1 Introduction

IT HAS BEEN SAID, not least by the Japanese themselves, that Japan has changed only twice over the past 150 years: once in the Meiji Restoration of 1868, which marked the downfall of the Tokugawa shogunate after some 265 years of continuous rule, and again in 1945, when Japan had lost the Pacific War.

This is, of course, a vast overstatement. Nothing, and certainly no social system, ever stands still, and Japan is no exception. However, in the context of developments in the Japanese business system[1] over the past fifteen years, it contains a kernel of truth. A comprehensive review of the available empirical evidence, presented later in this book, suggests that the core structure of the Japanese business system today is not much different from that in 1990. Viewed from the perspective of the business system as a whole, institutional[2] change in Japan seems to be proceeding at a relatively slow rate.

This would not be remarkable had this slow rate of change not occurred in the face of extended economic crisis, which should have been conducive to institutional change (Katznelson 2003; Krasner 1976; North 1990; Oliver 1992). With the burst of the bubble economy of the 1980s, real economic growth in Japan slowed from an average 4.1 percent in the 1980s to 1.5 percent in the 1990s (OECD 2004). Asset prices collapsed: at their nadir in 2003, stock prices were more than 80 percent off their 1989 highs, and 2005 prices of residential land in Japan's six major cities stood some 65 percent lower than at the peak in 1991 (Kurosu 2003; Miyawaki 2005). The

[1] The institutional structure governing economic activity of firms and employees (cf. Redding 2005; Whitley 1999), where the term "institutions" is defined as "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).

[2] See the previous note for a definition of the term "institution."

consequences were severe for individuals, firms, and especially the financial sector, which was heavily exposed through direct ownership and lending. Bankruptcies, once rare, tripled between 1989 and 2001 (Kurosu 2003) and came to include firms previously thought too large or prestigious to fail, such as Hokkaido Shokutaku Bank, Yamaichi Securities, and (almost) Nissan. Unemployment more than doubled, from around 2.5 percent in the 1980s, to a peak of 5.4 percent in 2002 (Kurosu 2003), a level unknown since the immediate postwar era. The Japanese banking crisis is possibly the costliest ever worldwide, with bad debts in 1999 amounting to about one-third of Japanese GDP (Amyx 2004).

Scholars and observers have proffered a wide range of possible explanations that shed light on the relatively low level of change from different angles and bear witness to the multicausality of the phenomenon. Among the mechanisms blamed for slow change are the weakening of the coordinating role of the Liberal Democratic Party (LDP) in the policy-making process following its electoral defeat and subsequent 11-month stint in opposition in 1993–4 (Amyx 2004); the relative absence of pressure on the private sector to initiate institutional adjustment given a corporate governance system that isolates firms from profitability pressures (Lincoln 2001); and the possibility that the Japanese people may, despite the crisis, not want fundamental institutional change (e.g., Curtis 1999; Lincoln 2001).

Of special relevance to this work are two other mechanisms laid out in the literature: the delaying role of vested interests (e.g., Amyx 2004; Katz 2002; Lincoln 2001; Sakakibara 2003; Yamamura 2003) and lock-in of the present institutional structure because of institutional complementarities (e.g., Amyx 2004; Lincoln 2001). Vested interests may delay the change process by offering resistance in the policy-making process. They exist in many quarters, including labor unions bent on maintaining their influence and employment for their members, firms keen on preserving barriers to competition and privileges such as subsidies, bureaucrats fearing loss of influence and shrinking empires, and indeed large portions of the population, who seem to equate structural reform with convergence on Anglo-Saxon-style capitalism (Yamamura 2003).

Institutional complementarity may reduce the rate of institutional change by increasing the complexity of change. Complementarity exists where the effective functioning of one set of institutions is

contingent on the presence of another set of "fitting" institutions (Aoki 1988; Hall and Soskice 2001). Adjustment in one set of institutions may break the functionality of the complementary set, which then also requires adjustment, which in turn may necessitate changes in other parts of the system.

Vested interests and complementarities have no doubt played their part in limiting the rate of institutional adaptation in Japan. But their ability to do so gives rise to a new puzzle. Vested interests and institutional complementarities exist in any institutional structure (North 1990; Pierson 2004), including in other advanced industrialized nations that have handled institutional adjustment processes with greater swiftness. Why is it that their delaying influence seems to be relatively more elaborated in the Japanese case? One may conjecture that the Japanese system shows relatively higher levels of vested interests and lock-in, or that vested interests are relatively more able to delay institutional change. Both are very likely the case. At the same time, this leaves unanswered the question of where this variation in the salience of vested interests and complementarities comes from.

Societal coordination and institutional adjustment

In this book, I argue that *societal coordination* in the political economy is a key source of this variation. Recent research on cross-national differences in the make-up and functioning of capitalist political economies has established societal coordination as a central dimension of variation across different varieties of capitalism (Hall and Gingerich 2004; Hall and Soskice 2001). Hall and Soskice (2001) differentiate between two broad types of coordination, strategic coordination and market coordination. Since the term "strategic" implies careful goal-oriented design that is not necessarily present in these processes, I will deviate from Hall and Soskice's nomenclature and refer to it as "societal coordination" or, for the sake of simplicity and readability, just "coordination." As the name implies, market coordination draws on market forces, especially the price mechanism (cf. Hayek 1945), to achieve order in the political economy. By contrast, in societal coordination, the organization of economic activity and the building of economic institutions occurs through formal and informal nonmarket interaction and cooperation of actors (cf. Hall and Soskice 2001; Streeck and Yamamura 2003). Social

networks and the social capital underlying them play a key role in societal coordination processes (Hall and Soskice 2001) as they facilitate cooperation (Fukuyama 1995; Putnam 1993a, 1993b) and the sharing and diffusion of information, values, and norms (DiMaggio and Powell 1983; Meyer and Rowan 1977; Oliver 1991; Pfeffer and Salancik 1978; Podolny and Page 1998).

A key notion advanced by Hall and Soskice (2001) is that different varieties of capitalism draw on market and societal coordination to different extents. In their work, this is expressed in a dichotomy between liberal market economies (LMEs) and coordinated market economies (CMEs), with the former relying more on market coordination and the latter on societal coordination. The result is a distinction, consistent with other works in the varieties of capitalism literature (e.g., Albert 1993; Dore 2000), between the Anglo-Saxon camp, representing the LMEs, and the continental European and Japanese camps, representing the CMEs. While societal coordination is not the only dimension along which different types of capitalism vary (e.g., Amable 2003; Boyer 1997; Orrù, Biggart, and Hamilton 1997; Redding 2005; Schmidt 2002; Whitley 1999), recent empirical evidence (Hall and Gingerich 2004) suggests that it is a key one.

In terms of economic outcomes, CMEs seem to have done at least as well as LMEs through the early 1990s (Hall and Soskice 2001), but lately a performance gap seems to have opened. When assessing the same groups of countries classified as LMEs and CMEs in Hall and Soskice (2001), OECD data indicate that, from 1993 through 2003, average growth rates of GDP reached 4.0 percent in the LMEs, but only 2.5 percent in the CMEs. OECD data on per capita GDP at purchasing power parity show the LMEs in the lead at an average of US$30,350, as opposed to a CME average of US$29,355. This is a reversal from the period 1985–1997, when CMEs were still ahead by US$17,902 to US$16,890 (Hall and Soskice 2001). The OECD also indicates that unemployment rates, which used to be lower in the CMEs than in the LMEs, over the 1993–2003 period declined by 5.2 percentage points in the LMEs, but by only 1.1 percentage points in the CMEs. Given widespread agreement in the literature that the quality of institutional structures and economic performance as expressed in long-term growth and unemployment rates are linked (e.g., Blanchard and Wolfers 2000; Nickell et al. 2003; North 1990, 1994; OECD

2005), this suggests that the institutional structures of CMEs may in recent years have lost some economic efficacy relative to those in LMEs.

Underlying this loss in relative efficacy is intense pressure on all economies to adapt their institutional structures to new and still evolving conditions in at least three areas: the ongoing transition to the information technology age, increased uncertainty and competition in the world economy, and societal ageing. Perhaps most important among these is the entry of the world economy into the information technology age (Lewin, Long, and Carroll 1999; Lewin and Stephens 1993; Perez 2002; Yamamura 2003). Transitional periods tend to be marked by massive reallocation of resources to new technologies, encompassing "radical changes in the patterns of production, organization, management, communication, transportation and consumption, leading ultimately to a different 'way of life', . . [T]he whole process takes around half a century to unfold, involving more than one generation" (Perez 2002:153). Assuming this transitional age started with the announcement of the Intel 4004 microprocessor in 1971, as Perez (2002) suggests, it is likely to last another fifteen years, with an attendant need for institutional adjustment.

The pains of the transition to the information technology age have been exacerbated by increased uncertainty and competition in the international economy (Yamamura 2003). The 1970s saw the end of the Bretton Woods regime, resulting in floating exchange rates and subsequent long-term depreciation of the US dollar, as well as two oil shocks. Financial deregulation from the late 1970s onward as well as continuing trade liberalization under successive GATT/WTO agreements fueled globalization of markets. The result has been an increase in economic interdependence, which not only allows for more efficient financial flows and more trade, but has been accompanied by higher volatility in financial markets as well as increased competition, and thus pressure on margins, in tradables. These latter trends have been reinforced by the arrival in international markets of emerging economies with feeble financial systems and highly competitive labor forces. Estimates suggest that the entry of China, India and the former Soviet Union into the world economy has effectively doubled the global labor force (*Economist* 2005). This has led to downward pressure on wages in the advanced industrialized nations

and has forced firms to seek new ways, such as web-based organizational structures (Fulk and DeSanctis 1995) and offshoring, to exploit these new developments in order to remain competitive.

Societal ageing poses a further challenge to extant institutional structures in many advanced industrial nations, and especially CMEs such as Japan and Germany. Ageing implies structural shifts in the economy toward providing goods and services for the elderly. It also threatens to undermine pension and medical insurance schemes, with concomitant implications for other spheres of the economy. For instance, a transition from today's increasingly unaffordable pay-as-you-go pension schemes to funded systems would have profound implications for the economy. Massive funds would seek investment opportunities in stock markets, with possible knock-on effects on areas such as corporate governance and the availability of long-term capital.

Institutional adjustment processes in LMEs seem to be able to respond to these challenges in a more timely fashion than those in CMEs. CMEs have exhibited a relatively slower rate of adaptation in response to these adjustment pressures because their societally coordinated adjustment processes tend to involve extensive bargaining and consensus-finding before any changes can be put into place. These coordinated and often political processes are relatively time intensive. By contrast, the rate of response tends to be quicker in the market-coordinated adjustment processes typical of LMEs, in which relatively more institutional adjustment occurs through autonomous action at the micro level of individuals, organizations, and firms with subsequent diffusion of institutional innovation through evolutionary and isomorphic processes (cf. DiMaggio and Powell 1983; Meyer and Rowan 1977; Williamson 1985). I will develop this argument in detail in Chapter 3.

Variation in the relative prevalence of coordinated versus autonomous adjustment processes helps shed light on the question posed at the beginning of this chapter of why vested interests and institutional complementarities seem to have a relatively greater impact on institutional adjustment processes of countries such as Japan. Vested and other conservative interests can delay institutional adaptation only if they get a say in the change process. This is often the case in societally coordinated adjustment processes, especially where there are norms of extensive consultation and consensus-building, as is the case in Japan.

In autonomous adjustment processes, by contrast, micro-level actors by definition initiate change without active consultation with other actors, which denies conservative forces the opportunity to exert influence. At the same time, societally coordinated processes are more likely to build complementary institutional structures. For one, it tends to be easier to do so when the major actors governed by these institutional structures cooperate in designing them. In addition, CMEs by definition tend to feature higher levels of formal institutionalization – as evident, for example, in higher levels of formal regulation – around which actors' expectations can converge to form complementarities.

An additional adjustment dynamic tends to develop at the micro level of individuals, organizations, and firms. As environmental change moves the extant institutional structure out of alignment with actors' needs (cf. Seo and Creed 2002) and coordinated adjustment processes fail to provide for speedy adjustment, micro-level actors may seek to isolate themselves from the cost of this misalignment through the adoption of a range of micro-level responses (cf. Oliver 1991). While these responses can be political in nature – for example, political bargaining, grassroots movements, or demonstrations (cf. Aoki 2003; Buchanan and Tullock 1962; Henisz and Zelner 2005; Knight 1992; North 1990; Seo and Creed 2002; Streeck and Thelen 2005; Thelen 2004; Tullock, Seldon, and Brady 2002; Van de Ven and Hargrave 2004) – many responses are likely to be at least initially autonomous, apolitical, and undertaken without intention to induce systemic institutional change. For instance, tax evasion or capital flight are rarely undertaken as political acts, but rather to reduce the economic costs of an institutional structure perceived to be out of alignment with actors' needs. As these responses and their costs accumulate and spread through the system, they can contribute to deinstitutionalization (cf. Oliver 1992) and serve to increase the felt pressure for adjustment by threatening the legitimacy of the societally coordinated adjustment processes and those involved in them. This feedback mechanism linking apolitical autonomous action at the micro level with coordinated adjustment processes represents an underexplored dynamic in the literature on institutional change.

The picture that emerges for Japan is that institutional adjustment there has been slowed by a combination of highly coordinated and thus time-intensive adjustment processes paired with relatively limited adjustment pressure from the micro level. The causes of

the latter phenomenon are at least three-fold. First, the insular geography of Japan dampens at least one part of common micro-level actions seen elsewhere, namely those that depend on legal or illegal exit of actors or their resources. Second, the present institutional structure seems to continue to enjoy legitimacy, which dampens the perceived need to take action. Third, micro-level action that deviates from established norms is seen as socially illegitimate. Enforcement of compliance with the extant institutional structure is facilitated by the extensive social networks that pervade the Japanese political economy. As mentioned earlier, these networks are conducive to coordination. At the same time, however, their role as conduits of information, norms, and values (cf. Oliver 1991) also makes them effective means of stabilizing established institutions by fostering compliance (DiMaggio and Powell 1983; Galaskiewicz and Wasserman 1989; Meyer and Rowan 1977; Oliver 1991, 1992) even when these institutions have moved out of alignment with the needs of those they govern. The overall effect of these three factors is to reduce the relative prevalence of micro-level action and the concomitant pressure for change, with the result of a relatively slower pace of institutional adaptation.

Social networks, social capital, and societal coordination

Social networks are formally defined as "any collection of actors ($N \geq 2$) that pursue repeated, enduring exchange relations with one another and, at the same time, lack a legitimate organizational authority to arbitrate and resolve disputes that may arise during the exchange" (Podolny and Page 1998:59). Their effects are closely linked to the concept of social capital, which is "the sum of the actual and potential resources embedded within, available through, and derived from the network of relationships possessed by an individual or social unit. Social capital thus comprises both the network and the assets that may be mobilized through that network" (Nahapiet and Ghoshal 1998:243). Social capital may have private good character; that is, the effects of social networking accrue at the level of the individual holders of social relations (cf. Adler and Kwon 2002; Inkpen and Tsang 2005). However, it may also have public good character, in which case any effects of social networking are felt at the

level of the community as a whole (cf. Adler and Kwon 2002; Inkpen and Tsang 2005).

The bulk of the literature has focused on illustrating the presence of benefits at the private goods level. For example, networks have been found to foster learning "because they preserve greater diversity of search routines than hierarchies and they convey richer, more complex information than markets" (Podolny and Page 1998:62). Networks may play this role either by acting as conduits for pieces of information (Burt 1992; Contractor and Lorange 1988; Hamel 1991; Kogut 1988; Liebeskind et al. 1995; Root 1988) or by creating learning synergies (Fountain 1998; Powell and Brantley 1992; Powell, Koput, and Smith-Doerr 1996). Networks may also allow actors to share the legitimacy or status of affiliated networking actors, which can affect such aspects as chances of organizational survival (Baum and Oliver 1992; Uzzi 1996), market value (Stuart, Hoang, and Hybels 1999), or access to scarce resources (Stark 1996). Further, networks can improve economic performance, for example by reducing transaction costs through trust (Dore 1983; Sako 1992), providing better information than markets and thus allowing higher quality in production (Sako 1992; Uzzi 1997a), and allowing actors to adjust more quickly to environmental changes (Powell 1990).

A separate stream of literature has taken a more macro approach and explored the public goods nature of social capital. The core argument of these works has been to link the degree of social capital, expressed in terms such as propensity of citizens to engage in voluntary associations, to the well-being and functioning of political entities and their economic performance characteristics (e.g., Fukuyama 1995; Harrison 1992, 1997; Jackman and Miller 1998; Putnam 1993a, 1993b, 2000; Yamagishi 2003). For instance, in his classic study contrasting northern and southern Italy, Putnam (1993a) argues that the dismal economic performance of southern Italy can be linked to the relative absence of civil society, and thus by implication to reduced levels of social capital.

Much less well explored[3] is the dark side of social networks (cf. Gargiulo and Ertug 2006). Networks may represent a private bad.

[3] Leaving aside the blanket dismissal of social networks by neo-classical economists as statutory market distortions.

For instance, the transmission of conformity pressures through network ties, as discussed earlier, may represent a private bad if the institution in question has negative utility for the individual actor. In addition, the trust implied in many social networks may lead to a decrease in vigilance and monitoring of information that is received (Szulanski, Cappetta, and Jensen 2004). This effect is especially detrimental when information is ambiguous and thus requires higher levels of verifying and monitoring. Third, network ties may entail needlessly burdensome obligations for the involved parties, a phenomenon known as "over-embedding" (Uzzi 1997a) of economic transactions. These obligations may negate the positive effects of the network ties in question. Failure to sever detrimental ties may be the result of enforcement of compliance through community pressure (e.g., Portes 1998; Portes and Sensenbrenner 1993) or by an external third party such as the state. In addition, actors may not recognize the private bad character of the tie because of cognitive lock-in, which occurs when strong bonds serve as filters of external information that prevent realization of the negative impact of these ties (Gargiulo and Benassi 2000).

Social capital may also represent a public bad. Putnam (2000) notes that social capital may facilitate not only socially desirable activities, but also undesirable ones. For instance, criminal organizations, such as the mafia, typically exhibit dense social networks and attendant high social capital. This social capital may work to the benefit of the individual member (or it may not, if s/he would prefer to quit), but is typically undesirable from the perspective of society at large.

In the concrete context of societal coordination and institutional adjustment in the present fast-changing environment, social capital can further constitute a public bad in two ways. First, as discussed, it acts as a conduit for conformity pressures, thus forestalling micro-level action that could contribute to the building of pressure for coordinated adjustment. Second, social capital facilitates coordination by fostering cooperation (Fukuyama 1995; Putnam 1993a, 1993b) and the sharing and diffusion of information, values, and norms (DiMaggio and Powell 1983; Meyer and Rowan 1977; Oliver 1991; Pfeffer and Salancik 1978; Podolny and Page 1998). Networks thus make it easier for actors to coordinate with one another directly, for instance, in the context of societally coordinated adjustment