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By Yoshiro Miwa & J. Mark Ramseyer*

Abstract: In several fields, modern academics trumpet the contingency of social science and the indeterminacy of institutional structures. The Japanese experience during the first half of the 20th century, however, instead tracks what much-derided chauvinists have claimed all along: modern legal institutions largely trump indigenous organizational frameworks, and modern rational-choice theory nicely predicts how people respond to such institutions. As orientalist as it may seem, such theory goes a long way toward explaining the real world in which we live.

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Old habits die hard. We heard in college if not before that all we know is culturally contingent. Now, we find it hard to make the objective cross-cultural comparisons inherent in serious social science. We heard with all the moral confidence of Jonathan Edwards that only orientalist boors make transnational value judgments. Now, we find it hard to admit that some economic systems consistently outperform others.

But of course they do. Over a decade has passed since the collapse of eastern Europe. Over a decade has passed since it forced most of us to come to terms with the socialist disaster, with the way it showed how economic incentives matter -- and matter in ways that track universal principles.

Usually cited for the opposite argument to be sure, Japanese management history illustrates the same point: institutional constraints (the "rule of law," in the organizing terminology of this conference) have effects that largely track a cross-cultural, pan-historical logic ("global norms," by the conference language). In the chapter that follows, we draw on empirical research in Japanese economic history to illustrate that logic.

We admit we do not prove the universality of the phenomenon. We confess we do not know how to prove that a universal logic governs societies about which we know nothing. Indeed, one of us still remembers the hostile respondent on a Law & Society Association panel years ago who seemed convinced he had proven that economics could not explain Japanese traffic accident data by showing it did not explain Indian religious practices. Knowing nothing about Indian religion and jetlagged besides, that one of us was at a loss to say much in response.

We may not know Indian religion, but we do know the Japanese and U.S. economies. In the chapter below we discuss the effect of institutional constraints on early 20th-century Japan. In the process, we illustrate two points. First, we show how modern institutional frameworks generally dominate indigenous arrangements (in the language of the conference, again, "culturally embedded practices"). Second, we show how our susceptibility to the relativist canon can lead to profound mistakes of fact. In our eagerness to avoid chauvinist biases, too often we take local stereotypes at face value, and too often the local stereotypes are wrong. Only by asking hard questions will we get the facts straight, but without good theory we seldom know what questions to ask.

We start by canvassing the capital and governance structures of turn-of-the-century Japanese firms (Section A). We outline the legal institutional basis for the arrangements (Section B), and discuss one aspect of the role the government played (or did not play) in economic growth (Section C). We conclude by suggesting some of the implications this history poses for understanding the role of law in economic development (Section D).

A. <u>Corporate Investment</u>:

1. Equity.[1] -- During the 1960s, in several sectors Japanese firms are said to have raised much of the money they needed from banks. From this well-known (but probably misleading) fact, many scholars extrapolate to firms pre-war. If equity markets did not provide the funds firms needed in the 1960s, they reason, equity markets must not have done so at the turn of the century either. Did not Alexander Gerschenkron (1962) teach us that "backward" countries will industrialize through bank finance and turn to securities markets only later? Does not modern theory teach us that banks mitigate informational asymmetries more effectively than securities markets, and do we not know that informational problems plague the less-developed world?

One could extrapolate in this way. But if one did, one would be wrong. Firms in turn-of-the-century Japan did not raise their funds through banks. Overwhelmingly, they raised them on the stock market. Take the flag-ship industry of the period, cotton textiles. Most of the firms that would eventually dominate this industry had already begun to operate in the 1880s. By 1930, they produced a quarter of all manufactured goods in Japan and employed 40 percent of all factory workers.

All this the spinning firms did without banks. On its balance sheets, the typical spinning firm in 1898 (there were 52 firms) had equity of 58 percent, and bank debt of only 11 percent. On average, it had 300-500 shareholders. The largest shareholder held about 8 percent of the stock, and the largest five collectively held 24 percent.

Nor was this reliance on equity peculiar to cotton spinning. Take railroads. In 1898, the 41 railroad firms in operation had equity capital of 94 percent and bank debt of 1 percent. On average they had over 1000 shareholders, and again the shareholdings seem widely dispersed. Or take electrical utilities. Until the 1930s, the utilities were private, unregulated firms operating in highly competitive markets. In 1910, the 178 firms in the industry had equity capital of 88 percent and bank debt of only 8 percent.

Finally, take the stock exchanges themselves. Both the Tokyo and Osaka Stock Exchanges began operations in 1878. By 1900 the TSE listed the shares of 113 firms. Ten years later it listed 142 stocks, and by 1920 569. Similarly founded in 1878, by 1900 the OSE listed the shares of 50 firms, by 1910 64 firms, and by 1920 206. What the firms listed, investors traded. Together, investors on the two exchanges traded stocks worth 512 million yen in 1900, 2.09 billion in 1910, and 8.13 billion in 1920. As a percentage of GDP, these figures amounted to 21.2 percent, 53.3 percent, and 51.1 percent – comparable to the amounts traded in advanced capitalist economies today.

2. Corporate law and governance.[2] – (a) Introduction. All this the turn-of-the-century firms accomplished with neither a regulatory apparatus nor corporate law. Japan had no securities regulation until Americans imposed one in the late 1940s. It had no corporate law until it passed a Commercial Code in 1890. Even that one did not last. Legislators promptly decided they disliked it, and replaced it with another in 1899.

Nor did investors and managers rely on local norms or indigenous traditions. To be sure, spinning-firm shareholders were often local. Presumably, through

[1] The subsection below draws on Miwa & Ramseyer (2000a) and (2000c).

[2] The subsection below draws on Miwa & Ramseyer (2000a) and (2000b).

geographical proximity they obtained information to which out-of-towners would not have had access. Beyond geography, however, in operating and governing their firms investors and managers primarily relied on institutional arrangements based on the modern legal system.

(b) Labor policy. For these new firms, entrepreneurs needed managers with expertise, and needed both managers and workers with the right incentives. To obtain the people they wanted and to motivate them to maximize profits, they (we focus here on the spinning firms) took basic, straightforward steps. First, they recruited from the universities. Notwithstanding the need for engineering and managerial sophistication, Lancaster firms had trained their own men. Not so in Japan. Instead, the Japanese firms turned to university graduates. The giant Kanebo spinning firm, for example, brought in Keio-University-trained Sanji Muto to run the firm in 1893, and Muto immediately began hiring other university graduates.

Sometimes, the firms recruited their new educated managers from competitors. So much for the bromides about how Japanese firms cultivate Confucian norms of loyalty by operating as a "family." Shamelessly, the spinning firms stole talented managers from their rivals.

Yet sometimes, they hired their managers from the schools directly. By 1914 Kanebo was hiring a dozen a year, and had placed university graduates in nearly all branch manager posts. At the outset, the firms recruited mostly engineering students. Soon, they were hiring men with managerial education as well.

Generally, the strategy worked. Managers from universities apparently brought an expertise others lacked. Other firm characteristics held constant, firms that hired university graduates earned significantly higher profits than their competitors.

Second, to motivate these managers to maximize profits, firms paid them a compensation package keyed to profitability. Although they did not use stock options, they used a variety of arrangements to similar effect. The Mie boseki firm, for example, explicitly provided by charter that officers would earn 13 percent of the corporation's net profits, and blue-collar workers another 7 percent. Other firms included similar provisions.

Third, to motivate the workers on the shop floor firms paid them "efficiency wages." So much for the tales about "exploited" female workers. Most of the employees were young girls off the farm, but to induce them to work hard and not quit, firms paid them wages significantly above market clearly levels. In 1898 a girl at a spinning firm could earn 1.2 the annual wage women earned in agriculture. By 1908 she could earn 1.9 the female agricultural wage.

(c) Agency slack. To police the inherent potential for agency slack between managers and investors, entrepreneurs again took several steps. First, they recruited to their boards men with substantial business experience. They did not hire these men because they brought banking or industry connections, for banking and spinning connections did not add value. Instead, they hired the men because they brought basic good business sense. They were men who knew how to monitor large firms. Through their presence on the board, they significantly boosted firm profitability.

Second, through explicit dividend policy the firms subjected new investments to the test of the market. By corporate charter, many promised to pay out a large fraction of earnings as dividends. As Frank Easterbrook (1984) shows, large dividend policies reduce the free cash managers can spend, and thereby force them to return to the stock market for large projects. Disproportionately, the firms that paid high dividends were those that listed their stock on an exchange. The greater the potential agency slack between managers and investors, in other words, the greater likelihood that the firms would commit themselves to market constraints on new investments.

Third, once the Diet passed a corporate law, the firms used it and charter provisions to limit managerial discretion more directly. The Kurashiki firm, for example, specified the number of spindles it would use by charter. The new corporate law imposed still other constraints. By the 1899 Commercial Code, managers had to call a special shareholders meeting if they lost half the firm's stated capital. They needed a shareholder vote if they wanted to issue bonds.

(d) Corporate control market. The most efficient spinning firms relentlessly acquired their less successful rivals. So much again for the notion that cultural values prevent Japanese firms from master-minding takeovers. In turn-of-the-century Japan, the most successful firms steadily acquired their less successful competitors.

(e) Results. Generally, these strategies worked, and worked to make equity issues advantageous. Too often, we hear that firms in primitive environments should avoid stock market financing. In fact, firm size held constant, in turn-of-the-century Japan (a) those firms with more shareholders were significantly more profitable than those with fewer, and (b) firms with stock listed on the national exchanges were more profitable than those not listed. Even at the very onset of the modern legal regime, firms used court-enforceable corporate charters and employment contracts to make broadly dispersed equity issues profitable.

B. Legal Structure and Growth:

To run this system, entrepreneurs needed a functioning legal system. They did not need a complicated one. Instead, they needed a system that let contracting parties define their rights to scarce property, that protected the property rights they defined, and that enforced any trades they negotiated in such property rights. For this, they needed an elementary private law regime of property, tort, and contract, along with basic criminal law enforcement. This the new Japanese government offered.

Within a few years of taking power, the new Japanese government had a functioning police force and court system. Although it did not have a Civil Code in place until 1896-98, judges understood from the start that enforcing private property rights was their business. This is not rocket science. As much as law school professors enjoy the ambiguities, most disputes do not involve ambiguities. Most are simple. And simple rules go a long way toward providing the legal infrastructure contracting parties need. As Richard Epstein (1995) put it – in what he calls "Blum's Law" -- the optimal rule is not one designed to get every case right. It is a simple rule designed merely to get most of the cases right.

If courts just try to enforce private deals straightforwardly, "the rest" is not "gravy." Instead, the rest will likely do more harm than good. One does not, for example, need a Securities & Exchange Commission to run a stock market. As George Stigler (1964) showed four decades ago, securities regulation instead imposes on investors a net harm. It raises the costs investors bear to little offsetting benefit.

Corporate law is less nefarious, but only if legislators are willing to limit it to a set of default contracts for investors (Easterbrook & Fischel, 1989; Ramseyer, 1998). If designed as a standard form contract with "off-the-rack" governance schemes, corporate law can indeed facilitate investment. As such, it reduces the cost of arriving at the contractual solution that investors could have negotiated anyway. Presumably, however, it facilitates investment more effectively among the smaller firms where incorporation costs would loom relatively larger. Among larger firms where incorporation costs would be relatively small, it would have only trivial consequence.

If such is the theory, such is not the practice. Courts and legislatures in modern capitalist economies frequently try to do more. In trying to do more, they dramatically lower aggregate welfare. When courts and legislatures impose mandatory terms through corporate law, they prevent participants to the firm from reaching the contract they would most prefer. Even when the participants can maneuver around the ostensibly mandatory terms, they necessarily increase the cost of reaching the most preferred solution.

None of this is peculiar to corporate law, of course. Whether by the dynamics of modern democracy or the idiosyncrasies of judicial ideology, modern capitalist governments routinely impose mandatory terms. Often, they do so to disastrous results. Whole bodies of law reduce the choice sets available to investors, consumers, and workers, to no positive effect: labor law and landlord-tenant law are perhaps the most obvious examples, but much the same could be said of medical malpractice and products liability law.

Because they will be subject to contractual terms they would not have chosen (else the "mandatory" nature of the term has no bite), private parties will now find the legal regimes costly. Necessarily, to the extent they stay within the ambit of the legal system, they will find it harder than before to reach the contractual arrangement that maximizes their joint welfare. Necessarily, they will now have greater incentives than before to try to "opt out" of the legal system. If possible, they will look to other ways of structuring their relationships. To the extent that indigenous customs and norms provide that structure, these inefficient legal rules should increase the extent to which the parties "opt in" to such customs and norms.

C. The Role of the Government -- the IBJ Example:[3]

Of course, scholars skeptical of any transcultural generalizations based on claims that Japan looks "Western" have long dismissed the country as a "special case." To do so, often they cite the putatively crucial role the Japanese government played in the economy. Famously ascribing "Japan's post war economic triumph" to its "state-guided market system," Chalmers Johnson (1982: vii) is the best known of this the-government-grew-the-economy school. In fact, this misreads both the Japanese experience and major swaths of economic and political theory (Miwa, 1996, 1998; Ramseyer & Rosenbluth, 1993, 1995).

Yet in the context of corporate finance, the issue is more narrow. The issue is not whether the government guided the economy generally. It is whether it helped route funds to growth-oriented firms. Claims that it did are not hard to find, and usually involve the Industrial Bank of Japan (IBJ). William Lockwood (1955: 250), for example, early claimed that government-controlled banks like the IBJ "played a large part in mobilizing resources for the introduction of modern techniques in commerce and industry."

From its founding in 1900, sympathetic observers had dubbed the IBJ the "central bank of manufacturing." The bank, according to observers like Lockwood (1955: 249), "specialized in financing large-scale industry and public undertakings ...." Fundamentally, however, the IBJ never had either the wherewithal

[3] The section below draws on Miwa & Ramseyer (2000d).

nor the independence to play this role. Largely, it faced the same regulatory and competitive constraints as other banks.

What special benefits the government granted the IBJ were modest. It bought enough of any IBJ bond offerings to let it raise funds through bonds rather than deposits -- except that the bank did not need bonds to raise funds. Large banks faced such a surplus of deposits over good loan applications that some (like the Mitsui Bank) regularly turned depositors away. The government also guaranteed IBJ dividends at 5 percent of capital -- except that the bank never had trouble issuing dividends. Throughout the period, it regularly posted profits higher than its dividends.

Even had the IBJ hoped to promote growth, it answered to the cabinet and the cabinet had other priorities. By the terms of the IBJ's implementing statute, the Finance Minister picked the bank's CEO; could veto bond issues, dividends, and new branches; and supervised bank policy and actions generally. Through these powers, he regularly forced the bank to invest in unprofitable and decidedly non-growth-promoting projects.

In the wake of the 1905-06 Russo-Japanese war, for instance, the government decided it needed more foreign exchange. At the time, that meant more gold and silver, so it ordered the IBJ to lend up to 4 million yen to the Hasami gold mine on an unsecured basis (all the bank's loans that year totaled 12 million). Alas, the mine could not repay the money, and the bank eventually dropped the loan from its books after a 1921 government-run bail-out (costing 11 million yen).

In the midst of the Hasami fiasco, the government decided to use the IBJ to subsidize shipbuilding and ocean shipping. It apparently wanted solvent ocean shipping firms; the military wanted solvent shipbuilding firms; and the Kawasaki shipbuilding firm -- headed by Kojiro Matsukata, the eminently well-connected son of a former Finance Minister -- wanted a place to unload the firm's inventory left unsold at the end of World War I.[4] As a receptacle for those unsold Kawasaki ships, in 1919 the government helped coordinate the creation of the Kokusai kisen shipping firm.

To make Kokusai kisen operational, the government wanted the IBJ to lend it 20 million yen (when the bank's loan portfolio totaled 81 million). It did, but that was not enough. Soon, the firm needed another 57 million, and obtained it from a syndicate of the IBJ and three other banks. Several more attempts to refinance the firm followed, along with additional subsidies from the government to the IBJ.

Yet it was all to no avail. Like the Hasami mine, Kokusai kisen never made money. In 1937 its assets passed to the Osaka shosen shipping firm, and the IBJ took a loss. Ironically, however, the escalating war in China had substantially increased the demand for ships. Although the bank lost money, in the end it did not lose as much as one might have expected a fear years earlier.

By the 1930s, the government was heavily pushing munitions firms. Not surprisingly, it used the IBJ to lend to them. And lend the IBJ did. In 1936 it loaned firms in the (overwhelmingly military-related) machinery industry 5 percent of its total loan base. By 1940 it was lending them 30 percent of its loans, and by 1945 45 percent.

Despite its reputation as "the central bank to manufacturing," other than munitions firms the IBJ never lent heavily to manufacturers. In the mid-1920s, the government declared that the bank should lend to small manufacturers, but by 1930 it was still lending them only 6 percent of its loans. Instead, more than to any other

[4] In addition, Kawasaki shipbuilding's principal creditor, the 15th Bank, was headed by another son of the former Finance Minister.

industrial sector it lent to electric utility firms (13 percent of its loan base in 1929), textile firms (9 percent), and food-stuff firms (8 percent). Even to these sectors, however, it loaned (in 1929) less than Kokusai kisen's outstanding syndicated debt. Indeed, even in 1936 it loaned manufacturing firms less than 28 percent of all loans.

Nor did the IBJ promote manufacturing through the bond market, where it did play a key underwriting role. During 1930-36, the two manufacturers raising the most through the bond market were the Nippon chisso fertilizer firm (60 million yen) and Oji paper (25 million). They were dwarfed by the Tokyo electrical utility (303 million), Tokyo city (330 million), and the infamous Southern Manchuria Railway (700 million). By this point, however, it should come as no surprise that the IBJ mostly underwrote the bonds of entities like the Southern Manchuria Railway, Tokyo, and the public utilities.

Over the last decade, several prominent economists have found in the war-time IBJ the basis of what they call Japan's modern "main-bank system." Tetsuji Okazaki and Masahiro Okuno-Fujiwara (1999: 10), for example, claim:[5]

> [T]he high monitoring capability of banks these days owes much to an improvement of the monitoring practices established pre-war mostly by the Industrial Bank of Japan (IBJ), and the spread of these techniques from IBJ to other banks (mainly government lending institutions) since the war.

In fact, during the late 1930s and early 40s, the IBJ had no incentive to monitor the firms to which it lent. Like other banks, it lent to the firms because the military told it to lend to them. Whether it monitored or not, it had no choice but to ignore any default and to renew any loan as the government urged. Any effort it expended monitoring a firm would have been pure waste.

D. Law and Custom:

1. Too little law, too much law. – By the logic to Section B above, private parties will structure their relationships by indigenous norms primarily in two contexts: when the legal regime provides "too little" law, and when it provides "too much." In Tokugawa Japan, courts only haphazardly protected property rights. Predictably, investors chose other ways of structuring their arrangements. A wide variety of their trades they kept within the family. If a successful merchant had a smart and enterprising son, he passed the business on to him. If it did not, it found a good young man and adopted him into the family.

In modern Russia, the police and courts arguably protect property rights even less. When they can, businessmen make do with extra-legal arrangements. Much the same thing happens in the less developed countries the world over. The legal systems provide too little law, and investors and entrepreneurs make their own arrangements.

The private arrangements reappear in worlds with "too much" law. Where courts try to stop private parties from reaching their desired contractual outcome, they will either opt for the second-best solution within the legal regime, or leave the regime altogether. In American cities where urban governments try to cap rents, some landlords convert apartments to condominiums. Others let the apartments deteriorate to the point where the legal rent equals the market rental. If labor law in northern states require firms to negotiate with a cartelized labor force, firms try to relocate in

[5] Juro Teranishi (1994: 51) argued that "the particular pattern of corporate control [characterized by the main bank system] which utilizes the monitoring activity of a bank in loan syndication" traces its origins to the war-time loan dications. However, he explicitly notes that these syndications did not involve monitoring (id., at 75),.

the south. If even there restrictions on labor arrangements prevent mutually beneficial arrangements, they move to Mexico. If legislatures in western Europe require firms to place labor representatives on the board, they shift decision-making out of the board room.

2. Comparative statics. -- In some industries in some countries in some periods, contracting parties abandon the legal system for private, indigenous arrangements. But when do they make these choices, and why? The discussion above should give us some clues -- for the private, indigenous arrangements generally substitute for formal, court-enforceable arrangements.

Suppose that we observe the indigenous arrangements only in worlds where the legal system either fails to provide basic property rights protection (too little law), or where courts and legislatures try to use the legal system to limit the choice set available to contracting parties (too much law). If we observe the indigenous arrangements only in such worlds, it suggests that private parties see them as distinctly second best. They choose the indigenous arrangements only when the legal system does not work.

On the other hand, suppose that private parties choose the indigenous arrangements even where the legal system cheaply enforces the desired arrangements. If even here they avoid the legal system, it suggests they prefer the indigenous arrangements to the courts. Crucially, however, only in such contexts could we reach that conclusion.

In short, a sensible comparison of modern and indigenous arrangements requires that we compare them in contexts where both are available. Academics fascinated by the idiosyncratic and foreign typically extol the marvelous benefits of the indigenous systems, at the same time that they preach the culturally contingent nature of modern law. Yet if private contracting parties routinely choose the former only where legal options are unavailable or over-regulatory, that very fact suggests ordinary humans see less merit in the indigenous arrangements than do academics.

As with much that matters, this is ultimately an empirical exercise. But at least the evidence from Japan suggests that when the legal system offers private parties to business arrangements a workable option, they choose it. Throughout the Tokugawa period, they formed firms through kin and fictive-kin ties. Once courts protected private contractual arrangements, they switched with blinding speed to formal court-enforced arrangements. In doing so, they also learned – with equal alacrity – how to manipulate those arrangements to reach contractual arrangements that protected their private interests.

E. Conclusions:

When sensible, legal policy is not about redistributing rents to politically favored minorities. Neither should it be about facilitating indigenous business practices. It should be about facilitating consensual deals, whether indigenous or no. Whether those deals involve management contracts, labor arrangements, consumer credit contracts, or corporate capital structure, they take place among consenting adults. Necessarily (not generally or usually, but necessarily -- as Kaplow & Shavell, 2001, show), the legal regime that maximizes social welfare is the regime that enforces the deal these consenting adults want.

Japanese courts at the turn of the last century understood this. Imperfectly to be sure, they let private parties define claims to scarce resources; they enforced those claims; and they enforced most contracts the parties negotiated over those claims.

They enforced, in short, a basic set of property rights. The earlier courts had not done so, and entrepreneurs had used a wide variety of informal indigenous arrangements instead. Faced now with a working modern court system, entrepreneurs invoked it voraciously. In virtually all business arrangements they used the modern legal machinery. The economy boomed, and the rest -- as they say -- is history.

Provided a legal regime both (a) cheaply defines and enforces property rights, and (b) cheaply enforces consensual deals involving those rights, the Japanese experience suggests (obviously does not prove) that businessmen will generally use it. Generally, the experience implies, legal regimes that enforce such rights dominate indigenous customs. To return to the organizing language of this conference, provided it avoids the rent-seeking detritus of the modern regulatory state, the "rule of law" generally dominates "culturally embedded practices." There is progress in science. There can be progress in law. Provided we avoid the Saidian bog where departments whole have sunk, there may yet be progress in social science too.

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