The Future of Capitalism (5)
"Build on the Strengths of the Japanese Model"
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The conventional wisdom on Abenomics, especially in the foreign press, is that it succeeded with the first two arrows, monetary easing and fiscal stimulus; but faltered with the third, structural reform, due to political constraints. And if only the Japanese government could overcome political obstacles and boldly deregulate its economy – then it would recover its dynamism.

This conventional wisdom is wrong on both counts. The Japanese government has implemented a considerable array of structural reforms, especially when compared to the political gridlock in the United States. Yet structural reform of a deregulatory nature will not deliver the promised boom in productivity and growth.

In fact, Takeo Hoshi and Anil Kashyap have shown that deregulation in the 1995-2005 period did not correlate with any improvement in total factor productivity. I would expect the same to be true for the current period.

Why is that? The answer is both deceptively simply and infinitely complex. In essence, markets require governance, meaning everything from corporate law to financial regulation, antitrust policy, and intellectual property rights. So empowering markets does not mean "deregulation" in the sense of reducing regulation or liberating the market, but rather improving market governance. If the government wants to enhance competition or stimulate innovation or promote equity, then it has to design markets to achieve those goals.

So that means that just reducing government regulation is not the answer. The government has to set policy goals; assess the strengths and weaknesses of domestic political and economic institutions; and then craft reforms to better match capabilities with goals. Let's see what that would mean in concrete terms for two of the most critical elements of structural reform: labor market and corporate governance reforms.

Japan has engaged in considerable labor market reforms since the 1990s, including both employer-friendly measures to increase firm flexibility and employee-friendly measures to strengthen worker protection. But with the recent work style reforms, the balance has shifted from the former to the latter. The government has moved from zero-sum reforms, whereby it sought to help firms by reducing labor costs, to positive-sum reforms, whereby it sought to enhance labor participation and productivity by improving working welfare. To be honest, the Abe government has been motivated more by economic goals, such as luring more women into the workforce, than by worker welfare or equal rights issues per se.

Nonetheless, the work style reform effort points in the right direction. The earlier reforms of a more "deregulatory" nature ended up increasing inequality and undermining economic security. And this had the side-effect of dampening demand and weakening macroeconomic performance as well.

Corporate governance reform is even more difficult to comprehend in terms of the common juxtaposition of government versus market, or regulation versus deregulation. It has been an exercise in revising laws and business practices, not one of removing regulations or unleashing markets.

The Japanese government and industry have undertaken major corporate governance reforms over several decades. In many instances they have sought to emulate the shareholder model of the United States, despite the fact that this model has failed in its country of origin. Academic studies have found that the core features of that model – including stock options, share buybacks, hostile takeovers, and independent directors – have not consistently improved the performance of American firms. And the U.S. shareholder model has contributed to the extraordinary levels of economic inequality in the United States.

Japan should not aspire to the shareholder model – but that does not mean that it does not need corporate governance reform. Many Japanese companies would benefit from greater transparency, accountability, and diversity in their management systems. To put this simply, there are two sides to corporate governance reform: improving management processes and fostering long-term growth, on the one hand, and increasing profits for capital at the expense of labor and enabling short-term rent-seeking, on the other. The graph implies that recent corporate governance reforms may have leaned in the latter direction. That is, trends over the past ten years appear eerily consistent with the common depiction of capitalist exploitation: higher profits, lower labor share, and stagnant investment.

This brings us back to the question of the strengths and weaknesses of the Japanese model of capitalism. In my own view, the strengths include a powerful and competent government bureaucracy; close government-industry ties; well-developed mechanisms of coordination among industry, such as industry associations and industry groups; collaborative labor-management relations; a stakeholder model of management; and a well trained and disciplined workforce. That leads me to the conclusion that Japan has not failed to reform boldly enough in the direction of American-style capitalism over the past few decades, but rather that it has tried too hard to do so. And in the process, it has undermined some of its own institutional strengths.

So does that mean Japan should just stick with its traditional model? Not at all. The postwar model had some major flaws, including blatant gender discrimination in the workforce and rampant collusion in some sectors. Moreover, recent developments in the international economy have undermined Japanese institutional strengths and exacerbated weaknesses. The heart of value creation has switched from manufacturing to services, and manufacturing itself has become more interconnected with services and software. Manufacturing processes have shifted from integral production to modular production, from national supply networks to global supply chains, and from proprietary systems to more open innovation.

So Japanese firms have to adapt to this new reality. They have to become more international and more open, and to invest even more in the physical infrastructure and the human resources to excel in the digital era.

But they should do so by building on Japanese institutional strengths, not trying to adopt American practices that have failed in the United States or that will not work in the Japanese context.

So how can Japan preserve its strengths and tackle its weaknesses at the same time? Let’s return to labor market and corporate governance reform to see what this might mean. The labor shortage offers an opportunity to address some of the core weaknesses of the employment system, such as blatant gender discrimination and a lack of flexibility for workers, while preserving core strengths, such as job stability and collaborative labor-management relations. The government can achieve this by focusing more on flexibility for workers than flexibility for firms. That means flexibility in work styles, such as telework; flexibility in career patterns, including more accommodation for temporary leaves; and flexibility in job definitions, including various categories between permanent (*shain*) and temporary (*hiseiki*) workers. Ultimately this will benefit firms and the economy more broadly by increasing labor participation and productivity.

For corporate governance, the trick is to improve management without increasing corporate and executive rent-seeking. Instead of emulating the shareholder model, Japan should seek a more open and accountable version of its own stakeholder model. In practice, that might mean bringing in outside directors that represent stakeholders, such as labor representatives; training board directors to address the broader range of stakeholder concerns, such as corporate social responsibility; or engaging in direct outreach activities with stakeholders as well as shareholders.

More broadly, Japan will require strong government leadership and government-industry partnership to meet the challenges of the digital era. That includes making large-scale investments in key technologies, such as electric batteries; promoting the diffusion of information technology systems in government, firms, and schools; and nurturing human resources with key software and service skills. Japan's core institutional strengths are not obsolete in the digital era – but rather more critical than ever.

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