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Japan’s Orientation towards Foreign Investments: Inertia Effects and Driving Force of Institutional Changes*

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Japan’s Orientation towards Foreign Investments: Inertia
Effects and Driving Force of Institutional Changes

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Abstract
We use an institutional perspective to develop a framework for understanding the contexts, mechanisms and processes associated with institutions and institutional changes related to foreign investment in Japan. We examine power dynamics and relational boundaries between diverse actors and analyze why and how some components of institutions have changed and others have not. Also explored in this paper are the conflicting discourses that have been raised in regards to the participation of foreign investors. We also examine purposive efforts of various institutional entrepreneurs to change prevailing institutions in Japan. We assess structural factors working as sources of inertia in Japan’s openness to FDI including the nature of capitalism, power of bureaucracy and culture and analyze various internal and external sources associated with exogenous shocks and gradual changes in institutions.

Keywords: Institutions, institutional changes, foreign investors, Japan, global financial crisis, institutional entrepreneurs, institutional field

1. Introduction
In recent years, Japan has made a considerable progress in attracting foreign investment. In the fiscal year (FY) 2004/05, foreign investment in the country exceeded its investment overseas for the first time in about fifty years (BBC News, 2005). During 2001-2009, Japan’s stock of foreign
direct investment (FDI) as a proportion of GDP grew from less than 1% to over 3.5%. It is fair to say that the growth in FDI is associated with and facilitated by a wave of change that is coming in foreign investments-related institutions in Japan.

Unlike in the 1960s, politicians and government officials are wholeheartedly promoting and encouraging FDI inflows in recent years. A Ministry of Foreign Affairs (2002) provided the rationales: “Japan cannot secure the advantages of FTAs without enduring some pain arising from the opening of its markets, but this should be regarded as a process that is necessary for raising the level of Japan's industrial structures”. In 2006, Japan announced a plan to accelerate efforts to attract foreign investments so that the total FDI stock would be 5% of GDP by 2010.

Significant efforts have been made to encourage foreign firms to invest in Japan. The quasi-governmental organization JETRO has over 70 overseas offices in more than 50 countries to help foreign companies (Jetro, 2011). Japan has also announced a plan to translate relevant laws into English (europa.eu, 2008). Observers have noted that trade associations and industry bodies, which acted as informal barriers to inward FDI in the past have weakened (The Economist Intelligence Unit, 2008). Despite this progress, however, foreign businesses report that enormous and vexing troubles continue to frustrate their efforts to enter and operate in the Japanese market (Bebenroth, Kshetri & Huenerberg, 2012). Observers often note that the costs of doing business in the country remain high (The Economist Intelligence Unit, 2008). It has long been recognized in academic and policy debates that Japan poses unique challenges for foreign businesses. The popular press has also published many articles in which foreign traders and investors face various barriers to operate in the Japanese market.

We argue that contexts, mechanisms and processes associated with foreign firms’ perceptions of trade and investment barriers in Japan, while well documented, are only partially understood.
While some researchers have recognized the importance of studying “deeper, underlying problems” in the Japanese economy (Porter & Takeuchi, 1999), in little research have scholars examined this problem from an institutional theory angle. On the contrary, there seems to be declining interests about Japanese companies and business environment among academic and business scholars. In this regard, Numagami et al. (2010) are surely correct to claim that researchers can get novel and unique insights by exploring the underlying processes and mechanisms at play in Japanese firms that have been relatively under-performers lately. Likewise, Porter & Takeuchi (1999) have emphasized the importance of understanding the sources of successes as well as failures in providing prescriptions for Japan.

In light of the above observations, we have two objectives in this paper. First, we wish to investigate various forces in Japan that have led to the rise in foreign investment to the country in recent years. Second, we seek to better understand the various forces that may still tend to act as barriers to changes in institutions related to foreign investment.

The paper is structured as follows. We proceed by first providing some anecdotes and observations regarding barriers to trade and investment in Japan. Then we discuss our theoretical framework. Next, we apply our theoretical framework to examine inertia effects and driving force related to institutional changes in Japan. It is followed by a section on discussion and implications. The final section provides concluding comments.

2. Barriers to Trade and Investment in Japan: Some Anecdotes and Observations
A number of indicators point to the fact that the inflows of trades and investment in Japan are proportionately less than the country’s share of the global GDP of about 8.7%. For example, according to the CIA World Factbook, Japan’s consumption accounts for about 4% of the world’s oil and 5% of base metals. Another suggested indicator is to look at the revenues of
major multinationals in Japan and compare them with corresponding global revenues. In this regard, revenues of MNCs such as AstraZeneca, GlaxoSmithKline, Citigroup, British American Tobacco and Diageo in Japan as proportions of their global revenues are less than Japan’s share of global GDP (Ashby, 2011). Japan also consumes fewer commodities than its share of global GDP.

Table 1 around here

According to the CIA World Factbook, Japan’s FDI stock by the end of 2010 was $199.4 billion or 3.7% of its GDP of $5.4 trillion. Japan thus failed to achieve its FDI goal for 2010. Although Japan’s economy in size is comparable to China’s, the latter has been more successful in attracting FDI. As of March 2010, China's inward FDI stock exceeded $1 trillion (Global Times, 2011).

Prior research indicates that Japan’s restriction to FDI can be traced back to as early as the Meiji period in the late 19th century (Chang, 2004). Excluding the socialist bloc, Japan’s dependence on FDI was the lowest until the 1960s. Japan started opening its economy by the end of 1960s and continued the process until the mid-1970s (Suginohara, 2008). The increasing openness of the Japanese economy during that time, however, was the result of external pressures and obligations associated with entering international organizations, rather than from long-term dynamics within the country. Japan’s position vis-à-vis other industrial countries, however, did not change much during the 1980s and 1990s. During 1981–95, FDI in Japan accounted for 0.1% of total fixed capital formation compared to the developed country average of 3.5% (Chang, 2004). Japan’s FDI stock of 3.7% of GDP is much smaller than about 20% of GDP in most European countries (europa.eu, 2008). The 2008 Economic Survey of the
Organization for Economic Co-operation and Development (OECD) indicated that Japan was the least open OECD state.

Observers have noted various restrictive practices related to foreign investment in Japan. Starting the mid-1960s, the level of intra-keiretsu shareholdings increased, which discouraged foreign acquisitions by reducing the number of stocks publicly traded (Suginohara, 2008). For instance, cross-shareholdings between companies, business partners and clients make it difficult for foreign investment firms to buy sufficient stock to ensure a voice in management (Nannichi & Kakuta, 2010).

The low levels of trade and investments can be attributed to a host of barriers facing foreign businesses. Foreign companies and policy makers have expressed their feeling that they face a hostile environment in Japan. The EU has shown concerns about nontariff barriers in Japan. In a speech given to a business and government audience in Tokyo in 2008, EU Trade Commissioner Peter Mandelson described Japan as “a globalisation paradox” and noted that while Japan benefitted from an open global investment climate, “at home it remains the most closed investment market in the developed world” (europa.eu, 2008, p. 1).

As a final observation, we should make it clear that the various agencies and programs that are created to help foreign firms to invest in Japan lack the financial tools that have helped other industrial economies to attract investment (Political Risk Yearbook: Japan Country Report, 2011). For instance, some of the lead agencies created for this purpose include The Ministry of Economy Trade and Industry (METI) and Japan External Trade Organization (JETRO) (Jetro, 2011). Moreover, several prefectural and city governments have programs to attract foreign investors. It has been observed that these agencies’ effectiveness has not been proven.

2.1 Perceptions and experiences of foreign businesses operating in Japan
Japanese and foreign businesses have expressed differing and competing views and beliefs about Japan’s openness. Foreign businesses often are skeptical about Japan’s FDI friendliness (Table 2). As Table 2 makes it clear, Japan’s relative openness vis-à-vis its major trading partners, stated and perceived motivations of foreign investors, potential social and economic consequences of foreign trade and investment, intended and expected changes in orientation, foreigners’ involvement in and partnership with Japanese companies, and victim vs. victimizer roles. Foreign firms’ experiences, actions, activities, and behaviors describe the complexity of the Japanese market. They have observed that government policies have superimposed onto unique interactions with various elements of Japan’s economic system such as lifetime employment, cross-shareholding, keiretsu and the banking system to amplify the entry barriers to the Japanese market (OECD Economic Surveys: Japan, 2006).

Foreign firms’ complaints about specific aspects of the operations in Japan continue. One compelling example concerns the requirement of local studies for pharmaceutical products. One complaint is that while human genome research has demonstrated the similarity of human race in genetic composition, Japan forces foreign drug companies to conduct bridging studies with the local population in addition to global trials. As one might expect, this requirement delays the introduction of well-established drugs (Ashby, 2011).

To move to a different point, the reactions of many Japanese companies to the prospect of mergers have been to create poison pill schemes, which allow the existing shareholders to buy stocks at lower prices (BBC News, 2005; europa.eu, 2008). Hamao, Kutsuna & Matos (2010) observed that shareholders widely adopted "poison pills" after 2006, especially those targeted by activists, which led to a subsequent drop in investor activism. From the standpoint of the
participation of foreign firms, the 2007 revision of Japan’s mergers laws to allow triangular mergers of foreign companies with Japanese companies is an important milestone (Table 1). Until 2009, however, there was only one instance of triangular merger in which a foreign company (Citibank) acquired a Japanese company (Nikko).

3. Theoretical Framework

3.1 Institutions and institutional fields
Nobel Laureate Douglas North defines institutions as “macro-level rules of the game” (1990, p. 27) which consist of ‘formal constraints (rules, laws, constitutions), informal constraints (norms of behavior, conventions, and self-imposed codes of conduct), and their enforcement characteristics’ (North, 1996: 344). Institutions can be considered as a conceptual subset of the social ecosystem. An economic system, on the other hand, is a “coordinated set of formal and informal institutions” (Dallago, 2002) influencing economic agents’ behavior (Matutinović, 2005). Put differently, all economic phenomena have institutional components and implications (Parto, 2005).

One way to view the Japanese FDI landscape would be to consider it as “arenas of power relations” (Brint & Karabel, 1991, p. 355) in which various domestic and foreign players with competing interests and disparate purposes negotiate over issue interpretation (Hoffman, 1999; White, 1992). These activities fit squarely into the framework of institutional field. An institutional field is “formed around the issues that become important to the interests and objectives of specific collectives of organizations” (Hoffman, 1999, p. 352). A field is a dynamic system characterized by the entry and exit of various constituencies with competing interests and disparate purposes and a change in interaction patterns among them (Brint & Karabel, 1991). That is, fields are “evolving” rather than being “static” (Hoffman, 1999).
In an institutional war, dominant field members exert control and influence in the development of structures and practices and shape the field’s evolution (Phillips et al., 2000). Prior research indicates that powerful and dominant field members tend to be those with “greater formal authority, resources and discursive legitimacy” (Phillips et al., 2000, p.33). Formal authority is related to an actor’s “legitimately recognized right to make decisions” (Phillips et al., 2000, p.33). In most cases, such power lies with the government (Hardy & Phillips, 1998).

Actors with discursive legitimacy, who have less obvious self-interest are likely to be more influential than resource-rich actors or formal decision makers (Hardy & Phillips, 1998). In this regard, in some cases, foreign investors engaged in activism were perceived as looking for short-term advantages.

3.2. Institutional changes and associated processes and mechanisms

Notwithstanding their connotation of inertia, resistance to change (Hoffman, 1999), persistence (Parto, 2005), durability (Hodgson, 2003) and stability (Scott, 1995, 2001), institutions are subject to change. Institutions arguably have a higher propensity to change when they are characterized by contradictions that “create conflicting and irreconcilable incentives and motivations” (Campbell, 2004; p. 186). These conditions are prevalent in the current Japanese economy.

A simple approach to understand institutional changes would be to look at the various contradictions that institutional embedding the Western traders and investors produce with the institutions in Japan. Institutional changes can be seen as an outcome of the dynamic interactions of contradictions and “praxis” (Seo & Creed, 2002). Seo & Creed (2002) have proposed four sources of contradiction: “(1) legitimacy that undermines functional inefficiency, (2) adaptation that undermines adaptability, (3) intra-institutional conformity that creates inter-institutional
incompatibilities, and (4) isomorphism that conflicts with divergent interests.” These are arguably accumulated results of organizations’ continuous isomorphic adaptations (Burns & Nielsen, 2006). First, conformance to the existing institutions may be at the expense of technical and functional efficiency. Second, continuous isomorphic adaptations may lead to psychological and economic "lock-in" and “competency traps,” which may undermine further adaptability. Put differently, “adaptive moves make adopters less able to adapt over the long run” (Seo & Creed, 2002). Third, the legitimacy seeking process may require appeasing multiple institutions that are conflicting and inconsistent. Finally, misalignment between institutions and the divergent interests of actors embedded in the institutions may lead to contradictions.

In prior theoretical and empirical research, scholars have identified three mechanisms related to changes in institutional fields (for a review, see Sauder, 2008). They are: “jolts” or exogenous shocks (Meyer, 1982; Meyer et al., 1990; Haveman et al., 2001), changes in organizational logics (Friedland & Alford, 1991; Leblebici et al., 1991; Haveman & Rao, 1997; Thornton & Ocasio, 1999) and gradual changes in inherent structure of the field (Clemens & Cook, 1999; Fligstein, 2001; Schneiberg, 2005; Scott et al., 2000).

**Exogenous shocks**

“Jolts” and other exogenous shocks can disrupt a field (Sauder, 2008). Exogenous shocks can create opportunities for new norms in the field and may change existing boundaries and lead to the emergence of new hierarchies (Meyer, 1982; Meyer et al., 1990). Examples of exogenous shocks include the introduction of discontinuous technological innovation, social unrest, political changes, new government regulations, and economic/financial crashes (Haveman et al., 2001).

**Changes in organizational logics**


In prior theoretical and empirical research, scholars have emphasized the coevolving nature of institutions and the organizational forms that embody them and found that changes in organizational logics lead to a change in a field’s practices and conventions (Friedland & Alford, 1991; Leblebici et al., 1991; Thornton & Ocasio, 1999).

**Gradual change in field structure**

Institutional fields also change gradually (Scott et al., 2000). Related to this approach are studies of how fields may be influenced by general institutional changes (Clemens & Cook, 1999; Schneiberg, 2005). Some important mechanisms in this category include modifications in regulative and normative institutions, institutional logics, and the composition of actors constituting the field (Scott, 1995, 2001, 2005).

### 3.3. Institutional change agents and institutional entrepreneurs

It may be helpful to consider the roles of institutional change agents. A central concept here is institutional entrepreneurship. New institutions arise when institutional entrepreneurs “see in them an opportunity to realize interests that they value highly” (DiMaggio, 1988, p. 14). A growing number of studies have suggested that institutional entrepreneurs challenge or disrupt particular models of social or economic orders and construct new organizational fields (Bartley, 2007; Daokui Li et al., 2006; DiMaggio & Powell, 1991). They “lead efforts to identify political opportunities, frame issues and problems, and mobilize constituencies" and "spearhead collective attempts to infuse new beliefs, norms, and values into social structures" (Rao et al., 2000, p. 240). They also engage in activities related to deinstitutionalization or dissolution of existing logic or governance structure as well as institution formation, which entails the birth of a new logic or governance structure (Scott, 2001).
Institutional entrepreneurs' "subject positions" need to be dominant that can allow them to gain wide legitimacy, bridge diverse stakeholders and compel other actors to change their practices (Hoffman, 1999; Maguire et al., 2004). It is important for them to mobilize external and internal constituents, have financial resources (DiMaggio, 1989; DiMaggio & Powell, 1991; Holm, 1995) and be able to communicate with other institutional actors in the system so that their initiatives are perceived favorably (Groenewegen & van der Steen, 2007).

Theorization or "the development and specification of abstract categories and the elaboration of chains of cause and effect" is an important process through which institutional entrepreneurs facilitate the diffusion of new ideas (Greenwood et al., 2002:60). Theorization provides rationales for the practices to be adopted and thus increases the likelihood of acceptance of the practice (Strang & Meyer, 1993). Two key elements of theorization concern framing and justifying. Framing focuses on the need for change and justification is value of the proposed changes for concerned actors (Greenwood et al., 2002; Maguire et al., 2004).

Discursive legitimacy concerns speaking legitimately about particular issues and affected organizations (Phillips & Brown, 1993). For example, Greenpeace derives discursive legitimacy because it speaks on behalf of the environment (Hardy & Phillips, 1998). The research literature provides abundant evidence that acquiring discursive legitimacy is important for new field members without formal authority or resources to secure a right to voice (Phillips & Hardy, 1997).

4. Sources of Institutional Inertia
Organizational inertia can be defined as formal organizations’ tendency to resist internal changes in response to external changes (Larsen & Lomi, 2002). Such a tendency may constraint an organization's ability to exploit emerging opportunities (Dean & Mayer, 1996). In this paper’s context, an inertia effect (resistance to change) is likely to lead to an underestimation of benefits.
associated with openness to foreign investment. Some of the important sources of inertia associated Japan’s approach to foreign investment are discussed below.

4.1. The historical and societal circumstances behind Japan’s approach to foreign investment

In most cases, compared to formal institutions, de-institutionalization and reinstitutionalization of social practices, cultural values and beliefs occur very slowly (Clark & Soulsby, 1999; Ibrahim & Galt, 2002, North, 1990, Zweynert & Goldschmidt, 2006). North (1990, p. 6) noted that “although formal rules may change overnight as the result of political and judicial decisions, informal constraints embodied in customs, traditions, and codes of conduct are much more impervious to deliberate policies”. In this regard, especially relevant to this article's context concerns an observation made by Junichi Arai, head of M&A at Morgan Stanley Japan: “The notion that commercial code changes will lead to a wave of international firms snapping up Japanese companies is over-simplistic” (Ibison, 2005). The findings of prior studies suggest that informal institutions act as barriers for foreign firms’ operations in Japan (Bebenroth, Kshetri & Huenerberg, 2012).

In a *New York Times* Op-Ed, Yukio Hatoyama, who headed the Democratic Party of Japan and was prime minister from September 2009 to June 2010, noted: “The economic order in any country is built up over long years and reflects the influence of traditions, habits and national lifestyles. But globalism has progressed without any regard for non-economic values, or for environmental issues or problems of resource restriction” (Hatoyama, 2009).

To understand the problem of institutional changes in Japan, it may be helpful to consider Japan’s history and culture. Historically Japan is characterized by high levels of cultural and trade barriers. The country’s self-imposed isolation ended in the mid-1850s. While Japan
gradually started opening its markets to international companies, analysts say that it is more closed than most industrialized economy (Ashby, 2011).

A related point is that Japan’s tight, insular and consensual culture is associated with a higher incentive to cooperate than in other relatively loose countries such as the U.S. In a study of 33 countries, Gelfand et al. (2011) found that Japan is among the 10 'tightest' countries. An upshot of this orientation has been an emphasis on personal relationships. Japanese businesses are reluctant to break or modify existing business relationships and prefer to do businesses with familiar corporate partners. A corollary is that Japanese companies tend to resist hostile mergers and acquisitions (M&A) but that they are active in overtaking foreign firms (Yeh, 2011). Understandably foreign investors trying to enter the Japanese market tend to label such preferences and practices non-tariff barriers (Political Risk Yearbook: Japan Country Report, 2011).

A consideration of traditional Japanese corporate governance would offer further insights and understanding of the historical and societal circumstances. In the traditional Japanese practice, a firm is not viewed as “a mere property of shareholders (Sako, 1997). Indeed, employees are considered to be “the most important stakeholders” (Araki, 2005). Until the 1980s, Japanese companies’ common stockholders were treated like preferred shareholders of western companies, who lacked a say in corporate affairs (Abbeglan & Stalk, 1985). The top management team consisted of internally promoted managers rather than appointed agents to act on behalf of shareholders. Managers obviously identified more with other employees than with shareholders (Sako, 1997). Overall Japan’s insider-dominated corporate board differs significantly in the structure of corporate boards of Western countries (Charkham, 1994; Shleifer
That said it is also the case that Japanese institutional investors increasingly monitor and control their targets (Yoshinori, 2011).

4.2. Japan’s big firm capitalism and cartel like arrangement

While the Western and Japanese economies are based on free-market ideologies and models, they have exhibited different types of capitalism. In Japan’s big firm capitalism the government has a tendency to collaborate with large firms to drive economic growth and entrepreneurial activities (Schramm, 2004). Consequently, some industries are characterized by formal and informal cartels (Political Risk Yearbook: Japan Country Report, 2011; Kimino et al., 2007). Some considered the collaboration between the former Ministry of Trade and Industry and the large conglomerates equivalent to a cartel (baltimoresun.com, 1991).

To understand the cartel like arrangement, it might be helpful to consider Japan's securities market and tobashi, the practice of reconciling favored clients’ accounts to compensate for stock losses. Estimates suggested that between the 1989 Tokyo market crash and the mid-1991, Japan's "Big Four" securities firms had reimbursed about $1 billion to over 225 favored clients (fundinguniverse.com, 2011). In 1991, the presidents of two of the top 3 Japanese securities firms, Nomura and Nikko quit after law enforcement investigations found that they had links with underworld figures and they had compensated selected clients for stock-trading losses (baltimoresun.com, 1991). Furthermore, analysts argue that these practices were too common in Japan.

Japan’s big firm capitalism is associated and facilitated by close ties between government and industry. For instance, professional and trade associations act as quasi-regulatory bodies and are allowed to devise their own rules to regulate their business sectors (Japan Country Review, 2011). We can illustrate this point with an example of legal profession. Foreign lawyers face
strict eligibility restrictions for legal practices in Japan. Foreign lawyers that are licensed in Japan under the 1986 Foreign Lawyers Law are not allowed to advise foreign investors on various aspects. Moreover, these restrictions are strictly enforced by the Federation of Japanese Bar Associations (Nichibenren). Consequently, there are only a small number of Japanese lawyers that can handle international business transactions, which means that foreign investors lack adequate access to legal services related to doing business in Japan (Japan Country Review, 2011). Using the approach of Phillips et al. (2000), we can say that the Federation of Japanese Bar Associations is a powerful and dominant field member with significant formal authority and resources.

4.3. Bureaucratic system

Foreign companies doing businesses in Japan have expressed their frustrations with the Japanese bureaucracy. For instance, an EU official recently put the issue this way: "You export a car to Japan and later you discover that the authority in charge of road security blocks its sale because it does not respect complex safety standards, like the shape of a side-window" (euractiv.com, 2011). Japanese bureaucrats' power today is to a large part due to their past success in guiding, planning and implementing Japan’s developmental state model which led to the economic miracle. Politicians’ excessive reliance on bureaucrats has acted as a barrier to institutional change.

One of the most important features of Japanese institutions concerns its bureaucratic tradition, which has received a considerable amount of attention. Japanese bureaucrats have played an unusually important and interesting role in the policy-making arena (Haggard, 2004). About 75% of bills presented to the Diet come through Japan's bureaucracy. Scalise & Stewart (2009) comment: “In Japan, laws are usually vetted by ministerial advisory councils, drafted by
the bureaucracy, reviewed by the relevant minister, reviewed again by the relevant Diet committee, and finally rubber-stamped in a plenary Diet session. This is not because the bureaucracy has a chokehold on the legislative process, but because politicians lack the time, energy, staff, and expertise necessary to write bills”.

In this regard, one view is that there is a tacit division of labor between bureaucrats and politicians. In this division of labor, bureaucrats were the de facto rulers in the country’s economic and social affairs, who pursued their own developmental objectives irrespective of what the politicians wanted to accomplish (Johnson, 1982). The opposite argument is that politicians dictated the country’s policy and the bureaucrats acted as politicians’ agents (Noble, 1998; Ramseyer & Rosenbluth, 1993).

Irrespective of which view prevails, most experts agree that bureaucrats in Japan possess more power over policy than their Western counterparts. Analysts point out that historically “bureaucrats have always been held in high esteem and politicians played second fiddle” (Jain, 2009). For instance, following World War II, while Japan transformed most of the pre-war institutions, the bureaucracy remained virtually untouched and unchanged. They became role models for many other Asian nations. The Democratic Party of Japan has maintained that institutional reforms are arguably hampered by “decades of policy collusion between bureaucrats and ruling party lawmakers” (Nishikawa & Sieg, 2009). After the 1994 failed talks on economic reforms with the U.S., Motohisa Furukawa, a DPJ representative in the House of Representatives, was quoted as hearing a Japanese official say: “In our country, even if the prime minister says 'yes', nothing will change unless we agree" (Sieg, 2009).

5. Driving Force of Institutional Changes in Japan
Internal and external sources of institutional changes in Japan are presented in Table 3. Table 4 illustrates how institutional changes may affect the four key institutional actors in Japan: the
government, bureaucrats, big businesses and the consumer (public). Some of the forces such as the Tohoku earthquake, tsunami and nuclear meltdown can be considered as jolts, which take place in a discontinuous fashion. Others such as Japan’s integration into the global economy constitute gradual changes.

5.1. Domestic sources of institutional changes

**Poor economic performance and existing institutions’ association with functional inefficiency**

Adverse economic indicators such as the government indebtedness at 200% of GDP, low returns on capital in the domestic corporate sector state have forced state, non-state and private actors to rethink the Japanese model and realize the drawbacks of prevailing institutions. Politicians in Japan know full well that opening their domestic markets for greater levels of investment would be a compelling strategic choice. Financial and economic crises served as an important trigger for the Japanese government to open its market for FDI.

Due to failures and losses, Western profitability and efficiency measures such as ROA and return on sales are increasingly diffusing in the Japanese corporate culture. To take one example, in the late 1990s, Sony reduced its board from 38 to 10, which included 3 outside directors (Porter & Takeuchi, 1999). The Chief Japan Strategist for Goldman Sachs Japan was quoted as saying: “Japanese did not know what ROE was in 1995” (Robinson & Shimizu, 2006). ROE has been an explicit goal for a large number of companies in Japan in recent years.

**Political changes: DPJ’s victory**

The DPJ, which won a landmark victory in August 2009 over the long-governing Liberal Democratic Party, created an impression among foreign investors that Japan would be more open to foreign investment, especially from emerging Asian economies (Kodaira, 2009). Then Prime
Minister Yukio Hatoyama promised a “grand cleanup of postwar governance” (Fackler, 2009). Observers also noted that the DPJ's victory opened the door for the Japanese to ask themselves a fundamental question related to orientation towards foreign investments (Scalise & Stewart, 2009).

**Triple Disaster: Earthquake, tsunami and nuclear meltdown**

Natural catastrophes such as the earthquake, the tsunami and nuclear meltdown have also been the sources of jolts. The disaster led to a significant decline in output in the first quarter of 2011 (OECD Economic Outlook, 2011). At the same time, there will be significant reconstruction spending in areas affected by the earthquake and tsunami. Japan's huge public debt has forced the government to find alternative sources to finance reconstruction spending. Following the tsunami and nuclear meltdown in March 2011, Japan pressed the EU for a formal summit to launch free trade negotiations (channelnewsasia.com, 2011).

**Unethical and corrupt practices of local firms driving changed in the perceptions of foreign firms**

A December 2004 survey conducted among Japanese by Nomura Research Institute, for instance, indicated that foreign companies’ image in Japan was improving. Over 30% of respondents participating in the survey said that foreign companies’ image had improved compared to a decade before then whereas less than 9% thought that it had worsened. This change is at least partly due to unethical acts of fraud and corrupt practices of local firms. Suginohara (2008) notes: “.. complaints that foreign companies are disruptive, ignorant of local customs, and destructive of the Japanese economic system hold less water after the scandals surrounding Japanese entrepreneurs such as Murakami Yoshiaki and Horie Taka Tumiki, who jolted the Japanese economy in 2004 and 2005 by behaving contrary to the traditional Japanese way”.

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5.2. Foreign sources of institutional changes

Perceived functional efficiency of foreign institutions and mimetic isomorphism

Institutional changes are more likely to take place when institutionalized values, norms and practices conflict with functional efficiency and are incompatible with and fail to respond to a changing environment (Seo & Creed, 2002). In this regard, an increasing number of Japanese firms are considering Western practices associated with a higher degree of functional efficiency and are imitating such practices. This phenomenon is also referred as mimetic isomorphism (DiMaggio & Powell, 1983). Wilbur Ross, chairman of W. L. Ross & Company noted: "Now that Ghosn has become a cult figure in Japan, there's a growing awareness that some degree of Western notions might not be a bad thing. Restructuring is no longer the dirty word it used to be" (Belson, 2003).

Foreign investors and activists’ roles as institutional entrepreneurs

Foreign investors and activists are playing a key role in bringing changes in Japanese institutions. Prior research indicates that institutional change measures are likely to be initiated by less powerful actors from the periphery of an inter-organizational field (Leblebici et al., 1991). For such actors, the costs for changing the existing order are arguably lower and they are also less likely to be sanctioned by the central powerful players.

Due to its highly tight, insular and consensual business culture (Gelfand et al., 2011; Political Risk Yearbook: Japan Country Report, 2011), institutional entrepreneurs to challenge the existing order are less likely to come from inside the country. Unsurprisingly, foreign institutional actors have initiated most of the visible activities to change the existing institutional order.

A commonplace observation in recent years is that Japanese corporate governance has been strengthened by foreign institutional investors (Mizuno, 2010). An institutional
entrepreneur that stands out as the most influential foreign actor is California Public Employees’ Retirement System (CalPERS). In addressing, Keidanren, the peak association for large Japanese companies, CalPERS board president William D. Crist reminded his audience that CalPERS was an investor interested in long-term returns rather than speculation. He provided detailed criticism of Japanese corporate governance based on the CalPERS programs in the U.S. (Jacoby, 2007).

In the beginning, many Japanese companies viewed CalPERS as a foreign blackmailer (Learmount, 2002). CalPERS seemed to have an obvious self-interest and perceived as looking for short-term advantages. As one can expect (e.g., Hardy & Phillips, 1998), the agency struggled to achieve discursive legitimacy and receptivity in the country. The attitude, however, changed over time. Subsequently CalPERS’ actions generated intense interest among local companies. Some Japanese companies sent delegations to the U.S. to meet with CalPERS officials (Jacoby, 2007). To some extent, entrepreneurial activities of CalPERS and other activists have been successful to bring change in the existing institutional order.

Integration into the global economy

Japan’s integration into the global economy has also generated unprecedented pressure to open for foreign businesses. In the 2008 World Economic Forum in Davos, Switzerland, the former Japanese Prime Minister Fukuda Yasuo promised that his administration would intensify efforts to attract foreign investors (Suginohara, 2008).

Regional rivalry

Some activities related to institutional change took place in the context of regional rivalry. For instance, the EU-South Korea free trade agreement of December 2010 forced Japan to accelerate FTA negotiations with the EU. South Korea's lead served as a jolt to Japanese policy makers and put pressures on them to close the gap with their challenging competitor (euractiv.com, 2011).
Global financial crisis (GFC)

Due to heavy dependence on exports, particularly to the U.S. market, Japan has been affected by the GFC more than many other economies (Wall, 2010). Slowing export demand, especially from the U.S. remains a matter of concern for Japan. Japanese are thus forced to realize the importance of increased domestic consumption. In this way, the GFC has acted as a jolt or an exogenous shock, which has disrupted the field formed around foreign investment.

6. Discussion and Implications

In this paper, we provided insights into the forces of institutional changes as well as the sources of institutional inertia and the problems associated with overcoming them. While formal institutions such as laws and regulations restrict foreign companies’ market access, informal institutions are no less restrictive (Bebenroth, Kshetri & Hunerberg, 2012). Although foreign actors such as CalPERS have had some success in changing Japanese corporate governance, economic and political factors have limited its influence and permitted the persistence of Japan’s distinctive governance system (Jacoby, 2007). A critical barrier to foreign firms’ effectiveness in bringing institutional changes is a lack of intangible resources.

Japan’s powerful bureaucracy, big firm capitalism and tight culture have superimposed onto a unique interaction that has led to vague legal standards in some aspects notwithstanding its strong rule-of-law tradition. To cite one compelling example, in the Nikko scandal mentioned above, most of the charges against the company were dropped. It was found that the firm technically had not broken Japan's securities laws, which were arguably vague (fundinguniverse.com, 2011).

As noted above, some of the Japanese politicians seem to be interested in increasing their country’s openness to FDI. One of their obvious goals is also vote maximization. Looking from this angle, the government can be viewed as a mediator for various institutional actors (Kshetri,
Palvia & Dai, 2011). From the government’s perspective, various institutional actors differ in terms of power to affect an outcome. Prior researchers have provided valuable insights into organizations engagement in decoupling. The exact nature of decoupling is a function of relative powers of competing organizational interests (Westphal & Zajac, 2001). Clearly, substantial responses cannot be made to appease actors that oppose diametrically. The substantive response relates to the actor that is perceived to be more powerful and the symbolic response relates to the actor perceived to possess less power (George, Chattopadhyay, Sitkin, & Barden, 2006). In some cases, symbolic actions constitute measures that just satisfy the minimum expectation of the less powerful actor (Kshetri, Palvia & Dai, 2011). The various external and internal stimuli discussed in Table 3 have led to an increased power of foreign businesses. As discussed above, foreign businesses are resourceful and acquiring discursive, which is likely to lead to bigger right to voice (Phillips & Hardy, 1997). Such changes are likely to force the Japanese government to take substantive actions to appease foreign investors.

Informal institutions both reflect as well as determine the nature of the formal institutions (Hayek, 1979). North (1994) observes that informal rules provide legitimacy to formal rules. Likewise, Axelrod (1997) notes: “Social norms and laws are often mutually supporting. This is true because social norms can become formalized into laws and because laws provide external validation of norms” (p. 61). Even if Japanese politicians like to open their market for FDI, informal institutions such as power and influence of bureaucrats and life time employment are less likely to provide validity to formal rules favoring FDI. Especially, Japanese bureaucracy, by virtue of its association with past success, still possesses enormous power and influence. On the contrary, changes in formal institutions related to FDI in Japan are likely to trigger changes in informal institutions and vice versa.
Zucker (1988: 26) draws an analogy from physics to describe institutional change mechanisms. She argues that institutions continuously undergo change due to entropy, the tendency toward disorder or disorganization. An implication of the entropy-like characteristics is that institutions can be modified and reproduced (Scott, 2001). Understanding the contexts associated with the effectiveness of a strategy would help devise effective measures to bring progressive institutional changes. For one thing, to function effectively in Japan, managers need to recognize the power dynamics that frames the relationships among various institutional actors such as bureaucrats, politicians, big conglomerates, trade associations and foreign investors. Moreover, various national as well as international social, political, demographic and economic events and natural catastrophes may affect such dynamics.

In some cases, what some consider as a non-tariff barriers and discriminative practices against foreign firms are actually equally enforced and applicable to domestic companies. Indeed, researchers have reported that the “stringent government standards” in some industries have helped stimulate innovations (Porter & Takeuchi, 1999; p. 70). Likewise, buyer-supplier networks and alliances (or "keiretsu") also limit the entry of domestic newcomers (Japan Country Review, 2011). Likewise, Ibison (2005) quotes Junichi Arai, head of M&A at Morgan Stanley, on the widely criticized poison pills: “While in some cases genuine concern about foreign hostile bids has led companies to put poison pills into place, in general they are being used to protect Japanese companies from domestic acquirers, especially from non-traditional players”.

Just because a strategy is successful in one context does not mean that it would work in a different context. Prior research has indicated that successful organization may stick to outdated strategies because past success has encouraged them to follow the strategies that worked well (Audia & Locke, 2000). In this regard, experts agree that while Japan’s policy-making process
dominated by bureaucrats worked well during a growth period, such approach is much less effective in the current contexts facing the country (Sieg, 2009). A similar point can be made about the consensual nature. Researchers argue that while internal consensus offered various practical benefits and helped Japanese firms to respond quickly to various challenges during a growth period, it may have potential negative impacts when they need to identify new directions for continued growth (Makino & Roehl, 2010; Numagami et al., 2010).

Some sources of resistance to FDI are more economic rather than cultural. Prior research indicates that if institutionalized norms and practices are serving the interests of certain actors, they may resist any attempts to bring changes in such norms and practices (Seo & Creed, 2002). Given the many examples of Japanese companies’ hostile takeover of U.S. firms, analysts argued that hostile and unsolicited deals were culturally acceptable for Japanese companies (Ibison, 2005). The problems started when Japanese companies themselves started becoming targets of hostile deals, which obviously were against their interests and desires.

6.1. Future research
Clearly, there is much to be learned about the institutional changes undergoing the Japanese economic system. The above analysis indicates that foreign actors such as CalPERS as well as domestic actors such as the Democratic Party have taken various initiatives to change institutions in Japan. In future conceptual and empirical work scholars need to compare and contrast the various institutional entrepreneurship related activities associated with domestic and foreign actors. The domestic and foreign actors may differ in terms of opportunity they would like to realize, their framing of issues and problems, and economic and non-economic resources they possess and mobilization of various constituencies.

Further inquiry is also needed to investigate the differences in the natures of practices that Japanese companies imitate and mimic from domestic companies and foreign companies. For
instance, it is observed that foreign companies are bringing “cutting edge” corporate governance in Japan. At the same time, Japanese companies are the world leaders in some areas such as total quality management. In this regard, research would benefit from a comparison of business practices that Japanese companies are perceived as world leaders compared to those that non-Japanese companies are perceived as on the cutting edge.

Future research based on the present framework can be extended to other economies in Asia and elsewhere. For instance, other economies in Asia may differ in terms of powers and orientations of various institutional actors (e.g., the government, bureaucrats, businesses and consumers) discussed in this paper. They are also likely to differ in the contexts, mechanisms and processes associated with various forces discussed in this paper.

7. Concluding Comments
Our explanations shed some light into idiosyncratic and unusual features of the Japanese institutions that have led to various real and perceived barriers to the inflows of foreign trade and investments. From the Western perspective, one important source of complexity has been the Japanese culture. Some practices that limit competition from foreign firms are acceptable and legitimate according to the traditional norms.

This paper identified various sources of institutional changes. Important economic and political changes have triggered new views, considerations and strategies with respect to foreign investments. Various actors representing domestic and foreign firms’ interests are competing for power and discursive legitimacy. Natural catastrophes and international political events have also triggered big Jolts for Japanese politicians and forced to take actions to further open the Japanese market. In some cases, political changes have also been an important trigger for institutional changes. For instance, if nothing else, the DPJ victory prompted the Japanese to critically think
about the economic models prevalent in the country. Overall, there are ample signs of institutional changes that are likely to affect the Japanese FDI landscape.
Table 1: Some milestones that have had an impact on institutions related to foreign investment inflows in Japan

<table>
<thead>
<tr>
<th>Time</th>
<th>Event</th>
<th>Explanation</th>
</tr>
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<tbody>
<tr>
<td>1993</td>
<td>CBCC invited CalPERS board president William D. Crist to visit Tokyo and address the Keidanren</td>
<td>This was arguably a historic event, which was widely covered by the Japanese media</td>
</tr>
<tr>
<td>2003</td>
<td>Japan adopted the “company with committees” system.</td>
<td>It gives companies the option of not having statutory auditors if they have a majority of outside directors on board committees and if operational responsibilities are with the board.</td>
</tr>
<tr>
<td>FY 2004/05</td>
<td>Foreign investment exceeded the country's investment overseas for the first time in 50 years.</td>
<td></td>
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<tr>
<td>June 2005</td>
<td>The upper house of parliament backed a law facilitating a merger with foreign firms, which was already passed by the lower house. The 2005 Companies Act expanded the types of possible corporate structures and M&amp;A transactions available for corporate consolidation/restructuring.</td>
<td>The law allowed a foreign firm to use stock as consideration in a cross-border M&amp;A transaction by means of a triangular merger.</td>
</tr>
<tr>
<td>December 2006</td>
<td>The Diet approved legislation to relax restrictions on political donations by foreign-owned companies</td>
<td>The old Political Funds Control Law did not allow companies with more than 50% shares held by foreign investors to make political contributions.</td>
</tr>
<tr>
<td>May 2007</td>
<td>Financial Instruments and Exchange Law was enacted.</td>
<td>Restrictions in the use of shares as payment in triangular merger deals were lifted for foreign firms.</td>
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<tr>
<td>December 2010</td>
<td>An EU-South Korea free trade agreement was concluded</td>
<td>It was the EU’S first FTA in Asia</td>
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<tr>
<td>March 2011</td>
<td>The Tohoku earthquake, tsunami and nuclear meltdown.</td>
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Table 2: Japanese and Western views on the status and contexts associated with the openness of the Japanese

<table>
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<tr>
<th></th>
<th>Japanese views/perceptions</th>
<th>Western views/perceptions/arguments</th>
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<tbody>
<tr>
<td>The degree of openness</td>
<td>Japan's foreign ministry spokesperson Satoru Satoh: &quot;The European market is much more protected than the Japanese&quot;.</td>
<td>EU Trade Commissioner Peter Mandelson: &quot;As a foreigner looking at Japan from the outside what I see is a globalisation paradox. For decades Japan has taken advantage of an open global investment climate. Both it and the host economies have benefitted from that investment. Yet at home it remains the most closed investment market in the developed world.... Japan went global long ago, but at home it holds back from becoming globalised&quot;.</td>
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<tr>
<td>Motivation of foreign investors</td>
<td>Referring to foreign funds’ orientation towards short term-profits, an official of a company listed in the First Section of the Tokyo Stock Exchange whose largest shareholder was once a foreign investment fund, was quoted as saying: &quot;Honestly, I don’t understand what those funds are really thinking about or what they are after&quot;.</td>
<td>In addressing, Keidanren, CalPERS board president William D. Crist reminded his audience that CalPERS was an investor interested in long-term returns rather than speculation.</td>
</tr>
<tr>
<td>Potential consequences of foreign investment</td>
<td>Ex-prime minister Yukio Hatoyama: “It is no exaggeration to say that the global economy has damaged traditional economic activities and destroyed local communities”. “How can we put an end to unrestrained market fundamentalism and financial capitalism, that are void of morals or moderation, in order to protect the finances and livelihoods of our citizens? That is the issue we are now facing”.</td>
<td>Crist stressed “we are not crusaders – we do not want to make over countries’ corporate structure&quot;.</td>
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<tr>
<td>Framing the need for change (allowing more FDI)</td>
<td>Hatoyama: &quot;...we must not forget our identity as a nation located in Asia. I believe that the East Asian region, which is showing increasing vitality, must be recognized as Japan’s basic sphere of being. So we must continue to build frameworks for stable economic cooperation and security across the region&quot;.</td>
<td>EU Trade Commissioner Peter Mandelson: &quot;Japanese companies have been manufacturing in Europe for decades. Yet until the reform of the Large Retail Store Law ..., a foreigner setting up retail operations in the Japanese market was extremely cumbersome&quot;.</td>
</tr>
<tr>
<td>The degree of foreigners’ involvement and participation</td>
<td>Some Japanese investors’ views: outside funds tend to pursue short-term profits, which tends to make collaboration with them unattractive.</td>
<td>Foreign investors’ view: foreign funds tend to be disregarded by Japanese management.</td>
</tr>
</tbody>
</table>

*euractiv.com (2011); †Jacoby (2007); °Nannichi and Kakuta (2010); ²Hatoyama (2009); °Nannichi and Kakuta (2010); †europa.eu (2008, p. 1)
Table 3: Internal and external sources of institutional changes in Japan

<table>
<thead>
<tr>
<th>Domestic sources</th>
<th>Foreign sources</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Exogenous shock/Jolts</strong></td>
<td>• GFC</td>
</tr>
<tr>
<td>• Triple Disaster: earthquake, tsunami and nuclear meltdown</td>
<td>• Korea’s FTA agreement</td>
</tr>
<tr>
<td>• Political changes: DPJ’s victory</td>
<td></td>
</tr>
<tr>
<td><strong>Gradual changes</strong></td>
<td>• Perceived functional efficiency of foreign institutions and mimetic isomorphism (e.g., Foreign companies bring “cutting edge” corporate governance)</td>
</tr>
<tr>
<td>• Poor economic performance and existing institutions’ association with functional inefficiency</td>
<td>• Foreign investors and activists’ roles as institutional entrepreneurs</td>
</tr>
<tr>
<td>• Unethical and corrupt practices of local firms driving changed in the perceptions of foreign firms</td>
<td>• Japan’s integration with global economies</td>
</tr>
</tbody>
</table>

Table 4: Benefits of the status quo and institutional changes: The prospective of key institutional actors in Japan

<table>
<thead>
<tr>
<th>Actor</th>
<th>Benefits of the status quo</th>
<th>Benefits of institutional changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>The government</td>
<td>• Support from big businesses which have driven the Japanese economy.</td>
<td>• Gain in legitimacy from international institutions and foreign countries.</td>
</tr>
<tr>
<td>Bureaucrats</td>
<td>• Enjoy power and privilege under the current institutional arrangement.</td>
<td>• Can win the support and approval of the government and the public if they make genuine efforts in formulating policies to attract foreign investments.</td>
</tr>
<tr>
<td>Big businesses</td>
<td>• Privilege of a shield from competition.</td>
<td>• Increased competition and opportunity to observe foreign business practices would make them more effective.</td>
</tr>
<tr>
<td>Consumers/public</td>
<td>• A sense of national pride.</td>
<td>• More choices for consumption and employment.</td>
</tr>
</tbody>
</table>
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Notes:

1 Other estimates put Japan's inward FDI stock by the end of 2009 at $221 billion (Global Times 2011).