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Introduction to Institutional Change in Japan

Magnus Blomström and Sumner J. La Croix

Magnus Blomström is a Professor, Stockholm School of Economics, and President, European Institute of Japanese Studies, Stockholm School of Economics. He is coeditor of *Japan's New Economy* (Oxford, 2001), *Structural Impediments to Growth in Japan* (Chicago, 2003), and *Institutional Change in Japan* (Routledge Courzon, forthcoming 2006).

Sumner J. La Croix is a Professor in the Department of Economics, University of Hawaii at Manoa, and a Senior Fellow at the East-West Center. He is coeditor of *Japan's New Economy* (Oxford, 2001) and *Institutional Change in Japan* (Routledge Courzon, forthcoming 2006).

Introduction to Institutional Change in Japan

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Abstract

Japan's prolonged economic stagnation has left many observers questioning the wisdom of Japanese economic organization and institutions. The current system is often viewed as so cozy and inflexible 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. Conventional wisdom, in both media analysis and academic research, is that a coalition of powerful, political interest groups is blocking critically needed reforms, because these groups would lose wealth and power. This view provides, we argue below, a far too simplistic picture of institutions and institutional change in Japan.

This essay brings together several recent articles analyzing changes in important Japanese institutions. It addresses the origin, development, and recent adaptation of core institutions, including financial institutions, corporate governance, lifetime employment, and the *amakudari* system. To place current institutional changes in perspective, it also includes discussion of both historical and international comparisons. Emphasis is placed on comparisons with Meiji Japan, a period in which Japan borrowed and adapted foreign institutions to its unique circumstances. Comparisons with recent economic and financial reforms in Korea, Switzerland, and New Zealand are also included to provide a broader perspective on the current reform process in Japan. The conventional wisdom is that Japanese institutions have remained relatively rigid since the collapse of the 1980s bubble, while our findings indicate that there has been significant institutional change over the last decade.

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Sumner La Croix is Professor, Department of Economics, University of Hawaii, and Senior Fellow, East-West Center. He is co-editor (with Magnus Blomström and Byron Gangnes) of *Japan's New Economy*, Oxford University Press, 2001, and co-editor(with Magnus Blomström) of *Institutional Change in Japan*, Routledge, forthcoming 2006.

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Japan's prolonged economic stagnation has left many observers questioning the wisdom of Japanese economic organization and institutions. The current system is often viewed as so cozy and inflexible 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. Conventional wisdom, in both media analysis and academic research, is that a coalition of powerful, political interest groups is blocking critically needed reforms, because these groups would lose wealth and power. This view provides, we argue below, a far too simplistic picture of institutions and institutional change in Japan.

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Institutional Change in Theory and in Practice

Akihiko Kawaura and Sumner La Croix (2005) review theories of institutions and reflect on their applicability to Japan. They begin by discussing Douglass North's (2005, 48) definition of an institution—"the formal rules, informal norms, and their enforcement characteristics" that determine how humans beings interact with one another in a given context. North (p. 60) makes a sharp distinction between institutions and organizations, with organizations being "groups of individuals bound together by some common objectives." Organizations compete to earn rents within the existing institutional structure (which sets the expected payoffs to actions) and also compete to make changes in the institutional structure which are to their advantage. To gain an advantage in both types of competition, organizations invest in skills and knowledge. This accumulation of human capital leads to incremental changes in institutions as well as changes in the way these groups of individuals view their world and social institutions. Because organizations exist within the complex, intertwined web of relationships with other organizations and institutions, institutional change is, in most cases, incremental and path dependent (North 2005, 62). Path dependence is a much debated concept, but fundamentally relates to the proposition that current choices "are constrained by the heritage of institutions accumulated from the past". Its importance 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" (North 2005, 51).

Kawaura and La Croix use this theory of institutional change to place Japan's "lost decade" in perspective. First, they note that Japan is not unique among industrialized countries in being slow to implement effective policy and institutional changes in response to a major crisis. This prompts an obvious question: Why do rich countries in depression wait such a long time to undertake needed reforms? One obvious reason is that their wealth and high per capita income provide households 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 household incomes, Japan fits this model well. The absence of a crisis in the 1990s that could have forced reform was a major factor in turning stagnation into depression.

A second reason, according to Kawaura and La Croix, 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 grew rich because its institutions were stable and functioned well, and it is to be expected that individuals would worry that change would bring expectations of further change and disrupt the stability that initially generated the prosperity. From this perspective, change will only be instituted when a large majority of individual, firms, and the legislature become convinced that the existing institutional structure will never again function well and that there is an alternative which they are convinced represents a rational experiment for the society. Kawaura and La Croix note that many citizens and policymakers in Japan may not have perceived an obviously superior alternative institutional structure with which to experiment during the course of Japan's lost 13 years (1991-2003).

A third reason is that countries become rich and stay rich because their governments had ongoing commitments to economic reform. Thus, when stagnation appears, policymakers reasonably believe that they are already undertaking reform measures that may be sufficient to carry the society back to robust growth. Policymakers and citizens rationally view most downturns as the product of unexpected, temporary, negative shocks, e.g. the sharp, temporary oil price shocks that have regularly punctuated the last 50 years, and believe that their impact can be mitigated with timely, expansionary monetary and fiscal policies. In this environment, policymakers are likely to initiate extensive reform programs only after monetary and fiscal policies have been tried and shown few timely results.

Kawauara and La Croix then consider a variety of additional explanations in the literature for Japan's slow change. First up is the emerging conventional wisdom that Japan has experienced difficulty in transiting between the institutions that facilitate rapid catch-up growth and those that allow for growth once the frontier of production and organizational technology has been reached. In these scenarios, Japan used command-and-control style regulation to facilitate resource allocation to industries that could imitate frontier technologies and compete on export markets. In some theories, Japan's lost decade occurs because of the difficulty in transiting from imitative to innovative institutions. In other theories, the economy declines because the deadweight losses from regulation have increased as the economy became more complex. According to Kawaura and La Croix, these theories suffer from the presumption that the developmental state was highly effective, and they present evidence questioning this widely held presumption.

Kawaura and La Croix also consider whether other theories of institutional change can explain Japan's post-1990 malaise. First, they consider a public choice analysis of Japanese politics; it places the LDP's drive to stay in power and multi-member legislative districts at center stage. Second, they consider the theory of institutional change propounded by Mancur Olson. Olson argued that established interest groups typically become more powerful over time and eventually retard economic growth. Third, they review Noguchi's theory that Japan's institutions were an artifact of central planning during World War II and were eventually doomed to reflect the usual flaws associated with central planning. Finally, they pay particular attention to Masahiko Aoki's theory of complementary institutions. Aoki believes that Japan's institutions evolved in an interlocking fashion, making it very costly to reform just one institution at a time. When changes in the economic, social, and political environment require institutional change, this becomes a complex process as it is necessary to have simultaneous reform of the complementary institutions. The high costs of institutional reform impart a rigidity to institutions that often serves the society well by providing the foundations for stable durable expectations and agreements. The rigidity is less advantageous when political, social, and economic changes produce a new environment in which reformed institutions would yield markedly better performance. In these cases, change is sometimes delayed until actors have reached consensus on how to change the interlocking institutions; or institutional change occurs sequentially, with the transition period being a dysfunctional mix of old and new institutions that do not function well together.

Janet Hunter (2004) analyzes the course of the Meiji reform process to indicate whether it might offer any lessons for institutional and organizational reform in Japan at the start of the twenty-first century. Hunter focuses on the presence or absence of short-run pressures for institutional change, the need to view institutional change as a long-run process rather than as a short-run event, and the role of the state in engineering institutional change.

The substantial institutional and organizational changes in Japan that followed the Meiji Restoration of 1868 have often been portrayed by historians as an unmitigated success story. Hunter argues, however, that the reality of the Meiji transformation was invariably more problematic than the successful image often portrayed. Analysis of the Meiji experience provides insights into three key areas at the heart of current debates in Japan – financial institutions, business enterprises, and the labor market. Hunter suggests that in all three cases, the process of institutional and organizational change before the First World War was slow and sporadic. It is notable that the uneven nature of this transformation came against the backdrop of a sense of national urgency—that Japan had to develop economically or face domination by Western powers—and of the strong political will of the Meiji Emporor. Hunter suggests that great caution needs to be exercised in drawing any lessons for contemporary Japan from the Meiji experience, but is able to draw two tentative conclusions. First, the Meiji transformation, successful as it was, cautions us that it is unrealistic to expect fundamental institutional change within a very short time span. Second, the relative merits of importing new institutions and modifying existing ones are rarely clear cut. Application of her analysis to modern Japan must also be tempered by noting the vastly different international environments that Japan faced 140 years ago and that she faces today.

Chung Lee (2004) compares institutional changes in Japan and Korea. In contrast to Japan, South Korea undertook speedy economic reforms soon after the 1997-98 crisis. According to

Lee, the difference in the reform experiences across the two countries may be that in comparison to Korea, Japan is a rich country and has been suffering from an economic malaise, not a severe economic crisis. For example, at the height of the 1997-98 East Asian Financial Crisis, Korea faced the specter of being unable to service its short-term debt obligations. This threat forced Korea to accept an IMF loan with conditional requirements that forced rapid reforms. Japan was also impacted by the Crisis, yet during the lost decade of the 1990s, Japan continued to run current account surpluses and thus was not forced to adapt its policies and institutions.

Lee then argues that there is another rather critical factor that accounts for the differences between Japan and Korea: For a country to change its institutions, the advocates for change need to have a model of institutions that the advocates for change and the society at large can understand and accept as a model that is superior to the extant institutions. Japan has gone through two major institutional reforms in its modern history—the Meiji Reform of 1868 and the post-WWII reform. In those two cases Japan was compelled to reform its institutions by outside forces and had definite models to follow. This time the situation is different: given that Japan has successfully caught up with the West with a political-economic system that is often claimed to be uniquely Japanese, many in Japan, even those who advocate a systemic reform, lack a clear vision or a model for institutional reform. Japan is now in a *paradigmatic crisis*, a crisis that has shaken the beliefs held by many Japanese about the wisdom of their political-economic system, and is in need of finding an alternative paradigm that the people can accept—a process that inevitably takes a long time. By contrast, in Korea, even before the crisis of 1997-98 there was a strong move to establish a liberal economic order, and the crisis served as a catalyst for reforms that had already been widely discussed and in some cases partially implemented.

Japanese Institutions: What Has Changed, What Has Not, and Why

Curtis Milhaupt (2004) examines major changes in Japanese corporate law and in corporate practice, which typically lags behind changes in corporate law. He shows that analysis of Japanese corporate law reveals a striking amount of formal institutional change since the early 1990s and that it is occurring at an ever-accelerating pace. This feature of law reform can be traced to a heightened awareness of the organizational straightjacket imposed on Japanese firms by the Commercial Code, and to a more competitive and market-responsive environment for the production of corporate law. It has been a “sea change decade” for Japanese corporate law.

Milhaupt also claims that it has been an ambiguous decade for Japanese corporate practices. Signs of change in response to the new institutional environment can be found in the areas of shareholder activism, corporate mergers and acquisitions and other organizational changes, board structure, and corporate finance. At the same time, however, domestic institutional investors remain passive, management remains largely insulated from the market for corporate control, and “lifetime” employment practices, while covering a shrinking subset of the Japanese workforce, remain firmly in place.

Milhaupt accounts for the observed pattern of change and rigidity by analyzing the political economy of corporate law reform, the complementarities at work between corporate law and other institutions, and the relationship between corporate law and corporate governance. Japanese corporate law has become more adaptable and responsive to “demand-side” impulses, but it also increasingly reflects the interests of Japanese management, an organized group potentially threatened by corporate law reform. Without external pressures, Japanese managers are able to use the newfound flexibility of the corporate law to entrench themselves as well as to improve returns to shareholders. Moreover, while Japan's corporate law has improved, several complementary institutions needed to complete the institutional package are still incomplete. Ultimately, corporate law bears only a limited relationship to corporate governance. Changes in corporate practices are brought about by dynamics external to the formal corporate governance institutions. Thus, according to Milhaupt, the sea change in Japanese corporate governance must await further changes in the distribution of shareholders, in the capital markets, and in the incentive structures for management, as well as the further erosion of corporate norms that promote employee and managerial interests over shareholder interests.

Thomas Cargill (2004) reviews the reasons for Japan's failure to resolve fully the economic and financial distress that started in 1990 with the collapse of asset prices. Despite the many efforts to stimulate the economy and redesign the financial system, the recent recovery has proven to be very fragile, and most observers are worried about its durability.[1] Cargill then poses a worrisome question: Is Japan entering into a second lost decade in terms of economic and financial development?

Cargill opens by providing a general framework or taxonomy of financial reform as a background for exploring the failures of financial redesign in Japan. His central theme is that resistance to institutional redesign is normal and that one can reasonably identify those factors responsible for differing policy outcomes across countries. While the United States and Europe have been able to overcome resistance to institutional change, Japan has found been unable to accomplish this, perhaps because the resistance has deep roots in the ruling Liberal Democratic Party.

Cargill also discusses restraints embedded in Japan's financial system that account for the slow and incomplete reform process. These are referred to as country-specific restraint factors, because they reflect the basic foundations of the old Japanese financial regime. He then considers a variety of explanations for Japan's continued reluctance to reform its financial system, including: Moral hazard affects Japan's financial less directly than in other countries; Japan's banks have been successful, so why should they undergo reform; Japan has not faced a crisis so there is no pressure for reform; liberalized financial systems are incompatible with Japan's culture and belief systems; and changing BIS capital requirements have held up or reduced the necessity for reform.

Cargill then turns to general or global restraints to reform and focuses on policies adopted by the Bank of Japan and the adverse effects of deflation. Explanations for the tight monetary policy of the Bank of Japan, especially since 1995, are explored and the impact of deflation on the economy is identified. He then discusses three issues related to the reform process: First, the difficulties created by government financial intermediation for establishing a deposit guarantee system consistent with financial stability; second, the lack of sustainability of the old regime; and third, the diminishing window of opportunity for dealing with economic and financial distress because of the demographic changes that are rapidly transforming Japan.

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1 . Japan registered GDP growth of xx percent in 2003 but only gg percent in 2004, which also saw two consecutive quarters of negative GDP growth—a recession as defined by the U.S. NBER.

In conclusion, Cargill argues that Japan's difficulties in reforming its financial system are not due to a lack of resources or a lack of understanding about the sources of the problems and the changes that need to be undertaken. Cargill is confident that Japan has both the capability and the knowledge to enact and implement the changes needed to restore the economy and financial system to stability and sustained growth. He claims that institutional redesign is a matter of will and political leadership and that, to date, Japan has not shown a willingness to accept the cost of reform and continues to engage in forgiveness and forbearance. According to him, Japan need not adopt a western-style financial system modeled exactly on the lines of those in the United States or Great Britain. It does, however, need to find a way to depart from its reliance on mutual support to resolve problems in the banking system and to develop a system that allows for bankruptcy to play a more meaningful role in the allocation of resources.

Another important Japanese institution is the system of lifetime employment. Chiaki Moriguchi and Hiroshi Ono (2004) examine the origins and dynamic evolution of the lifetime employment system in Japan from the beginning of the twentieth century to the present. Based on the historical perspective developed in the paper, they derive implications to the future course of the Japanese employment system. Moriguchi and Ono view lifetime employment as an economic as well as social institution, characterized by an implicit contract and reciprocal exchange of trust, goodwill, and commitment between employers and workers. They argue that this institution emerged as an equilibrium outcome of the dynamic interactions among management, labor, and government and became an integral part of the nation's employment system over the past hundred years, reinforced by complementary institutions such as state welfare policies, labor laws, corporate governance, social norms, family values, and education system.

The historical analysis surveys how employment relations evolved from spot contracting toward implicit and long-term contracts. Lifetime employment traces its origin back to the prewar years. The practice emerged among leading Zaibatsu firms in response to economic conditions during the interwar period and diffused under the wartime government regulations. The employment practice was fundamentally reshaped during the years of the U.S. Occupation after WWII, and was firmly established and socially embedded during the high-growth period. The lifetime employment system persisted through both supply-side shocks (e.g., labor shortage during economic prosperity) and demand-side shocks (most notably the oil crises) to labor markets. More recently, however, the practice has been under serious threat as the economy plunged into a recession in the 1990s. There is now widespread criticism that the practice undermines efficient resource allocation, and a majority of Japanese firms claim that the practice can no longer be sustained.

Moriguchi and Ono also document the formation of complementary institutions that reinforced and institutionalized the lifetime employment practice. Most notably, the lifetime employment practice evolved concurrently with collective bargaining through enterprise unions and corporate governance based on stable shareholders. State welfare policies, such as national health insurance, pension, and unemployment insurance, developed complementary to corporate welfare provisions since the 1930s. The courts accumulated case laws that restricted employers' rights to dismiss since the 1950s, citing employers' social responsibility to provide employment security and a minimum standard of living. Workers who changed their employers came to be associated with social stigma, discouraging the development of external labor markets for mid-career job seekers. The lifetime employment system, confined to core employees in relatively large firms, gave rise to sharp distinctions between regular and non-regular employees within firms, as well as the division of labor along the gender line, inhibiting career prospects to a majority of Japanese females.

Based on their long-run historical analysis, Moriguchi and Ono reevaluate the cost and benefit – both in terms of economic and social – of the lifetime employment system and explore the factors that determine its efficiency and stability. They emphasize the importance of understanding labor market conditions, technology and the nature of human capital, interactions between social and economic aspects of employment relations, and the role of complementary institutions. The chapter concludes by assessing changes in these factors in the post-bubble period, offering some insights to the future course of the Japanese employment system.

Another aspect of Japan's labor regime is its stance towards labor unions. Lonnie Carlile (2004) traces the evolution of the Japanese labor movement's stance toward institutional change from the early post-World War II era to the present and argues that, like most labor movements, the Japanese movement began as a movement that promoted the wholesale reconstruction of national political economic institutions. The emergence of a "productivity bargain" at the firm level, the institutionalization of the Shunto wage bargaining system, and the employment security provided to the bulk of the unionized work force through the Japanese lifetime employment system combined to moderate the stance of organized labor towards Japan's economic institutions.

Over time, Carlile argues, the labor movement's role vis-a-vis institutional change shifted. In the late 1970s, the stance of the Japanese labor movement shifted, as it became generally supportive of the institutional status quo in the industrial relations arena. Outside of the industrial relations arena the labor movement, together with big business, emerged as a force pushing for deregulation and privatization. By the 1970s, rather than being a force devoted to precipitating wholesale institutional change, the Japanese labor movement shifted to a stance of active defense of the institutional status quo in both industrial relations and the Japanese political economy writ large. In the late 1990s the overarching union organization, Rengo, showed signs that it was once again altering its stance in reaction to government and management assertions that many Japanese corporations had "excess" labor and that layoffs could serve to improve corporate efficiency.

Carlile uses the concept of "social contract" to make sense of these shifts in the labor movement's stance toward institutional change. He argues that the earlier shift, from promoting institutional change to defending the status quo can be understood as a byproduct of the establishment of a social contract acceptable to organized labor that was forged between business, labor, and government in the 1960s. The initial steps taken in the late 1990s to alter that stance are perceived to be a consequence of a perceived breakdown of that social contract precipitated by Japan's prolonged recession of the 1990s and increased international competitive pressures. Carlile sees the latest changes in stance as an attempt by organized labor to forge an alternative vision of Japanese society that is moves away from the firm-centered collectivism of the Japanese employment system to one in which the state intervenes more directly in the assuring the welfare of the individual.

The Japanese institution of elite-circulation between government and business, known as *amakudari*, is investigated by Kenji Suzuki (2004). This re-employment of officials retired from the government into senior management positions in private companies, is one of the most famous informal institutions that are frequently mentioned in the literature on Japanese political economy. In his study, Suzuki focuses on the re-employment of high-ranking bureaucrats from the Ministry of Finance and the Bank of Japan in regional banks at retirement from their government posts. He carefully discusses the mechanism of *amakudari* appointments and how this mechanism has gradually changed over time.

Four different perspectives (human resource, communication, monitoring and compensation) are presented, and their validity is tested by an empirical analysis with annual panel data from 96 regional banks over the period 1991-2000. His results support the hypothesis that the appointment of a retiree from a ministry to a regional bank upon the retirement of a predecessor from the same ministry—a chain appointment—has recently become less likely. On the other hand, Suzuki also finds that *amakudari* appointments are more likely to occur at banks which are safer and generally more profitable than other banks. He argues that this supports the traditional view of the *amakudari* system, that it is used to provide extra compensation to retired bureaucrats.

Finally, Hiroshi Ono (2004) examines the social institution of marriage through the lens of divorce. Divorce provides a good example of a normative shift that often accompanies institutional change and which usually has its roots in economic and demographic pressure. In his chapter, Ono addresses two empirical questions about divorce in postwar Japan: Why is the divorce rate so low compared to other industrialized economies? And, why is it rising?

He examines patterns of marriage and divorce in Japan as a process of institutional change and ties it to the changing economic roles of men and women. When the Japanese economic miracle began in the 1950s, the practice of lifetime employment strongly favored men over women. Men were expected to be highly committed to their job and women to their family. Tax and benefit programs, prevalent social norms and the exclusion from lifetime employment combined to relegate women to part-time low-paying jobs, making them extremely vulnerable in the event of a divorce.

Ono then discusses how the rising divorce rate in Japan is an outcome of the dynamic interactions between economic development and demographic change at the macro-level, and changes in social norms and attitudes that govern the behavior of individuals at the micro-level. Since 1975 the legislative and social movements promoting equal status between the sexes in Japan has narrowed the dependency between the spouses, allowed women greater voice, and lowereds the cost of exiting a marriage. The diversity of family forms, such as civil unions and cohabitation, has allowed couples to choose alternatives to marriage, which in turn weakens the institution of marriage.

Demographic change has been one of the major forces generating institutional change since the beginning of human history (North 2005). Japan's rapidly declining birthrate—registering just 1.29 births per woman in 2003—is clearly associated with the increasing divorce rate, although the direction of causation is far from clear. With the secular decline in the birthrate, the couple is, at any given age, less likely to have any children, and is more likely to have fewer children.

Because one of the main costs of divorce is the cost imposed on the children – a cost that will be somewhat considered by the parents – having fewer children or no children at all lowers the cost of divorce. On the other hand, if women perceive that the marriage is more likely to end in divorce, then they are also less likely to have children.

Conclusion

Japan is changing, albeit not as rapidly as some might prefer. The pace and extent of institutional change across different aspects of the economy and society has been very uneven. We're not surprised. Japan is a consensus society, and change requires extensive consultation and often the mustering of a considerable majority before policymakers will move to make changes. Japan's achievement of remarkable economic growth over the 1952-1973 period must not obscure its equally remarkable achievement of narrowing per capita income differentials both within and across prefectures. It's not surprising that the Japanese are reluctant to abandon their economic institutions for Anglo-Saxon replacements that they associate with increased inequality.

Curtis Milhaupt's observation that corporate law has changed but corporate practice lags behind is a critique that could be aptly applied to many other Japanese institutions. The norms that built up around Japan's unique employment, corporate, and financial institutions are not ones that will disappear overnight. Still, as labor market institutions for the "after-market" of laid-off salarymen in their 40s and 50s begin to function more effectively, we are likely to see the norms associated with the old regime make, at some point, a fast exit. When this happens and the new legal institutions become more effective, Japan will finally be able to make more sense of its evolving economic, political, and social institutions

There are puzzles, however, that we have not come close to addressing. It's easy to see why the Japanese have not addressed the looming problems in their social security system. The public pension systems of Germany, France, and Italy, all speeding towards a collision with demography, have been equally resistant to change. As in Europe and North America, analysts have correctly warned that early reforms will be painful but much less painful than delayed reforms (Horioka 2001). Regardless, in a country with a declining population, a birthrate of 1.29, and a national consensus that immigration must be limited, the national reluctance to address this problem is one that strains theories of institutional change.

Our analysis has also done little to address the reasons for and the implications of Japan's remarkably low birth rate. Ono touches on some of the reasons for Japan's declining birth rate in his essay, and a battalion of demographers continues extensive work on this issue. Demographic change has, however, been at the heart of institutional change throughout history. Usually downward demographic change has been due to the Malthusian ravages of "war, pestilence famine or the convulsions of nature" (Malthus, 1798 [1960], ch. 6). Japan's downward fertility spiral is due to choices by affluent couples, an unprecedented event in history. As with previous demographic changes of large magnitude, it is sure to induce far-reaching institutional change throughout the society.

Thomas Cargill's lucid discussion of how financial system reforms have been coupled with *ancíen regime* norms parallels the discussion by Curtis Milhaupt. Changes in norms once again have lagged behind changes in a critical Japanese institution. But not just any institution: an institution that by all accounts plays a critical role in any economy. Understanding changes in the financial system clearly involves a much deeper understanding of the role of bureaucracy in institutional change in Japan, and that is still an understanding that we do not possess.

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