episodes, the Japanese government used expansionary monetary and fiscal policies to stimulate the economy after higher oil prices had reduced growth rates.[16] Equally important, when growth resumed in the early 1980s, the Japanese government implemented several deregulatory and privatization programs to restore budget balance and adjusted monetary growth to achieve low inflation—critical steps that other industrialized nations often fail to take.

An Alternative Institutional Framework. Chung Lee (ch. 4, this volume) has argued that the lack of a clear model for current reformers to emulate is one reason why institutional change in Japan has been slow. By contrast, there were numerous competing models of success to choose from when the Meiji emperor chose to adopt and adapt institutions and organizations from Germany, France, England, and the United States. After World War II, elements of the U.S. model were imposed on top of wartime and pre-war institutions, ultimately forging a unique Japanese blend. Today, there are fewer economic models that resonate with the Japanese public. Europe and the United States both struggled with low productivity growth from the mid-1970s to the early 1990s. While the internet-bio-tech boom of the mid-late 1990s put the bloom back on the American model, the post-millenium stock market crashes and fragile growth in the United States and the European Union have once again raised the caution signs for Japan's decision makers.

Deflation and Its Effects on Institutional Change. Since the late 1980s, Japan's use of monetary and fiscal policy has been dismal. Unnecessarily loose monetary policy contributed to Japan's land and stock market price bubbles, while tight monetary policy subsequently helped to burst both bubbles in the early 1990s. Expansionary monetary and fiscal policy helped revive the economy in the mid-1990s, but since 1997 the Bank of Japan has engineered a monetary policy that appears to be expansionary—nominal interest rates were .25% until 1999 and zero thereafter—but has actually been contractionary in practice. This was because the continuation of price deflation left real (inflation-adjusted) interest rates at relatively high levels. The high real interest rates served to at least partially offset a decade of massive deficit spending by the national government.

Economists are virtually unanimous in their judgment that deflation in Japan must be halted if its economy is to prosper.[17] Unlike the media, which tends to stress the effects that deflation has on postponing consumption—as prices of consumer goods will be lower tomorrow, economists stress that the main channel through which deflation hurts the economy is its negative impact on firm balance sheets.[18] With nominal interest rates near zero in Japan,

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[16] Over-expansive monetary policy prior to the first OPEC oil shock resulted in high inflation rates in 1974. Management by the Bank of Japan of the second OPEC oil shock was considerably better.

[17] Japanese economists have cited numerous reasons why monetary policy cannot be made more expansionary without risking serious consequences such as hyper-inflation or severe problems with the central bank balance sheet. Foreign economists have emphasized that there are many additional tools that can be used to increase the money supply without impairing the future viability of the Bank of Japan. See Cargill (2001) for a full discussion.

[18] Media discussions have emphasized that deflation provides incentives for consumers to defer consumption to

deflation raises the burden of firms' debt; increases the likelihood that firms will not be able to service bank loans; and reduces or even eliminates bank profits. The combination of financially weak firms and struggling banks works to reduce the efficiency of investment and impair the ability of the economy to restructure and to respond to new opportunities.

Deflation also works through a second less noticed channel: *It harms the economy by reducing the demand by existing firms for economic reform.*[19] Consider, for example, the quite far-reaching deregulation of fare and entry restrictions in taxi industries in large cities. The new environment has presented significant opportunities to low-cost taxi companies, as they can expand their market share and earn higher profits under the new regime. If, however, these efficient taxi companies have found their debt burden increasing due to deflation, banks will perceive them as poor credit risks, access to capital markets will be limited, and the needed expansion of taxi fleets in major cities will remain just a mirage. Low-cost taxi firms may now become opponents rather than supporters of deregulation. Ending deflation is a critical step towards achieving successful economic reform.

IV. Conclusion

Are there ways in which the Japanese government can encourage and speed up institutional change? Perhaps. We suggest a few while remaining cognizant of the risks and problems associated with each of these policies and political initiatives.

Reforms, Political Entrepreneurship, and Compensation of Losers. Media and academic analysis of Japan's slow reforms has rightly emphasized the central role of interest group politics in Japan's economic stagnation. There are constant reminders of how organized interest groups in Japan have blocked needed institutional change in the 1990s and are likely to continue to block it over the next decade. Although there is much truth in this perspective, it is too pessimistic. In particular, it ignores the basic insight that good economic reforms provide net benefits to Japan. Some groups gain and others lose from reform, but the gains always outweigh the losses from carefully designed and properly executed reforms. The existence of net gains to society is particularly important for two reasons.

First, net gains mean that the winners have more at stake than the losers in pushing for reform. Since the gains are larger to potential winners than potential losers, these groups should prevail if they can overcome free-riding problems and other organizing costs that impair coordinated political action. While potential winning groups may be poorly organized initially, there are incentives—reaping part of the social gains—for political entrepreneurs to take action to organize them and lobby effectively for institutional changes. The rapid emergence of Prime Minister Koizumi within the LDP is a prime example of such political entrepreneurship. The resurgence of traditional forces within the LDP during Mr. Koizum's tenure as Prime Minister also shows how difficult it can be to overcome organized interests. Mr. Koizumi's fairly modest success in implementing economic reforms has increased the probability that political

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future periods, thereby contributing to a fall in aggregate demand today and a stagnating economy.

[19] See Kroszner and Strahan (1999) for an analysis of factors driving banking deregulation in the United States.

entrepreneurs in other political parties, e.g. the New Democratic Party, will have more success. The process of mobilizing potential winning groups has been hampered in Japan due to the late development of consumer and public interest groups to counter well-organized industry associations. Non-profit organizations did not even exist in Japan until a few years ago.

Second, the existence of net gains means that losers can potentially be compensated. Full compensation is expensive and is unnecessary in many situations. Partial compensation of all or some losers or full compensation of a few losers may be sufficient to lessen opposition enough to ensure passage of reforms. There are, of course, several problems associated with compensating losers. First, paying compensation makes the reform package more complex and difficult to understand. Second, the losers may not always be easy to identify, as many reform measures have unintended consequences and generate effects of uncertain magnitudes. Third, if compensation is only paid to some groups, then voters may perceive the reform process as unfair—a consideration that may be particularly important in equity-conscious Japan. Finally, compensation has costs beyond the payments to losers. If the administrative costs and the deadweight losses from the increase in taxes outweigh the net gains, then compensation which seems feasible in theory will prove impractical as legislation.

Daron Acemoglu and James Robinson (2000) have argued that it may not be economic losers that impede institutional and policy changes, but political losers. Economic losers without political power will not have the ability to impede change. Groups with political power who will not lose the political power when there is institutional change will not have incentives to block the net gains enjoyed by society from the change. However, those who have political power and will lose it if there is institutional change have incentives to block this change. Their analysis could provide some insight into the resistance to change in Japan because of the numerous interest groups assembled under the umbrella of the Liberal Democratic Party (LDP). If institutional change causes economic losses to even a few of these groups and results in the expansion of groups tending to vote for opposition parties, then LDP politicians may be reluctant to move ahead with the changes even if most groups within the LDP gain from the changes. On the other hand, umbrella political parties may also be well equipped to provide compensation to losing groups within the party and thereby keep them from leaving the party.

Trade Agreements as Vehicles for Institutional Change. Japanese manufacturing firms producing high-technology products could reap significant gains if Japanese trade with Pacific Rim countries were to be further liberalized. Since Japan's comparative advantage clearly lies in human and physical capital-intensive industries, trade liberalization would also imply increases in imports from other countries in the region, in particular the ASEAN countries and China. These gains would come at the expense of significant losses to Japanese farmers and manufacturers and workers producing goods intensive in unskilled labor.[20] The Singapore-Japan Free Trade Agreement (FTA), concluded in January 2002, signals Japanese interest in more liberal trade, yet was relatively easy to conclude due to Singapore's lack of a significant agricultural sector, its relatively high wage rates, and its small size. A draft of the Japan-Mexico FTA was rejected by Mexico in 2003 due to inadequate consideration provided to agricultural

[20] Increased imports in these sectors could induce Japanese firms to improve their productivity. See Weinstein (2001), 39.

exports from Mexico. Additional concessions to Mexico's agricultural sector allowed the FTA to be concluded in April 2004.

The Japan-Mexico FTA and the recent Japanese interest in negotiating FTAs with the Association of Southeast Asian Nations (ASEAN), South Korea, and China signals that potential Japanese winners from increased trade, i.e., high-technology Japanese manufacturing firms and their labor force, may finally be organizing more effectively to press their interests within Japan. Liberalized trade with Pacific Rim countries (the participants in Asia Pacific Economic Cooperation (APEC)) would have three major consequences: (1) It would shift the Japanese economy towards its comparative advantage—just the recipe for a long-lived burst of growth; (2) it would reduce pressure on Asian governments to resist yen depreciation, as new markets would open to offset any losses to their existing exporters from yen depreciation; and (3) lower prices on goods produced in highly competitive foreign markets would produce new pressures for additional reform in Japan. The pressure that WTO membership is exerting on China to reform its inefficient state-owned enterprises could well be replicated in Japan if were to negotiate a series of substantive FTAs with ASEAN, China, and Korea.

Shrinking the Banking System. Since 2002, the Japanese government has exerted considerable effort to clean up non-performing loans in its banking system. The clean-up of non-performing loans has been accompanied by a consolidation in the commercial banking sector which has seen the emergence of several very large nationwide banks. The consolidations do little to address one of the major problems of the banking system: widespread excess capacity. Takeo Hoshi and Anil Kashyap (2004) have concluded that the Japanese banking system is about one-third too large, and they cannot see how a small number of large banks will find it easier to downsize than a larger number of smaller banks. If anything, the consolidated banks should find it easier to organize for political action (as free-riding is less of a problem), thereby reducing opportunities for downsizing and productivity improvement in this troubled industry.

Decentralization of Government Responsibilities. During the 1930s, Japan centralized its political system, leaving few powers with prefectural governments. The nationally-focused political system persisted with few changes through the mid-1980s when Japan began a series of reforms, ultimately transferring some limited functions of governments back to the prefectures. Japan's limited grant of powers to prefectural governments deprives the system of two important features: limited experiments with innovations in government and relative performance evaluation (Besley and Case, 2003).[21] One well-known advantage of a decentralized political system is the ability of one regional government to experiment with an institutional or policy innovation and for other governments to study the results of such innovations. Such regional experiments allow a variety of alternatives to be studied before a nationwide policy is chosen; the parallel experiments should generate sufficient information for a better choice of policies by other regional governments. The limited powers granted to Japan's prefectural governments limits the scope of such experiments. A second advantage of a decentralized political system is the ability it provides voters to engage in relative evaluation of institutions and policies. If two neighboring regions are hit with the same shock, then voters in each jurisdiction can examine the

[21] We abstract from the well-known sorting result--when consumers are mobile and heterogeneous, endogenous policies will arise across jurisdictions to cater to the heterogeneous preferences.

relative performance of institutions, policies, and politicians in both jurisdictions. This provides voters with a yardstick by which to measure performance in their jurisdiction. The sharply circumscribed powers granted to prefectural governments in Japan limits this channel of institutional evaluation and change.

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