

Assessing Theoretical Approaches to Economic Crisis Management

Comps Paper

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Abstract:

In this paper, I examine why states respond to common economic crises the way they do. I analyze two similar crises: The United States in the Great Depression from the stock market crash in 1929 to the first New Deal, as well as Japan's stock market and real estate crash of 1990 and the respective response of the Liberal Democratic Party until the year 1993. I test two non-institutional approaches against each other; the psychological prospect theory and the ideational approach with the institutionalist rational choice theory as a baseline in identify which specific or combination of characteristics best explain state response amongst similar economic crises. In this paper I argue that psychological prospect theory initially reveals when actors, both politicians and citizens, recognize and legitimize the need for risk taking, and therefore, the launching of a new policy response. Prospect theory does not, however, explain how actor's political interests shape economic policy response, therefore, it is necessary bring forth insights from the baseline rational choice approach. I also incorporate the ideational analysis, which serves as a balance to the political interest formation arguments presented by rational choice. The strength of the ideational analysis is found in situations of path dependency and in its ability to identify at specific time periods what actors perceived the problem of the economic crisis to be, and thus the various policy responses that resulted at different stages of the crisis.

In this paper, I examine why states respond to common economic crises the way they do. To determine the domestic factors that shape policy making, there are three theoretical approaches of significance. The first is an institutional analysis known as rational choice, which serves as my baseline comparison to two non-institutional theories: psychological and ideational. These theoretical schools lay out different key assumptions about the role of institutions and how actor's interests affect policy formation. Each theory places emphasis on various means of investigation: and therefore, provide a unique look into economic policy response. As a result, I test these two non-institutional approaches against each other to identify which combination of characteristics best explain state response amongst similar economic crises. I argue that psychological prospect theory initially reveals when actors, both politicians and citizens, recognize and legitimize the need for risk taking and launching of policy response. Prospect theory does not, however, explain how an actor's political interests shape economic policy response. Rather this is the strength of the baseline rational choice approach. I incorporate the ideational analysis, which serves as a balance to the political interest formation arguments presented by rational choice. The strength of the ideational analysis is found in situations of path dependency and in its ability to identify at specific time periods what actors perceived the problem of the economic crisis to be, and thus the various policy responses that resulted at different stages of the crisis.

The Baseline Rational Choice Approach

The rational choice (RC) approach uses micro level cost-benefit analysis and claims that actors use rational pluralist interest formations in order to maximize utility (Grindle, 2000: 23).¹ To truly define one's interests a person takes rational and predictable anticipations of other individual's interests, which are shaped and limited by institutions (Pierson, 2000: 251). Thus,

institutions serve as ‘coordinated mechanisms’ (Thelen, 1999: 369). Also in line with economic theory, is the belief in decreasing marginal utility, which claims that with each increase in utility, the value gained relatively diminishes (Weyland, 2002:39). “This implies universal risk aversion” (Weyland, 2002: 39), which argues that an individual that finds themselves in a crisis, no matter how badly affected, assigns the same amount of ‘risk propensity’ that is uniformly applied to the type and degree of policy response (Weyland, 2002:38).

The RC approach best provides an analysis of institutional creation and continuation (path dependency) (Gorges, 2001: 140).² RC shows how an actors interests shape the type of policy response. Two example of this will be shown in this paper. The first case is how the political utility (reelection goals) of President Roosevelt shaped the economic relief of the New Deal during the Great Depression. In the second case RC analysis will also argue that Japan’s LDP party limited their respective policy response in the economic crisis in the early 1990s to maintain their status as the political hegemonic power. In both cases policy response of the government was shaped by political and economic factors.³

Prospect Theory Approach

The psychological prospect theory (PT) argues that cost benefit analysis cannot truly provide actors with the tools needed to always act in their best interests.⁴ In the same vein, PT offers an alternative to RC’s belief of universal risk aversion that is rooted in cognitive psychology. PT analyzes human risk taking that “...provides an individual –level base for predicting that ongoing deterioration eventually triggers efforts at reform and involvement” (Weyland, 2008: 286). PT allows one to determine whether or not, at different time periods, the various parties involved feel the need for policy response, which drastically affects whether any response will occur.⁵

More specifically, PT “draws on situational character – risk seeking in the domain of losses vs. risk aversion in the domain of gains” (Weyland, 2002: 5). Before a crisis is understood, admitted, or occurs, prospect theory claims that risk aversion dominates individual’s policy response decisions (domain of gains) and institutions are often maintained (path dependency). Two examples of risk aversion are provided in this paper as during the Great Depression President Herbert Hoover was placed in the domain of gains from 1929 to 1932, while the American population was already in the domain of losses. Here, even though the American citizen was willing to take on risks through new governmental policies, Hoover did not realize the need to substantially act until it was too late. A similar outcome occurred in Japan during the 1990s. In this case, however, the LDP party realized its position in the domain of losses, yet, at the same time, the Japanese citizenry was still in the domain of gains. As a result, path dependency occurred, as citizens did not legitimize risk taking through new policy responses.

On the contrary when both the government and the citizenry realize the severity of a crisis, risk taking dominates, and policy response occurs as both set of actors are placed in the domain of losses (Weyland, 2002: 41). For the greatest risk and policy change to occur the realization in the domain of losses must be coupled with a condition: a new political leader who is not handcuffed by political pressure from previous incumbents (Weyland, 2002: 50).⁶ By using Prospect Theory as opposed to RC there is ‘decreasing marginal utility’ during risk aversion, but ‘decreasing marginal disutility’ in the domain of losses (Weyland, 2002: 39).

To properly establish if actors in each case are in the domain of gains or the domain of losses analysis must focus on “...objective economic conditions- specifically recent trends in nation’s well being-are most important...when the process began in each nation, how far it proceeded, and when it ran into crisis” (Weyland, 2002: 51).⁷ With this focus placed on the

breaking point of the “discontinuous and disproportionate nature of institutional change” (Weyland, 2002:6), the causal mechanisms that are non-existent in RC can be determined.

Ideational Approaches

Ideational (IT) analysis emphasizes the importance of ideas. This method reveals what actors identify the problem of the crisis to be and the respective ideas generated to respond to the crisis. Therefore, focus is placed on collective actions of individuals in terms of “labor, business, and the state” (Blyth, 2002: 49). IT reveals the variety of policy choices actors’ face, regardless of contextual argument in the domains of gains and losses identified by the PT, or the limitations placed by the formal institutions of RC. The IT approach believes that ideas, not institutions, are the only things that can reduce ‘Knightian uncertainty,’ or ‘unknown unknowns,’ which are “situations regarded by contemporary agents as unique events where the agents are unsure as to what their interests actually are, let alone to realize them... [Therefore], interests become something to be explained, rather than something with which do the explaining” (Blyth, 2002: 9). IT reveals that President Franklin Roosevelt’s New Deal was not primarily due to his political interests as he simultaneously implemented both demand and supply side policy responses in the New Deal because at the time it was not completely clear what the true problem of the crisis was.

The path dependency argument is one of the strengths of the IT approach as is shown as Mark Blyth argues ideas serve as ‘cognitive locks’ (Blyth, 2001: 4). He claims, “Once ideas have become institutionally embedded, policy-making becomes possible only in terms of these ideas. As such, ideas can produce outcomes independent of the agents who originally developed them...and is thus an ideational rather than an institutional approach” (Blyth, 2001: 4). The LDP’s response to the Japanese crisis will serve as the most solid evidence for path dependency.

The Main Argument

In this paper I test the non-institutional PT and IT approaches against one another with the institutionalist RC as my baseline comparison. Each of theories provides strengths and weaknesses when analyzing the domestic factors that shape policy responses to economic crises. I argue that the U.S. case first favors path dependency with president Hoover, which is strength of the IT analysis. Yet with the election of Roosevelt, only PT analysis can identify the psychology behind risk taking and new policy formation. The political interests that shaped the New Deal; the weakness of PT, is the strength of RC approach. The Japan case also provides a legitimate test of these theories, yet favors the IT approach as path dependency occurs. However, only with PT analysis can one understand psychologically in terms of risk why change did not occur. Once again, only RC shows how the political interests of the LDP partially caused the difference in the domain of losses and gains of the LDP and Japanese citizens. Thus, where one of these theories fails to control for other explanations, the others fill in and provide an important insight to various circumstances.

Method

These non-institutional approaches will be tested with two cases in two different time periods: 1) The Great Depression: The United States (U.S.) from the 1929 stock market crash to policy responses in first New Deal, and 2) Japan stock market and real estate crash in 1990 and the response of the Liberal Democratic Party up to 1993. This comparison allows for detailed examination of the “operation of specific causal factors at certain points in time and thus permits a tentative sequential isolation of these factors”, (Weyland, 2002: 49) in regard to policy response to economic crises. As far as economic crises go, these two cases are very similar as each experienced similar asset bubbles and manias. A bubble in these cases refer to an increase in the price of stock and, or real estate that eventually bursts. Bubbles often occur because of a

mania, which is summarized as irrational behavior on the part of individual actors to increase wealth (Kindleberger & Aliber, 2005: 29).

This paired comparison reveals the benefits and weaknesses of the core logic of RC, PT and IT. Only PT analysis can identify psychological placement of actors in the domain of losses or gains and thus the degree of risk-taking, legitimacy, and demand for policy response called for by the citizenry. For example, a high demand for change due to extreme risk acceptance by American citizens was the catalyst that allowed Roosevelt to react and launch the New Deal. However, in order to understand how political interests shaped the economic policies of the New Deal one must use RC analysis. Similarly, in the Japanese crisis only PT analysis can identify the placement of the LDP in the domain of losses and the citizens in the domain of gains. However, it is RC that reveals why political interests of the LDP lead to this difference of placement in said domains.

Similarly, only IT analysis exposes what actors at specific time periods perceived the problem of the crisis to be and then identifies the respective problem solving process that followed. The IT approach reveals the ideational factors, such as socially embedded viewpoints of Japanese society, which further explains why institutional change and policy response did not occur (path dependency), beyond the initial psychological placements of domains by PT, and also with more skepticism than RC's view of actor's interests. As a result it is essential to understand the strengths and weaknesses of the aforementioned theories, and combine the qualities of these approaches to truly understand domestic policy response.

Cases Analyses

In this section of the paper, I apply both PT and IT analysis to the two cases, and where necessary RC. The goal of my PT analysis is to identify the breaking points that brought forth

policy response or institutional change: the causal mechanism of legitimacy (Weyland, 2008: 285). This will be done first by placing state actors (politicians) and then citizens (voters) in the domain of losses or gains to determine if risk taking to create new policy response is legitimate. If policy response or institutional change does not occur, PT will provide arguments that show why asymmetries between actors resulted in different domain of gain or losses. Next, to further add to PT analysis, RC shows how political interests shape economic policies, which adds insight as to why different actors were in different domains (Weyland, 2002: 31-32). With my IT analysis, I reveal the ideational thought process that led to respective policy response. Oftentimes, it provides further insight into how ideas serve as ‘cognitive locks’, a path dependency argument (Blyth, 2001: 4). Conclusions will then be drawn on the pros and cons of each analysis.

Prospect Theory Analysis of the Great Depression: The United States

During the decade prior to the Great Depression, the U.S. witnessed technical innovations that allowed for unheard of levels of personal wealth-creation. This increase, compounded by the relative length of the bubble expansion, resulted in non-rational behavior by the common person (mania) (Kindelberger & Aliber, 2005: 29). When the stock market crashed in 1929, government responses were limited to weak efforts from city or state officials. The first federal effort to intervene was in early 1932, with the establishment of the Reconstruction Finance Corporation (RFC) (Couch & Shughart, 1998: 70-71). During this time period, Herbert Hoover was the sitting president, and as history shows he expended very little federal political capital to address the growing depression. Even when Hoover had tools available, such as the Emergency Relief Act in the summer of 1932 he only distributed less than 1/3rd of the funds allocated to the Act (Shannon, 1960: 35). “Not until the summer of 1932, after three winters of depression, did he consent to any federal relief action” (Shannon, 1960: 35). This transition from local and state

level to federal action represents the stark transition from the executive placement from the domain of gains to the domain of losses as he implemented the Emergency Relief Act to lend money to state banks. PT claims, this anemic response was because Hoover's party controlled the White House for the past 12 years, therefore the condition of an unrestricted new incumbent was not met; as from 1921 to 1933, United States Republicans controlled the White House.

The next question of importance is what case specific factors could have triggered this transition of actors from the domain of gains to the domain of losses. A common measure of a nation's well being is monitoring the trend in corporate income tax receipts (Weyland, 2002: 51). This is especially relevant in this case, as the goal of the RFC was to restore business confidence; hence there should have been a corresponding growth in profits resulting in more income tax payments. As a base line, in 1929 the IRS collected \$2.9 billion in corporate income taxes, which then grew to \$3.1 billion the following year. This is a trend that appears to follow the path argued by Kindelberger that in the beginning of a crisis, "taxes and interest on loans...continue without interruption" (Kindelberger & Aliber, 2005: 188). In 1931, tax revenue began its downward plunge reaching a Great Depression era low of \$1.5 billion, for more than a 50 percent drop from the 1930 high point (Historical Statistics of the United States).

In and of itself, corporate taxes alone are not a solid measure of a nation's overall well being as the drop in collections could be explained away as being caused by other factors, such as changes in tax laws. Consequently, placement is brought more into focus when unemployment levels are considered. In March of 1930, unemployment levels in the U.S. had reached around 3.5 million and then more than doubled one year later to near 8 million. Additionally, for the year of 1932, estimates have unemployment up to 12.5 million to 16 million; a further 50+ percent year-on-year increase that places over 25 percent of the labor force unemployed. At this

point, almost every family in the country was affected either directly via being unemployed or by facing extreme daily economical conditions. Even the 75 percent that did keep their job were located in the domain of losses well before 1932 due to a decrease of weekly that decreased from \$28.50 in 1929 to \$22.64 in 1931, which on its own is a 20 percent reduction. Additionally, this weekly earnings total income shrunk more, as the workweek began to be restricted from a 48-hour to 40 hours (Shannon, 1960: 6-7).

The increase in unemployment levels led to increases in foreclosures. The negative impact that any foreclosure has to the direct parties involved is somewhat intuitive. However, there was also a negative leveraging impact to the rest of the local community as each foreclosure further impacted the already overall limited availability of money to help correct the economic slide due to the inability to collect taxes. This occurred as almost 90 percent of any given local government funding at that time was obtained via real estate taxes (Shannon, 1960: 37). As a further indication of the importance of the real estate market during this time period, Kindleberger argues it was more relevant to the nation's well being than the fact that stockholders lost \$74 billion in stocks by 1932 (Shannon, 1960: 74). Vindication of Kindleberger's opinion also comes from others that have opined that it was defaulting real estate loans that were the catalyst for some 4,800 bank failures for the period of 1930 to 1933 (Kindleberger & Aliber, 2005: 118). Thus, the amount of money lost in the stock market combined with unemployment, decrease in earnings and hours worked, mortgage defaults, decreases in local tax returns, as well as decreases in federal corporate tax revenue, along with other factors beyond the scope of this paper, first placed American citizens squarely in the domain of losses and then eventually encapsulated President Hoover into this domain.

In 1933 there was a change of the institutional guard, as Democratic President Franklin Roosevelt was voted into office. Since Republicans, not Democrats had dominated the presidency and institutional policymaking, Roosevelt was not politically pressured or limited by his party, as was the case of the LDP in Japan. He did not need to worry about hurting the hand that was feeding him. “Thus, the intersection of two conditions- the assumption of power by a new leader and the eruption of a severe problem that put this leader in the domain of losses- is crucial for the initiation of drastic adjustment”(Weyland, 2002: 5). Roosevelt was able to implement the launching of the first New Deal in March of 1933, due to the high demand from the citizenry for action. As was written in December of 1933, “It was Mr. Roosevelt who rode the whirlwind and have a sufficient discernment to realize his tremendous majority was a mandate to do something-no matter what-and do it quickly...the average American with no program of his own has been ready to support anything that seemed to offer relief”(Shannon, 1960: 129).

Rational Choice Political Interest Arguments

The next question is why specific New Deal policy responses were implemented. PT analysis explains that the citizens of the United States would have supported any change that appeared to benefit their situation, even if it was not equally distributed. RC analysis best reveals that while a policy response goal is to maximize an economic objective, it is often influenced by political interests in order to successfully implement the targeted change(s) (Grindle, 2000: 23). At its core, RC theory assumes that politicians are presupposed to want to gain more power and remain in office (Grindle, 2000: 21). With this assumption it is argued that Roosevelt’s New Deal was not solely created to help those in need of economic aid, rather more importantly as a tool for political gain (Couch & Shughart, 1998: 33).

RC claims that political interest shaped policy response in Roosevelt's first New Deal agencies such as the Agriculture Adjustment Administration (AAA), the Civil Works Administration (CWA) and the Federal Emergency Relief Administration (FERA). These three federal agencies are prime examples of how New Deal actions could be construed to have been designed to not only fill a perceived economic need, but with the added benefit of obtaining enduring favors from voters. In fact, the 'marketing' of and the actual implementation of the goods and services that these new agencies offered, is recognized with creating a swing of black votes from the Republican Party to the Democratic Party, which in turn is credited with allowing for the successful reelection of the Roosevelt administration (Couch & Shughart, 1998: 33).

One of the key objectives of the AAA was to reduce the amount of agricultural products being grown. Through the AAA, the government could influence actions in order to decrease the supply of a product while also controlling price levels. AAA had three sections (Titles) at its disposal to achieve its end goal. Title I allowed for controlling the amount of acreage being farmed, Title II covered expanding the Emergency Farm Mortgage Act, and Title III was to control inflation (Couch and Shughart, 1998: 46). By managing these three areas, the controlling political party could reap rewards to selected groups. As one would suspect, the least organized and most economically disadvantaged 'rural tenants', which were also the least likely to vote, received almost no benefit (Couch & Shughart, 1998: 50-53). As an indication to the level that the reward-for-votes appears to have been, there were allegations concerning the management of rewards based upon the need to address and maximize the 1936 Electoral College as "agricultural appropriations were distributed in ways that provided more help for states supporting FDR's presidential aspirations than for those whose economies had been devastated by the farm crisis" (Couch and Shughart, 1998: 194).

The next policy response worth noting is the temporary program called the CWA, which designed and paid for make-work projects such as building roads, bridges, dams, and government building. Through the CWA, the unemployed labor force was put to work creating these public assets at the same time the workers were also stimulating the economy with their new found pay-roll checks (Couch and Shughart, 1998: 92-93). However, “many congressmen objected to the fact that eleven states received 57 percent of the total spent by CWA” (Couch and Shughart, 1998: 136). The extent of this effort was significant, with the Federal Government disbursing more than \$900,000,000 in 1933-4, which was a large amount of money in 1930’s dollars (Couch and Shughart, 1998: 93). Although monies were distributed based on ‘a need base model’ “it is also true however, that economic need was not the administration’s only top priority: for better or worse, politics also seems to have played a significant role in determining which states benefited from the CWA’s attempts to prime the pump” (Couch and Shughart, 1998: 198).

FERA is the last institution that is analyzed with RC. FERA was created to help in emergency situations due to the sheer number of voters who were unemployed, in juxtaposition with the inability of the state and local governments to provide emergency related relief due to reduced local tax revenues. FERA was granted \$500,000,000 of initial funding that was to be used along with the affected state(s) to create a federal and local response in a manner that could leverage the total amount of cash available in an emergency through a matching basis’ formula. While an admirable goal, it becomes quickly evident that the poorer, less populated states were unable to take advantage of the matching opportunity. Eventually, the political benefits of FERA were capitalized when it was ordered to make ‘need base funding’ in tandem with the CWA discussed above. However, “It is nevertheless true that the marginal effect of popular political support for FDR in 1932 is of the same magnitude as the depression’s impact on personal income”

(Couch and Shughart, 1998: 200). In sum, as Couch and Shughart posit a variety of the New Deal policies show that as RC claims, politics did in fact shape the above mentioned policy formations (Couch and Shughart, 1998: 89-90).

The Ideational Approach Analysis of the Great Depression: The United States

The strength of the IT approach is that it identifies what government actors viewed as the perceived problem of the economic crisis and places that into context with the policy response. This allows the analysis to be extended in a new way that neither PT nor RC primarily emphasizes; it deepens and in some cases provides alternative understanding to the arguments above.

Before and after the stock market crash in 1929, President Hoover administered economic policies based on the erstwhile belief that the depression was just another natural downturn in the business cycle. He viewed “the economic collapse as being almost biblically ordained. In this view, the Great Depression was a necessary consequence of the economy’s rapid expansion during the roaring twenties” (Couch and Shughart, 1998: 12-13). In December 1931, the remedy to the perceived problem was justified in the name of ‘sound finance’ in order to balance the budget and minimize deficits with a \$900 million tax increase (Blyth, 2002: 51-53). In part, Hoover’s inaction to address the growing adverse economic situation with increase in federal spending could be credited to Mark Blyth’s argument of ‘cognitive locks’. Prior to the New Deal, the federal government considered its two most important functions as first, the defense of the country and second, maintaining a balanced federal budget, including paying off any prior debt. As an indication of how embedded the ‘balanced budget’ was in the mindset of the day, before 1930, the federal government ran surpluses in two years out of every three years (Raum, 2009).

In January 22, 1932, the previous idea that a depression was just part of a cycle, was combined with the ‘administered price thesis’, which brought forth the previously mentioned Reconstruction Finance Corporation (RFC) as Hoover perceived that ‘voluntary cartelization’ through increases in the availability of credit and funds would restore business finance. At this time, the problem was still viewed to be a ‘supply side’ problem, and thus, the belief of the heads of state was that monopolies needed to become more efficient. After Hoover combined these two ideas, citizens voted Roosevelt into office in 1932 as the crisis deepened (Blyth, 2002: 50-53).

With Roosevelt in office in 1933, came a movement away from Hoover’s ‘sound finance’ towards a two-pronged strategy that continued the ‘administered price thesis,’ but brought forth new ideas better known as ‘underconsumption’ that blamed the crisis on consumer confidence and expectations (Couch and Shughart, 1998: 14). Therefore, in the name of the administered price theses, Roosevelt continued the RFC, which was originally designed by Hoover as well as created the Agriculture Adjustment Act (AAA). At the same time with the ‘underconsumption’ ideology, Roosevelt also “facilitated increased public works spending through a host of new state relief agencies. Such spending, it was hoped, would stabilize purchasing power and help cement cartel arrangements” (Blyth, 2002: 56).

Similarly to the RFC, Roosevelt also placed emphasis on the recovery of Agriculture through the Agricultural Adjustment Act (AAA), which came in the name of administered price thesis. However, as it turned out there were two major differences, as cartelization was not an option in the agricultural sector since the goal was to decrease production, not make it more efficient. The IT approach counters the RC claim that the AAA was used to further Roosevelt’s political interests, because in time of economic crisis one’s true interests are not fully understood due to Knightian uncertainty, or ‘unknown unknowns’. The government spent drastic amounts of

money to support the agricultural sector, but this was only done because they government did not understand its best interests. Only an analysis of ideas reveals that agricultural labor “could neither cartelize supply nor provide the mass consumption base necessary to stimulate recovery” (Blyth, 2002: 61). Therefore, if Roosevelt did know his best interests he would have not attempted to stimulate the agriculture sector, as it could not solve the problem of the crisis.

During this same time period The Department of Labor, with the help of Congress and programs such as the Civil Works Administration (CWA) and the Federal Emergency Relief Administration (FERA), both directly and indirectly started to organize labor that eventual lead to the state coalition by priming the pump of the economy. These agencies implementation were fueled by the ‘underconsumption’ ideology and claimed that demand, not supply, as the administered price thesis claimed, was the problem that needed to be dealt with. This is highlighted as “FERA [as well as CWA] differed from previous relief efforts in that aid was given in the form of cash” (Couch and Shughart, 1998: 89). Accordingly, these efforts were combined with “A small pro-labor constituency headed by New York Senator Robert Wagner pioneered legislation that transformed the institutional position of labor” (Blyth, 2002: 63). It was this incorporation of the ‘underconsumption’ began to weaken the states’ frail relationship with business, which at the time was relatively organized (Blyth, 2002: 58).

The fact that these two ideological approaches were used at relatively the same time reconfirms what PT analysis has previously shown; the American people would accept almost any form of policy response. Therefore, at the time not fully knowing which idea was best, Roosevelt was able to use both ‘administered price thesis’, which viewed the Depression as a supply side problem, and underconsumption’ ideas that viewed the crisis as a demand side problem to create new policy responses in multiple sectors. He threw out a large net, and hoped

to catch a vast and positive response somewhere. It just so happened that FERA and CWA directly and indirectly resulted in coalitions with industrial labor with the eventual creation of the social security and the Wagner acts (Blyth, 2002: 64).

Prospect Theory Analysis of the 1989 Asset Bubble: Japan

I argue that Japan's conservative Liberal Democratic Party (LDP), which was in power from 1955 to 1993, was in the domain of gains for the bulk of this 38-year run, however, the party's position changed to the domain of losses in the late 1980's. There are multiple reasons for this transfer from risk aversion to risk acceptance.

First, the LDP became involved in a number of high profile scandals that tarnished its reputation in the eyes of the public, as the damage reached all the way up to and resulted in the resignation of the prime minister. All levels of the LDP were affected including televised arrests of members of the LDP while its parliament was holding sessions (Pempel, 1998: 140).

Compounding the LDP's very visible internal dilemmas was the double hit of the stock market and real estate crash in Japan at the start of 1990. Real estate was the catalyst driving the economy due to its banking laws, banks' holdings of real estate, as well as capital gains laws regarding real estate sales. This caused the market value of land grew to astronomical levels. During the 1980's, Japan's real estate prices increased by an astounding 900 percent and in total, the market value of land on the small island of Japan was at one point twice that of the multiple times larger United States (Kindelberger & Aliber, 2005: 119, 146). This has been labeled the "mother of all asset price bubbles" (Kindelberger & Aliber, 2005: 279).

During the 1980's bank customers used land as collateral, and as land values increased banks could afford to make more loans and, therefore, generate more profits. Japanese banks also had direct ownership in major real estate holdings and/or owned other separate corporate

stocks, which in many cases had further significant real estate positions (Kindelberger & Aliber, 2005: 120). As land values increased at a pace of 30 percent in any given year the banks were the natural benefactors and earned world leading financial results and record price-to-earnings ratios for its own stock (Kindelberger & Aliber, 2005: 36-37). Nevertheless, when that asset bubble burst along with the stock market crash from ¥ 38,915 at its high on the last day of 1989, to ¥ 14,820 by 1992, the combined impact had a massive negative leveraging shock and consequences to the Japanese banks, which in turn would touch all segments of the Japanese economy (Pempel, 1998: 201).

As the ruling party for the last three decades, the economic catastrophe could be blamed on the LDP, and thus, when combined with the corruption scandals placed the LDP in to the domain of losses. However, unlike the New Deal the Japanese citizens were located in the domain of gains. To understand how this is the case, PT analysis must be combined with RC to grasp the political interests and strategies of the LDP, which further explains why Japanese citizens were against risk taking and thus new policy responses.

Rational Choice Political Interest Arguments

Economic policy response was limited because the LDP relied on the votes of agriculture, business and thus members of the Ministry of Finance (MOF) and, in turn, the major Japanese banks. For example, in order to maintain power it was essential that the LDP not upset the “descent from heaven” (Svensson, Mabuchi, & Kamikawa, 2006: 64), which was the process where senior staff of the MOF or Bank of Japan were given high level positions with other private banks upon retirement. The LDP also had to negotiate any tax or financial matters with the MOF. The apparent power of the MOF is highlighted by action in late 1992 when the LDP proposed a plan for government assistance in regard to the bad loan problem, however the MOF

pushed for only support of the Jusen companies that had made real estate loans (Svensson, Mabuchi, & Kamikawa, 2006: 55). This further shows PT's claim that the LDP's was aware of its position in the domain of losses.

The relationships between the LDP and its voters resulted in a tax system that ultimately became part of the LDP's roadblock to finding a favorable policy response to address the economic crises it faced in the 1990s. During this time salary earnings were carrying a disproportionate amount of the tax load. However, it was understood that new tax policies would negatively affect the LDP's main political interest groups. For example, minimal tax restructures caused the LDP to lose agricultural support in 1989 (Pempel: 1998: 203). Therefore, with the LDP having a limited number of arrows left in its quiver, with business as its remaining strong political supporter and only weak support from the populous, it pushed for continued increases in government deficits via the use of bonds (Kato & Rothstein, 2006: 76). As the LDP had little to offer in the way of positive action, it took the path of not admitting the true severity of the crisis in order to preserve their individual reputations and political careers (Svensson, Mabuchi, & Kamikawa, 2006: 55-57). However, this strategy failed in 1993 and the LDP lost the support of the business sector due to controversies over unethical practices such as political bribes (Pempel, 1998: 140-141).

The LDP benefited for the better part of the last three to five years of its reign in power before 1993 from this natural process, as it was able to put off making controversial decisions that were necessary to help adjust the country to its degrading economic health (Pempel, 1998: 197). The action(s) that may have led to a quicker positive resolution of the economy had the negative impact of threatening the power base of the LDP, which in turn affected and minimized the respective economic policy response.

Prospect Theory Japan: Citizens in the Domain of Gains

As opposed to the LDP and its knowledge and insights into the economic crisis that Japan was facing, the lack of accurate information being passed on to the citizens in the country reinforced their otherwise overall positive view of their economic position and outlook for a favorable economic future. As such, in the early 1990s the average Japanese citizen was in the domain of gains even though the asset bubble started to deflate at the beginning of the decade.

Another influence of the citizens' irrational exuberance with the economy stems from the "six bear market rallies" (Kindelberger & Aliber, 2005: 32) that closely followed the crash of 1/1/90. These mini-rallies would push up stocks by some 20 percent on any given day and allowed investors to ignore the overall downward trend and even reinforced increases in the purchase of stocks, as they appeared cheap (Kindelberger & Aliber, 2005: 32). At the same time, it was accepted that while housing prices were on the decline, the view was that this burden was falling disproportionately to the financial institutions. Therefore, the populous comforted themselves that they were less damaged than the banks and, therefore, in a better actual position. When one looks at the income and outlay accounts for the household sector as a percentage of GNP, it was not until 1991 that the 'private residential investment' category begins to show a negative position (Matsuoka & Rose, 1994: 4). This index reinforces that the common person could be unaware of the adverse economic situation. This is further backed by the continued low levels of unemployment, which were in fact steadily declining from a 'high' of under 3 percent in 1986 to near 2.25 percent in 1992 (Matsuoka & Rose, 1994: 111). As these are remarkably low levels of unemployment for any other country, this again further masked the oncoming crisis. Continuing on the employment issue, in the mid-1980s, Japanese employees benefited from legislation that provided better working conditions; in particular, reduced demands for actual

hours worked. This was dramatic and it increased by up to 400 hours the amount of leisure time per year that an employee could enjoy. It is important to add that this was a very positive development in the minds of workers and not viewed as “laid off” time as that which occurred during the Great Depression in the U.S (Pempel, 1998: 153).

Therefore, through the lens of the prospect theory with help of RC analysis, the LDP’s economic policy response to the crisis was limited politically to deficit financing with bonds and make work construction projects (Kato & Rothstein, 2006: 76). While the LDP realized the need for aggressive policy response as early as August of 1992, RC shows that their real interests were to stay in office. Entertaining the interests of their political support, keeping the citizens in the domain of gains, and thus not changing their policy response accomplished this goal. In 1993 new electoral configurations brought forth a change in parliamentary politics. Therefore, also as PT claims policy response was limited as the necessary condition of new incumbent party was not meet.

Ideational Approach

Japan serves as another example of Robert Wade’s principle of ‘paradigm maintenance’ and a situation that Blyth would identify as ‘path dependent cognitive locks’ that were trapped amongst past performance measures (Blyth, 2002: 238 & Cargill, 2004: 14). Key to the Japanese case was the central philosophies of economic development policies post the WWII occupation period. As T.J Pempel shows, the first philosophy was that the ongoing government would have a heavy hand in economic planning. Second, was that the government would remain small, maintain fiscal responsibility, and endorse a weak yen in order to promote exports (Pempel, 1998: 103).

The first requirement was the creation of the ‘iron-triangle’, which was a system that included the sharing of ideas and proposals between senior government agencies, the LDP, and business leaders (Pempel, 1998: 103). In making economic decisions, ultimately all parties rallied together under a common goal of ‘economic betterment’ for all (Pempel, 1998: 110). Of interest is that in order for this guiding principle to be accepted, the members of the iron triangle had to recognize the premise that the Japanese citizen was no longer there to suffer for the common good of the country. This was understood as a ‘policy with no brought the citizenry to unite in a common cause. Throughout the first 35-years of LDP political dominance, its overall ideological positions yielded continuous economic growth. Given the success of Japan’s previous economic institutions and policies, the embedded ideas held by decision makers were that they should not fix something that was not broken and that Japan’s successful institutions of the past would not be affected (Pempel, 1998: 109).

Holding true to the idea that government intervention should be restrained, was a key component to the extremely limited social welfare programs provided to the Japanese citizens. Programs that were offered paled in comparison to the benefits that were provided by private enterprises (Pempel, 1998: 150). While this would seem to contradict the goal that citizens should not suffer, trumping that goal was that Japanese policymakers focused on government spending and the necessity of a small government. At the same time, ideational trends that defined the Japanese people were being established. For example, there was the idea that “Japan was special, [which] was manifested by the large number of articles and books published in Japan, the United States, and elsewhere during the 1980s praising ‘Japanese Management,’ ‘Japanese Industrial Policy,’ and ‘Japanese financial and monetary policy’ (Cargill, 2004: 16).

The end result was that the average person began to feel economic “invulnerability” (Pempel, 1998: 201).

In 1989, when the economic crisis first started to take form as stock prices declined and even when the economic crisis was realized, the LDP focused on staying true to its founding principles. However, “as ideological lines blurred between government and opposition, the LDP thus lost much of its cohesiveness. Ideological and policy differences between it and the other parties became blurred” (Pempel, 1998: 200). Even though some politicians wanted to take action, including the unthinkable of raising taxes, the overall accepted idea was to keep government small and ride it out. Ironically, while the government felt its role was to maintain fiscal responsibility, the citizens’ view of the Japanese crisis was that they expected the government to protect them from any loss (Kindleberger & Alibert, 2005: 5).

Conclusions

In this paper I have shown how PT, RC and IT analyses identify the domestic characteristics that explain a states economic policy response in two similar crises. PT theory provided a psychological approach that identified actors in the domain of losses or gains and the respective amount of risk said actors were willing to accept and legitimize in regard to policy response. Thus, PT, contrary to the RC belief, has proven that there was no such thing as universal risk aversion, which helps identify the causal mechanism that drove policy response. In the U.S. case, PT analysis revealed that at first, citizens demanded policy response as they were in the domain of losses, yet Hoover could not supply an acceptable response as he was placed in the domain of gains. Even when he transitioned into the domain of losses and attempted to use federal monies to alleviate the crisis, it was too little too late, and he was voted out of office. Only with the arrival of the new incumbent President Roosevelt did change occur, which was

politically and economically motivated as well as accepted by the citizenry. PT also explained the launching of the New Deal, but not exactly how the New Deal was implemented. Here, the baseline RC additive, which argued that rational behavior leads to utility maximization of interests by all actors involved at all times, showed how political interests shaped the New Deal's economic policy responses of the AAA as well as CWA and FERA.

IT arguments showed the importance of ideas, which reduce Knightian uncertainty, 'unknown, unknowns'. By identifying different ideas held at various times we can further understand policy change which explains actor's interests rather than take them as given. In the U.S. case the IT analysis further explained why Hoover's policy was limited; a path dependency argument based upon his long-held views of the role of government. IT also, provided a balance to the RC claim of political interests. In an economic crisis a leader can more likely than not identify who his or her 'friends' were in the past through voting results, and whom you want to include on your future circle. Thus, RC is not completely wrong in its claim that political interests shaped the New Deal policies. However, IT analysis shows that the perceived problem of the crisis and thus interests were not as clear-cut as RC makes it seem. As PT tells us, at the time Roosevelt happened to inherit a situation where almost any response was acceptable and that is why he used multiple types of responses; the AAA in order to focus on supply in the name of the 'administered price thesis', while FERA and CWA were implemented in the name of 'underconsumption' with a focus on demand. Only with time was it understood that this ideology would lead to a coalition with labor. Roosevelt did not use a handgun to respond to the crisis, he used multiple shotguns.

In Japan, PT analysis showed that the LDP was in the domain of losses, and the citizenry was in the domain of gains. It explains the cognitive psychology that resulted in minimal risk

taking and policy response. However, it was the RC approach that reveals the LDP's true interests, as most importantly, they wanted to remain in power. Therefore, they hid information from the public, which resulted in asymmetries of information, and amongst other things, made the voters unaware of the need for policy response due to their respective placement in the domain of gains. Thus, legitimacy of a new policy response was not present.

In the same vein, IT adds to the PT argument and shows that ideas serve as cognitive locks. Even though there were other factors which the PT as well as RC identified as restrictions to the LDP, they were also unable to implement change because both members of the LDP and citizenry believed the trend was their friend, that they were 'special', and that Japan was untouchable. So, even if the LDP made a public outcry for serious change, the people may not have accepted it as they believed Japan was 'untouchable'.

These three theories each have their respective strengths and weaknesses. Individually, PT, RC nor IT are the end all be all, as for example they only focus on the domestic characteristics that shape policy response. However, these specific attributes only become evident when combining these three theories and others like it to obtain a proper and in depth analysis through their different respective assumptions and emphases. By understanding these specific cases of policy response in similar crises and how said theories interoperate response, we can use them to provide guides to predict how states will promote policy responses to crises. We can further test the validity of these combined theories and attempt to explain policy responses in current economic crises. It may help predict what actors are predisposed to do. Conversely, if one wants to promote a different course of action, it allows an understanding of what arguments your opponent will use and how to prepare counter- arguments.

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¹ Utility, in this sense, is better understood as political goals of power, economic wealth, or wellbeing (Grindle, 2000: 21).

² Consequently, emphasis is placed on the institutional context of incentive structures rather than the study of state structures or the length and severity of the crisis (Thelen, 1999: 370).

³ This is known as a functionalist argument “which attributes large outcomes to large causes (Pierson, 2000: 251).

⁴ Contrary to RC the PT approach holds that individual actors are bounded in their ability to maximize utility or act completely rational due to information asymmetries and limited cognitive abilities (Weyland, 2008: 286).

⁵ This is referred to as the level of legitimacy assigned by state actors (politicians and citizens) to the possibility of an economic policy response (Weyland, 2002: 38).

⁶ This scenario eventually occurred in the U.S. during the Great Depression as not until the election of President Roosevelt did substantial policy response and institutional creations occur as both parties were in the domain of losses.

⁷ Politician’s respective position can be determined with indicators such as “large fiscal deficits, inability to collect taxes, high levels of social protest, low levels of voter mobilization” (Grindle, 2000: 9). Legitimacy of citizens is measured with indicators of unemployment rates, hourly wages, mortgage foreclosures, protests and, or riots (Weyland, 2002: 53, 279).