Barriers to U.S. Service Trade in Japan

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PREFACE

This report synthesizes and integrates the findings of, and draws policy conclusions from, case-study research on barriers to U.S. trade in Japan in several service industries. The research strategy employed the following elements: (1) interviews, primarily in Japan, with 30 companies in six service industries; (2) interviews with Japanese government officials in agencies and ministries with regulatory responsibilities over the case-study sectors; (3) discussions with U.S. government trade officials; (4) review of trade journals and scholarly studies; and (5) collection and analyses of independent data. The case studies concerned banking and securities, insurance, law, accounting, data communications, and advertising.

A companion to this report by the same authors, *Case Studies of U.S. Service Trade in Japan* (N-2169), provides a fuller development of the cases for the interested reader. The case studies and analyses use information current through June 1984. Because of rapid changes in several of the sectors examined, the detailed exposition is expected to become dated quickly. The authors have attempted to concentrate on fundamental issues to maintain long-term relevance.

The report is directed at government officials, business executives, and scholars with a policy interest in U.S.-Japan trade. The study on which the report is based is part of The Rand Corporation's research program in international economic policy.

SUMMARY

This report summarizes findings drawn from case studies of six industries involved in service trade between the United States and Japan. The research project identified the sources of barriers to industries that service businesses rather than final consumers. Information for the study was gathered from several sources: interviews with business, government, and research people in both the United States and Japan, but mainly the latter; trade journals and newspapers; and scholarly journals and books.

To a great extent, over the past ten years U.S. firms have been granted "national treatment" (treated like domestic companies) in Japan; the few lingering exceptions have been mainly in the professions. The most important barrier we observed is general regulation of specific industries. Regulation was found to limit entry into the industry, restrict the range of products, control prices, retard innovation, and validate cartelization. In all but advertising, industry regulation is the chief impediment to trade. Rapid deregulation is taking place now in telecommunications and finance because of powerful domestic forces for change. International efforts to reduce trade barriers arising from domestic regulation have a better chance of succeeding when coupled with domestic demand for deregulation. The ability of outsiders to initiate deregulation is limited in the absence of widespread domestic support.

Based on the case studies and on our review of the literature, we reached the following conclusions:

- The most important barriers to trade in services arise from government regulation of business.
- The U.S. government is more likely to be successful in moving Japan toward deregulation and reducing trade barriers when there are strong domestic Japanese forces for change.
- Even with internal and external pressure for change, conflicts within and among Japanese agencies can lead to interminable delays and shelving of issues.
- To resolve internal conflicts, the Liberal Democratic Party (LDP) has gradually emerged as a central agent of change.
- High-level political involvement in trade issues by both sides can sometimes stimulate accommodation.

- Such episodic interventions are limited in time and scope; they must be accompanied by continuous and long-term interactions by government and business, which can influence events in an undramatic but cumulative manner.

When movement for change grows, opinions on the direction of change are not monolithic. Views are based on whether parties will be gainers or losers under alternative policies, and consensus is difficult. When disputes cannot be settled by the ministerial bureaucracies, they are likely to be shelved unless sufficient political interest is present, in which case the LDP leadership may adjudicate the dispute. LDP officials may therefore be key actors in the formulation of policy and influential recipients of the expression of American interests. However, most decisions are made in the ministries' bureaus; continuity of U.S. interests and attention is required at both the bureau and LDP levels. We recommend a mixed U.S. strategy of routine exchanges of information and views, combined with rarer political interventions.

ACKNOWLEDGMENTS

Our first debt is to the management and staff of the 30 companies that participated in interviews, granting us the benefit of their experience, knowledge, and ideas. Several Japanese government ministries also supported our research efforts with frank discussions of the complex issues facing them. This research could not have reached its present state without the cooperation and time of the many individuals who helped us in this way.

Edward Lincoln of the Brookings Institution, and formerly Vice President of the Japan Economic Institute, saved us from several errors of fact and interpretation in an earlier draft. Rand colleague Adele Palmer performed the same function in catching lapses in logical thinking and economic analysis. Hiroko Hara, a consultant to Rand, helped coordinate the interviews and assisted in the data gathering. Our research assistant, Joan Schwartz, compiled the industry files and records that constituted the bulk of our published sources. The Rand library and reference staff skillfully supported this activity by identifying and obtaining often obscure documents from several continents.

CONTENTS

PREFACE iii

SUMMARY v

ACKNOWLEDGMENTS vii

TABLES xi

Section

I. CONTEXT OF THE STUDY 1
- Increasing Government Focus on Services 1
- The Service Sector 2
- Possible Explanations of Impediments to U.S. Service Trade in Japan 3
- Research Approach 5

II. INDUSTRY CASE STUDIES 6
- Banking and Securities 7
- The Insurance Industry 12
- The Legal Profession 15
- The Accounting Profession 22
- Data Communications 28
- Advertising 35

III. RESEARCH CONCLUSIONS AND POLICY IMPLICATIONS 37
- Main Conclusions 37
- Domestic Regulation as a Barrier to Trade 37
- International Pressures and Domestic Deregulation . . . 41
- Interagency Policy Conflict 42
- LDP as Arbiter of Conflict 43
- Implications for Policy 45

BIBLIOGRAPHY 49

TABLES

1. Income and Foreign Experience by Age of Tokyo Attorneys, 1982 18
2. Income Comparisons of Attorneys and Selected Professions 20
3. Average Reported Incomes of Japanese CPAs 25

I. CONTEXT OF THE STUDY

INCREASING GOVERNMENT FOCUS ON SERVICES

Since the mid-1970s, the U.S. government has been paying more and more attention to international trade in services. It has raised the issue of barriers to trade in services in multilateral forums such as the General Agreement on Tariffs and Trade (GATT), and in bilateral discussions and formal negotiations with individual countries. The principal reasons for this attention are that U.S. trade in services has produced a growing surplus, the United States is presumed to have a comparative advantage in service trade, and impediments to service trade are believed to have grown through lack of attention, thereby reducing the volume of U.S. exports below their potential. In trade with Japan, for example, the United States ran a $2.5 billion surplus in service trade in 1982, whereas merchandise trade showed a deficit of $17 billion.[1]

Because the emphasis on service trade is so recent, understanding of trade problems in this sector is underdeveloped, especially when compared with merchandise trade, which has been at the center of international trade negotiations and analysis for more than 100 years. The government's growing involvement in service trade has increased its demand for facts, analysis, and understanding of this hitherto ignored subject. Its dealings with Japan have been clouded by the complexities of the internal structure and behavior of that country. U.S. trade negotiators and business people often describe their negotiations with the Japanese by saying that a "veil" clouds their view of the reality behind the negotiations. Often, the U.S. participants in negotiations possess only a partial understanding of the important actors and their motivations on the other side, the interactions among them, and the forces guiding their behavior.

This study attempts to pierce that veil by identifying and then describing barriers to trade in Japan that may exist in six service areas, by examining the sources of these barriers, and by integrating the

[1]U.S. Commerce Department, *Survey of Current Business*, "U.S. International Transactions, Third Quarter 1983," December 1983, Table 3—U.S. Merchandise Trade, p. 48; Table 10—U.S. International Transactions by Area, p. 61. Service trade is defined as the sum of the following accounts: travel, passenger fares, other transportation, fees and royalties from affiliated and unaffiliated foreigners, and other private services.

findings. To do this, we conducted case studies of six industries that deal primarily with other businesses: banking and securities, insurance, law, accounting, data communications, and advertising. We chose to emphasize business services because these services facilitate trade in other sectors and are likely to depend less on the peculiarities of national tastes or preferences than trade in the consumer sector.

THE SERVICE SECTOR

The service sector in the United States, as in most economically advanced countries, has grown steadily in the twentieth century; broadly defined, services now constitute 50 percent or more of the nation's economic activity. In 1983, services accounted for half the GNP, 40 percent of national income (29.5 percent, excluding government), and 74 percent of all workers (56 percent, excluding government).[2] Few of these services are traded in international markets. Such personal services as automobile repair and hair styling are produced and consumed locally. However, the types of services we consider here are produced by American-owned companies for sale in foreign markets.

The United States had a merchandise trade deficit of $36 billion in 1982 with all countries, but a surplus of $7.6 billion in services. The total value of service exports was more than $40 billion.[3] Japan, in contrast, has a very different composition of trade. In 1980, it had a $10 billion deficit in primary products, matched by a $9 billion surplus in manufactured goods. In services, Japan was in deficit by $11 billion. Because service trade figures are notoriously imprecise and very likely understated, actual U.S. service exports (and imports) are probably even higher than shown by the official figures.

Foreign operations of many U.S. service industries produce a substantial share of their total business. For example, foreign revenues of the "Big Eight" accounting firms were 39 percent of total revenues in 1977.[4] The share of foreign billings of the 83 largest advertising firms

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[2]In the national accounts framework, the broad definition of services comprises transportation and public utilities; wholesale and retail trade; finance, insurance, and real estate; "services" industries; and federal, state, and local government. U.S. Council of Economic Advisors, *Economic Report of the President*, 1984, Table B-6, "Gross national product by major type of product," p. 228; Table B-22, "Sources of personal income," p. 246; Table B-37, "Wage and salary workers in nonagricultural establishments," p. 263.

[3]U.S. Commerce Department, 1983.

[4]Economic Consulting Services, Inc., 1981, Table A-2, p. 72.

in 1980 was 37.5 percent.[5] In banking, over 20 percent of total U.S. bank assets in 1980 were held in foreign branches.[6] For some individual companies, of course, foreign business will be more important than average industry experience. The foreign revenues of the accounting firm of Price Waterhouse was 49 percent of their total, and the foreign advertising billings of Mc Cann Erickson added up to 76 percent of their total business. Thus, the foreign operations of these firms and industries are not an insignificant part of their activities.

Official concern with barriers to trade in services by the world's governments has not matched the level of detailed attention attracted by merchandise trade. A web of restraints and barriers have grown around services without the countervailing opposition that has so effectively reduced the impediments to merchandise trade since the end of World War II. It is reasonable to expect, therefore, that identifying and reducing the barriers to service trade will have an expanding effect, especially for U.S. exports, which have demonstrated their competitive potential.

POSSIBLE EXPLANATIONS OF IMPEDIMENTS TO U.S. SERVICE TRADE IN JAPAN

During the course of this study we considered several possible explanations or hypotheses about the sources of impediments in Japan to U.S. service trade. A motivating rationale for understanding these sources is that appropriate policies depend on the type of behavior that gives rise to them in the first place. Different explanations of the sources of behavior call for different policies.

Impediments may arise from predatory monopoly or cartel behavior, from local business practices (e.g., tight links among members of industrial groups), or from language problems and consumer preferences that diverge from one's own customary business culture. We considered these, but we focused instead on nonmarket impediments to trade, especially those barriers that may arise from government policies. Initially, we considered two kinds of government-generated barriers: rules and regulations specifically directed against foreign products or companies (e.g., foreign ownership limits on telecommunications companies); and "traditional" kinds of economic regulation controlling pricing, entry, and product marketing.[7] Eventually, however, we saw that

[5]Ibid., Table B-1, p. 82.

[6]Ibid., p. 98.

[7]Industry regulation has proceeded from various goals, including protection of the public from the adverse consequences of natural monopolies in such areas as telecom-

this categorization was inadequate. Specific antiforeign regulations were usually only one part of a broader web of industry regulation that placed numerous barriers before foreign business. Similarly, the industry monopolies and cartels that we observed (in insurance, for example) were creatures of government control and regulations. When government itself was not the regulatory agency, the law had given authority to nongovernment organizations (e.g., the bar associations) to regulate industries, with the sanctions of government in the background. Thus, many of our hypotheses collapsed empirically into the finding that general government regulation (or government's legal authority) lay behind most of the observed impediments to trade.

Using American experience as an analogy, we conjectured that regulatory agencies or supervisory ministries in Japan may act as agents for the very industries they are regulating to obtain (through state powers) benefits that the firms could not get by themselves. One such benefit would be the erection of barriers to foreign competition by such techniques as onerous rules, outright prohibitions, long delays over applications, or biased interpretation of regulations. If this were the true source of barriers, U.S. efforts at negotiating away a particular rule would not attack the real source of the barriers, which the regulatory bodies could reinstate through other mechanisms. Regulation could also reduce foreign opportunities by constraining foreign firms under the same regulatory web of controls that govern domestic firms. The policy that would be required to combat these types of barriers would be deregulation of domestic industry.

We also considered the possible effects of local culture and business practice as impediments to foreign firms that did not fully understand Japanese preferences or ways of doing business. The appropriate response to such problems would be for foreign firms to use local Japanese agents or partners who are better attuned to the nuances of local requirements. Another possibility that could be included under the rubric of "business practices" is the sometimes close ties within large Japanese business groups wherein members of the groups have first preference for business services. To the extent that such practices increase costs by limiting business possibilities, a policy that increased competition would stimulate high-cost firms to move toward efficiency and would open up business possibilities to suppliers outside the group, including foreign suppliers.

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munications, railroad transportation, and electricity generation; protection of consumers from companies that may become bankrupt and dissipate the wealth of their clients, as in banking and insurance regulation; and protection of the public from fraud arising from inaccurate financial information, as in accounting regulation.

RESEARCH APPROACH

To determine which of the above hypotheses (if any) is most consistent with actual behavior, or is more important than the others, we used a multipronged research strategy to probe for answers. Any single approach would be at best fragmentary and provide only a partial view of the subject. We therefore combined the following elements: (1) interviews primarily in Japan, but also in the United States, with American and Japanese firms in the various industries we studied; (2) interviews with Japanese government officials in the agencies and ministries with regulatory or supervisory responsibilities; (3) discussions with U.S. government trade officials; (4) review of trade journals; (5) literature review of scholarly studies; (6) discussions with university and other researchers, mainly in Japan; and (7) collection and analysis of data that could provide additional insight or an independent check on our other evidence.

We selected our cases for analysis on the basis of interest to U.S. government agencies, diversity of characteristics, and availability of information. We then conducted interviews with close to 30 companies spread over the six sectors of study; most of the interviewed companies were American, but a few were the Japanese agents of U.S. firms, and two of the interviewed companies were Japanese. With some companies, we held several interviews over a period of six to twelve months to test the stability of the situation and to identify changes. We interviewed at least two companies in each industry to check the perceptions of one with those of another company in the same field.

We held discussions with relevant Japanese government ministries in all the examined fields, including several bureaus in the Ministry of Finance (MOF), the Ministry for International Trade and Industry (MITI), the Ministry of Justice, the Japan Federation of Bar Associations, and a research institute associated with the Ministry of Posts and Telecommunications (MPT).

The trade press was useful in providing chronologies of events and some analysis. The academic literature, in contrast, was rather sparse in its treatment of trade in services as well as in the particular industries we studied.

Although our conclusions, by and large, are based on only six case studies and must be subjective, we believe that our general findings came through clearly. Still, the conclusions derive from only these cases. Perhaps experience in other industries would yield different results.

II. INDUSTRY CASE STUDIES

The sectors that we examined—banking and securities, insurance, law, accounting, data communications, and advertising—represent a diversified mix of characteristics.[1] Advertising is competitive and unregulated with few nonbusiness barriers. However, long-term ties between advertisers and advertising agencies and close relations within industrial groups restrict the sources of business available to the foreign firm.

Law and accounting are both regulated professions. The legal profession is regulated under the law by the independent and powerful Japan Federation of Bar Associations, as well as by the Ministry of Justice; accounting is regulated by the Ministry of Finance. Both professions severely restrict domestic entry through examinations; foreign entry to the law is almost impossible, but accounting is more liberal.

Insurance is regulated by the Ministry of Finance, which has restricted the entry of domestic firms and permitted a small growth in the number of foreign insurance companies. Regulation extends to the standardization of price and types of policies. Barriers to U.S. insurance firms arise in the main from this tight web of control and also from close ties among Japanese companies.

The banking and securities industries are highly regulated by separate bureaus of the Ministry of Finance. Barriers to foreigners arise from general industry regulation rather than from explicit restrictions against foreign companies. However, the economic forces for change and liberalization are powerful, and considerable deregulation has occurred in the past ten years, including a slow but perceptible breakdown of the boundaries between banking and securities.

Data communications were tightly regulated by the Ministry of Posts and Telecommunications, which supervised the monopolized domestic and international common carriers. Dramatic changes in technology have altered the economic and technological basis of the communications monopoly, and insistent demands for deregulation have arisen throughout industry and from other government ministries. Deregulation has been proceeding at a rapid pace since the late 1970s. Barriers to U.S. firms come about primarily from regulation and the sometimes biased interpretation of the law. Despite impending liberali-

[1]See Alexander and Tan, 1984, for fuller versions of the six case studies.

zation, barriers may be imposed by limits on foreign ownership of telecommunications companies.

In summary, the cases include one competitive unregulated industry (advertising), two professions (law and accounting), two financial services (insurance, banking and securities), and one technology-based industry (data communications). In data communications and finance the domestic forces for change are powerful; in the other industries, however, external sources are the most insistent voices for change. In several cases, regulatory responsibilities overlap across several agencies. The Ministry of International Trade and Industry competes with the Ministry of Posts and Telecommunications over data communications; MPT and the Ministry of Finance are in dispute over the postal savings system; the MOF's Banking Bureau is at odds with its sibling Securities Bureau; the MOF contends against the Ministry of Posts, Ministry of Labor, and Ministry of Agriculture over the proliferation of alternative, lower-priced insurance products promoted by these ministries; and the Ministry of Justice struggles with the independent bar association over foreign lawyers. Above these disputes sits the adjudicating authority of the ruling Liberal Democratic Party (LDP).

BANKING AND SECURITIES

Structure of the Financial System

Regulations specifically directed toward foreign companies have gradually been eliminated, and U.S. financial companies are now generally accorded "national treatment." The general Japanese system of financial regulation and control, however, has placed firm bounds on every aspect of financial life from industry structure[2] to interest rate regulations, to the kinds of financial instruments that may be offered. These restrictions are gradually being relaxed and liberalized but at different speeds in different areas. Another type of barrier includes foreign exchange controls and foreign-based lending and borrowing restrictions that generally affect foreign institutions more acutely than their domestic Japanese counterparts because foreign banks and securities companies are more heavily involved in international business.

[2]The banking structure includes 13 large city banks; 67 regional banks; three long-term credit banks; seven trust banks; 4,600 agricultural cooperatives; 460 credit associations; and 480 credit cooperatives. The Postal Savings System with branches in the 22,000 post offices collects savings from individual depositors. The foreign banking sector included 74 banks in 1983 with 3 percent of total bank lending but less than 1 percent of deposits.

The MOF has controlled most aspects of the securities business. By law, the 250 securities companies have exclusive rights in the underwriting and trading of bonds and equities. The MOF managed the expansion of the securities companies' branch network, the rules for bond issues, the character of the bond market, and bond interest rates.[3]

Management of monetary policy is the chief responsibility of the Bank of Japan (BOJ). Since 1975, in pursuit of its goal of managing the money stock, the BOJ has been behind a policy of deregulated interest rates.

Rivalries among the MOF bureaus and between the MOF and the BOJ have been continuous and numerous. These have grown out of protective attitudes toward client industries, different responsibilities and goals, and conflicts over bureaucratic expansionist attempts to gain control over policy in new, overlapping, or poorly defined areas.

Forces for Change

The 1970s produced a set of forces that drastically shifted the balance of accommodations that had evolved in the postwar era. (1) There were fundamental shifts in the flow of funds, most notably because of the rise of the central government as a major borrower; (2) economic growth slowed and greater attention was paid to the control of inflation; (3) corporate activities spread abroad, which led to increased foreign yen holdings, more active foreign exchange markets, and increased demand for improved international financial services; (4) Japanese banking and securities activities abroad expanded, which provided learning and experience under looser regulatory guidelines; and (5) many areas of banking in Japan reached the limits of growth under the existing rules and system of operation.[4]

Until 1965, the central government maintained a strict policy of balancing its budget. Recession drove the budget into a deficit of almost $18 billion by 1975 and to $62 billion by 1979, where it remained for the next four years. To finance its debt, the government had to make the debt liquid and competitive. Japan issued medium-term bonds at market rates—a sharp change from the government-decreed rates of the past; by 1982, these tradable instruments accounted for 50 percent of newly issued government debt. Underwriting syndicates purchased ten-year bonds at negotiated rates, whereas formerly the government could specify the rate it was willing to pay.

[3]Horne, 1982, p. 25.

[4]Ibid., p. 377.

In the late 1980s, the government will have to refinance its debt of the 1970s and early 1980s. Financial analysts predict that this massive effort will lead to further deregulation of interest rates and increased marketability of government debt instruments.

Also during the 1970s, the city banks reduced their level of indebtedness to the BOJ from a share of almost 9 percent of their deposits in 1970 to 2 percent in 1980. With this loss of leverage over the banking sector, the BOJ desired methods other than verbal guidance to carry out monetary policy; to do this, it has sought (but not yet attained) control over a deregulated short-term government bill market as a means of using an open market mechanism for controlling the money supply, which would accelerate the decontrol of short-term government rates and bank rates.

During the 1970s, the holdings of yen outside Japan shot up with oil price increases and Japanese trade greatly increased around the world also. Long-term and short-term assets and liabilities held by Japanese abroad increased by more than 3–1/2 times between 1973 and 1979. By 1979, the private sector held more than $93 billion in foreign assets (short term and long term). Japanese participation in the world's financial markets began to break down the government's ability to isolate domestic financial affairs from international finance.

Opponents to Change

We have been able to identify three categories of opponents to change: (1) those to whom the government has granted exclusive rights over some class of business and who would face increased competition with deregulation, (2) high-cost and inefficient suppliers who have been protected by regulation, and (3) the regulatory agencies of the above. These categories identify the losers from deregulation.

Those granted exclusive rights to one class of business often are the first to attack someone else's privileged position. Few of the financial institutions can therefore unequivocally be called liberal or conservative. Their behavior often depends on circumstances. Both the city banks and the leading securities companies, for example, call for breaking down the barriers between trust banks and other financial institutions. This "liberal" attitude flows from the huge and highly promising trust business, at present totally monopolized by the seven trust banks and life insurance companies and a single authorized city bank. However, city banks oppose large-scale Euroyen bond liberalization because it could dismantle the long-term interest rate structure and shrink domestic corporate financing.

Similarly, possible loss of business placed the post office savings banks against deregulation of the post office savings system, the trust banks against opening the trust business to city banks or securities companies, the securities companies against breakdown of the separation between banking and the securities industry, banks against securities companies offering high-liquidity securities-based cash accounts, the long-term credit banks against long-term borrowing in the Euroyen market, securities companies against U.S. companies' management of new issues, and agricultural cooperatives against postal pension fund savings plans. The government itself, which has been favored in its ability to extract long-term loans at less than market rates, has fought deregulation of the government borrowing rate.

The exclusive rights granted to specific groups have become a highly valued property that few are willing to give up. However, when the cost of maintaining the status quo has grown to intolerable levels, some part of the system has had to yield. For example, when the major financial institutions went on a "bond holiday" and refused to buy government bonds at what they considered inadequate interest rates, the MOF allowed as a quid pro quo expansion of overseas bank lending and sale of foreign bonds to gain the banks' acquiescence.

Another category of potential losers under deregulation is high-cost providers of financial services. Japanese banks operate under the so-called "convoy" method of protection, which sets prices to cover the costs of the least efficient member of the industry. Several regional banks are not expected to be able to survive in their present form under deregulation of domestic banking.

Under deregulation, the government ministries that now control and regulate the financial system would find themselves in a system that substituted market regulation for bureaucratic control. Many of the bitter intergovernmental disputes over deregulation have had large doses of turf protection as elements, as ministries have attempted to retain outright control as well as to manage an "equitable" allocation of gains and losses among their traditional clients. The ministries supply a conservative anchor to the movement toward deregulation.

Price, Product, and Institutional Deregulation

Deregulation of price, product, and institutions encounters different patterns of acceptance and opposition. Interest rate deregulation and the new financial instruments alter the relative attractiveness of different financial assets, with the possibility of massive movements of funds from one asset (hence one type of institution) to another. This problem has been handled in several ways—for example, negotiable

certificates of deposit with minimum denominations of Y500 million (about $2 million) limited the number of participants in the market.

Breaking down institutional barriers is more difficult than price and product deregulation. Long-protected vested interests are harmed, and the forces for change often do not have the same potency. The attempt by the Morgan Guaranty Trust Company and Nomura Securities to form a joint venture to manage trust funds is a case in point. First announced in July 1983, this proposal ran afoul of two institutional barriers to securities company participation in the banking business and the entrance of newcomers into the closed-off world of trust investments. The motivation to scale these walls was access to the lucrative, large, and growing body of corporate pension funds expected to reach $60 billion by 1986.

The Ministry of Finance's response to this proposal was complicated by several factors. First, the law did not prohibit banks from engaging in the trust business, although the MOF (through administrative guidance) had circumscribed this activity since the mid-1950s. Second, several Japanese banks were engaged in the trust business in the United States, so the principle of reciprocity entered the discussion. Third, the U.S. government raised the proposal at high political levels as a symbol of Japanese barriers to financial services. Approval of this proposal would have been a major step in dismantling the entire compartmentalized financial structure.

The governor of the Bank of Japan was positive on the proposal, noting that the smaller and weaker of the trust banks had been protected from competitive forces. Even the MOF conceded that opening corporate pension funds to competition would increase the rate of return that the funds earned, but feared that as many as half of the seven trust banks would run into financial management problems.

The MOF attempted to confine discussion of the matter to narrow technical issues. When high U.S. officials publicly called for U.S. bank participation in the Japanese trust business with high political officials, this increased MOF technical staff worries that it was losing control to the political leadership. Also, because there was no legal prohibition against banks going into the trust business, MOF officials were concerned over the possibility of an American bank filing a lawsuit against the Japanese government, making it difficult to back up administrative guidance.

Unable to come up with an acceptable solution, the MOF reported to the Prime Minister in early March 1984 that it had decided to allow itself two or three years to study the matter, but the U.S. government continued to press on the subject as one of the more important elements of Japanese financial liberalization that it was then pursuing

with the Japanese government. In June 1984, a joint Japan-U.S. report announced agreement on a wide range of financial market deregulations, including "approval to be granted to foreign banking institutions to enter the Japanese trust market on their own." U.S. banks in Japan were to be permitted to act on their own or in a tie-up with a Japanese trust company. Links with city banks and security companies were prohibited, thus preserving—at least for a while—traditional institutional separation. The Trust Companies' Association of Japan called the decision "regrettable."

Within weeks, Security Pacific Corporation of the United States and the Sumitomo Trust and Banking Company announced an agreement on several matters including entering the trust business. Seven of the largest U.S. banks also planned to follow Security Pacific's lead by tying up with Japanese trust banks.

This case illustrates two points: institutional deregulation, primarily because it attacks protected privileges, will be difficult; and the U.S. government's active pursuit of deregulation helped the Japanese government overcome its own inertia. Indeed, the ultimate solution, although permissive to foreign banks, grants nothing to domestic banks; later developments, though, could very well lead to further domestic deregulation. The removal of the regulatory barrier will permit U.S. banking activity in Japan to grow, as demonstrated by the impending entry of the largest U.S. banks into the Japanese trust business.

THE INSURANCE INDUSTRY

Barriers to U.S. Firms

U.S. penetration of the Japanese insurance market, the second largest national insurance market in the world, in 1979 produced $350 million in premiums, or about 1 percent of the total Japanese market. In the nonlife insurance sector, 40 foreign insurance companies account for less than 3 percent of total premiums, but U.S. companies collect more than 80 percent of this. In the life insurance sector, six U.S. firms have 0.7 percent of the premium income of private companies.

The procedure for gaining MOF approval of entry into the market is one of negotiation. There are no standard forms to fill out, so applications for a license must be made in consultation with MOF officials. Also, because there is no statutory requirement that an application be acted on within a particular period of time, the applicant has no appeal

procedure to expedite the process; waits of two to three years for license approval are not uncommon. These long delays notwithstanding, since 1951, several foreign insurance firms have been approved but no new licenses have been issued to domestic companies.

The most important barrier that U.S. firms face is government regulation of both product and price. Nonlife insurance companies set rates on uniform products in a cartelized arrangement sanctioned by law and supervised by the Ministry of Finance. In the life insurance sector, insurance premium rates are established by ministerial guidance and by some competition. Strict uniformity of premium rates and policy forms inhibits the ability of U.S. firms to attract a good sales force or to compete effectively for market share. Because of standardization, the principal consideration in insurance placement becomes things other than cost or policy characteristics—for example, having a widespread distribution network in the life insurance sector or long-standing business ties in the nonlife sector.

The Japanese Insurance Industry

The insurance industry in Japan is supervised by the Banking Bureau of the Ministry of Finance under laws that provide the Bureau with sweeping regulatory authority over all aspects of the industry's operations, including tariff arrangements, other cartelized rate-setting procedures, and exemption from the Anti-Monopoly Law.[5] The MOF's stated policy is to protect the Japanese public by promoting the sound development of the insurance industry. In addition to regulation and guidance to minimize the potentially disruptive effects of "excessive competition" over product and price, this has meant ensuring the profitability and survival of all firms. The MOF controls new entry into the industry, standardizes premium rates and policies, approves new products, and regulates the distribution system.

Following World War II, 20 Japanese life insurance companies resumed operations. This number did not change over the next 35 years. In the nonlife sector only two new Japanese firms have been added since 1951. These 20 Japanese life and 22 nonlife insurance companies contrast sharply with the more than 1,800 life and 3,000 nonlife firms in the United States. The MOF has licensed about one new foreign company a year in each sector. Licensing approval was conditioned on the foreign firm introducing some kind of "novelty"

[5]A detailed discussion of these laws is contained in "The Japanese Insurance Industry," prepared by the American Embassy, Tokyo, July 1981.

into the market, in terms of either policy features or sales method, although this criterion was relaxed in the early 1980s.

Terms and conditions of insurance contracts are uniform in most cases. New products are first introduced to the ratings associations or industry associations, discussed, and approved before marketing. The rest of the industry can turn down a product if it is believed to be disruptive, or to imitate the idea if it looks attractive. Under the MOF's "no drop-out policy," rates are typically set at levels bearable for even the weakest firm in the industry. This policy has created a widening gap between large insurance companies and their smaller competitors in the average cost of generating new business. The largest firms appear to have a cost advantage of about 40 percent over the smallest firms. Because of standardized rates, larger firms are able to generate large surpluses, which are then plowed back into expanding the sales force. By one industry estimate, premium rates in Japan today are between 10 and 30 percent higher than international levels. Because of cartel-supported premium rates, Japan is also the only insurance market where insurance underwriting, rather than fund investments, is profitable. Companies compete on the basis of aggressively expanding sales volume.

Implications for U.S. Insurance Companies

By and large, the regulations that govern the entry and operation of U.S. firms in the Japanese insurance industry are not discriminatory. U.S. firms would like to offer new and diversified products but face MOF's reluctance to approve new products. Nonetheless, U.S. firms have continued to push for MOF approval of many new products, even though the potential gains from doing so are dissipated by imitative Japanese policies. The reason for pushing new products, as one foreign insurer put it, is that even a short lead time of three months can be capitalized on to expand sales.

Foreign insurers have also sought to compete by innovating in the distribution system. Examples include the use of booths in the Seibu chain of department stores (Seibu-Allstate), the installation of drive-in claims for automobile insurance (AIU), and the development of a professional sales force (Sony-Prudential).

U.S. firms in corporate lines of nonlife insurance feel the effects of standardized products and rates most strongly. Because of standardization, other things than cost or policy features become the principal consideration in insurance placement. Many of the major Japanese insurers belong to groups of firms closely related to a financial institution. Because of longstanding business ties, interlocking stock

holdings, and other financial services (e.g., for export financing), most such firms typically insure with the group's insurance company and rarely change insurers. However, U.S. firms have been able to use their special expertise and their worldwide network of affiliated insurance companies to provide coverage for Japanese firms going abroad.

Forces for Change

Although they are not yet strong enough to call forth a major policy reexamination, forces for change are present in the system. The most potent are the lower priced insurance schemes authorized by other ministries for their constituents. These alternative schemes not only draw business away from the MOF supervised industry, they demonstrate that the present regulatory climate does not permit lower prices and different products. The Ministry of Labor, for example, has authorized a labor federation to offer automobile insurance to its members at rates 40 percent below those of the insurance companies.

Future changes will probably be in the direction of lower rates and a greater flexibility in the kinds of products offered, but not soon. Few of the small firms that have been kept afloat by high cartelized prices would survive deregulation. Although forces for change are present, they do not as yet represent a crisis. However, with increased competition from insurance alternatives outside the regulated industry and with growing awareness (especially by firms with international experience) of the high price and limited services of Japanese insurance companies, a major policy reexamination is inevitable.

THE LEGAL PROFESSION

Barriers to U.S. Lawyers

Japanese barriers to foreign lawyers are formidable. Since 1955, Japan has allowed only one new foreign law firm. However, a group of young foreign lawyers, known as "trainees" (mainly American), act as consultants on U.S. law at Japanese law firms or corporations, but they cannot independently practice as attorneys. Also, a handful of American firms continue to practice under a grandfather clause of the Attorneys Law, as amended in 1955. Short-term visits by foreign lawyers to advise on specific issues (contract negotiations, for example) have been

allowed, although this practice has also been constrained by restrictive Japanese government treatment of visa requests by attorneys.

The 1949 Japanese Attorneys Law eliminated Japanese nationality as a prerequisite for qualification as an attorney, provided that an individual could meet the prescribed technical requirements; it also established a special rule for foreign-qualified lawyers (Article 7), but that was repealed in 1955. An alien could still become an attorney through the same procedures as a Japanese citizen, but since 1956, official public announcements of the law examination require Japanese nationality, even though "there is no express provision in any law or regulation justifying this action."[6]

According to some interpretations, the 1953 Treaty of Friendship, Commerce, and Navigation between the United States and Japan dominates restrictive provisions of the Japanese Attorneys Act. Article VIII of the Treaty states that U.S. companies and individuals shall be permitted to engage "attorneys, agents and other specialists of their choice . . . regardless of the extent to which they may have qualified for the practice of a profession within the territory" of Japan. The Japanese Federation of Bar Associations (JFBA), however, interprets the Attorneys Law as prohibiting all legal advice by foreigners, partly on the ground that at some future time, all matters may become a litigious case, an activity that is reserved to members of the bar.

Behind the Barriers

Two plausible motives have often been cited for these barriers: protection of monopoly incomes and preservation of a Japanese approach to conflict and the law.

The JFBA is an autonomous body that licenses and supervises Japanese lawyers; all practicing attorneys must be JFBA members. Because of its independence and authority, the JFBA has a considerable persuasive and coercive power over its membership.

Entry into attorneys' ranks is highly restrictive. In recent years, 25,000 to 30,000 applicants per year have taken the national law examination, but fewer than 2 percent have passed the examination and entered the two-year program of the Legal Training and Research Institute for the next step toward becoming an attorney. The passing number of approximately 500 has remained at this level since the early 1960s, even though the number of applicants has tripled. The number is administratively determined and bears no relationship to demand or supply conditions. There are only 12,000 lawyers in Japan—about one

[6]Fukuhara, 1973, p. 30.

for every 10,000 Japanese rather than one for every 350 as in the United States.

If the demand for lawyers has grown over the years, but the supply has remained fixed, legally supported barriers to entry have created monopoly returns to those in the profession, which the present members of the profession may be attempting to preserve. The limited entry into the legal profession may also preserve a socially valued constraint on Japanese litigiousness. Monopoly incomes may result from these constraints, but they would be secondary to the primary goal. In crude terms, the explanations come down to "income" and "culture."

Barriers to Preserve High Incomes Among Japanese Attorneys

The key to judging whether there is something to be protected lies in ascertaining whether the incomes of lawyers are higher than those of alternative occupations and whether these high incomes result from barriers to entry. In addition to direct income comparisons, we shall first look at some indirect evidence.

That fewer than 2 percent of the candidates have passed the legal examinations in recent years and that despite this low rate almost 30,000 make the effort to sit for the exam suggest that there is some expectation of compensation or return for the effort. Many people spend several years in preparation, a substantial investment in lost time and income. The average age at passing has recently been almost 28 years, indicating an average postgraduate period of about six years. Some part of the increase in legal examination applicants can be explained by the substantial growth in the number of university students in Japan since 1950. However, the ratio of legal exam applicants to the total number of students has grown by 30 percent from 1950–55 to 1975–80.

Attorneys who would be most affected by competition from foreign lawyers would be those in Tokyo firms specializing in a foreign clientele. The *Martindale-Hubbell Law Directory*, which publishes listings in English of firms and their professional staff and is aimed primarily at the foreign community, was the primary source for identifying international practice attorneys.[7] We matched the names of attorneys in Tokyo firms listed in the *Directory* with names and incomes compiled by the National Tax Agency of the Ministry of Finance in its list of people with reported incomes greater than 10 million yen per year

[7]The rules for inclusion in our sample were that an attorney must be a "member" or "associate" of a listed firm and also a member of a Japanese bar association.

(approximately $40,000 in 1982).[8] For comparison purposes, we chose a random sample of about 200 Tokyo attorneys from the directory of the JFBA. We also analyzed a 1977 list of about 80 lawyers who had signed a petition calling for action against the practice of foreign lawyers.

Table 1 summarizes the age, experience, and incomes of the three samples. Tokyo attorneys in international practice earn substantially higher incomes than the random group of attorneys—a five-fold difference for those over 50 years old.

In seeking comparisons between the incomes of attorneys and those of other occupations, we selected professions that required at least as much training and education. In addition, to strengthen our test of the proposition that entry restrictions lead to high incomes, we compared occupations from among those with the highest incomes in the

Table 1

INCOME AND FOREIGN EXPERIENCE BY AGE OF TOKYO ATTORNEYS, 1982[a]

Item	Sample Group	Age		
		20-39	40-49	50 and Older
Number of Observations	Random	72	38	81
	International	174	78	74
	Petitioners	27	25	5
Percent in Age Group	Random	38	20	42
	International	53	24	23
	Petitioners	47	44	9
Percent with Foreign Experience or Training	Random	(b)	(b)	(b)
	International	40	64	42
	Petitioners	67	80	40
Percent with Income Greater than $40,000	Random	0	8	17
	International	9	50	62
	Petitioners	15	68	100
Estimated Average Income	Random	(c)	(c)	26,800
	International	16,600	64,500	121,300
	Petitioners	(c)	69,000	(c)

[a]An exchange rate of 240 yen = 1 dollar is assumed.
[b]Foreign experience and training information unavailable.
[c]Estimates unreliable because of small number of observations.

[8]National Tax Agency, 1983.

published survey. The results are striking. Attorneys in international practice over 50 years of age earned higher average incomes than any of the comparison groups. Even the attorneys in the random sample earned average incomes comparable to the high-income professional occupations. See Table 2.

It is difficult to demonstrate that high incomes are due to monopolistic restrictions on entry into an occupation. High incomes can arise from differences in investment in human capital, distribution of capabilities, the value or payoff to personal capabilities, or temporary market disequilibrium. We have attempted to account for some of these effects by examining people in their peak earning years and by comparing lawyers with those in the *highest* earning occupations. Although not conclusive, the evidence is consistent with the following interpretation: For the average random lawyer, entry restrictions lead to incomes near the top of the professions (below that of administrative physicians); from this limited pool, a small number have invested in additional education or experience to enter the international legal field; and this small group (which enjoys especially high incomes) would be in direct competition with foreign lawyers in Japan.

Examination of the trend in numbers of Tokyo lawyers listed in *Martindale-Hubbell* over the years indicates the attractiveness of international law. From 1960 to 1982, the number of firms has increased by almost five times, and the number of lawyers by eight times. The admission of foreign lawyers would help bring supply closer to demand more quickly than the present process, and it would reduce the high incomes that the members of the Japanese international legal community enjoy.

Barriers to Preserve a Japanese Legal Culture

The opposition to foreign lawyers in Japan may also stem from fear of introducing foreign legal philosophies into the country. Based on an outpouring of writing on the Japanese legal culture,[9] we can construct the argument that the Japanese legal system is the result of very deeply and widely held beliefs favoring a diminished role of law in resolving conflict and the priority of social obligations in the hierarchy of social values. An adversarial legal system based on individual rights and due process, like that found in the United States, is not only out of place, it is socially destructive. As the American Bar Association was told in discussions with the JFBA: "The foreign lawyer matter relates

[9]For a popular account of this thought, see Christopher, 1983, pp. 164–169.

Table 2

INCOME COMPARISONS OF ATTORNEYS AND SELECTED PROFESSIONS

Occupation	Average Age	Annual Income (1982 $ U.S.)
Hospital director	58	69,600
Chief of medical department	45	42,200
Head of research institute	51	28,300
University professor	55	24,500
Attorney, Tokyo, random sample	>50	26,800
Attorney, Tokyo, international	>50	121,300

SOURCE: Japan, Prime Minister's Office, Statistics Bureau, *Japan Statistical Yearbook, 1982*, Table 300, "Number of Persons Engaged, Average Age, and Monthly Earnings by Position and Occupation," pp. 440-441.

to the legal and cultural system of each country, and is not a trade matter."[10]

One study placed Japan mid-way in a table of civil cases with 1,257 per 100,000 population; South Korea had 172 and Finland 307 at the bottom of the list, and Australia had 5,277 at the top.[11] (Figures for California would place it in third place, with 4,838 cases.) The low Japanese figures are partly explained by the limited access to the courts produced by high caseloads and long delays. The small number of lawyers and judges powerfully restricts the accessibility of the legal system to potential litigants. Many cases are "self-argued," without benefit of legal counsel. A survey of self-argued cases revealed that three of the four main reasons given for not using an attorney were related to the small numbers of lawyers.[12]

Before World War II, the absolute number of cases was higher than in the 1970s; the per capita number was more than 2-1/2 times greater.[13] Furthermore, the per capita number of Japanese taking the legal examination in 1975 was actually greater than that of Americans taking a bar examination. There is an increasing tendency to make use of the courts in some areas of the law. For example, the number of persons injured in traffic accidents in Tokyo grew by 96 percent from 1963 to 1969, but new civil cases filed in Tokyo's Special Traffic Court

[10]"Memorandum on Tokyo Meetings of Ad Hoc Delegation of American Bar Association," December 20, 1982.

[11]Haley, 1978, pp. 359-390.

[12]The reasons given were: (1) Scarcity of lawyers; (2) lack of law consciousness; (3) high fees; (4) difficulty in finding a lawyer. Cited in Tanaka, 1976, p. 260.

[13]Haley, 1978, Fig. 2, p. 372.

increased by 240 percent.[14] The growth in traffic cases was most likely due to awards in traffic injury cases, which increased sharply from 1963 to 1969—the median award doubling for personal injuries and tripling for deaths.[15] (Other civil suits increased by only about 10 percent.) This response to changed incentives shows that although cultural factors may diminish or blunt the Japanese reactivity to legal costs and opportunities, the low level of legal activity cannot be laid solely to a low level of "law consciousness."

Since before the Meiji Period, institutional barriers to the use of the legal system have reflected the ruling elite's desire to "maintain a paternalistic order based on a hierarchical submission to authority."[16] The desire by today's governing elite to continue to emphasize the consensual and nonlitigious nature of the Japanese tradition attempts to thwart challenges to "national, social, and economic policies through the courts, and as a result, have helped concentrate power over such policies in the hands of government and business leaders."[17] Postwar governments' strategy of leadership through "administrative guidance" would be much more difficult to pursue if actions could be challenged in the courts. Government preferences, therefore, reinforce a presumed set of social norms.

Policy Issues

As Tokyo becomes a center of international trade and finance, the demand will increase for skilled international lawyers experienced in the complexities of negotiating, financing, and drawing up the instruments for multinational projects. Also, as more U.S. companies operate in Japan, they will require links into the Japanese legal system as well as advice on international matters; similarly, Japanese firms require specialized legal advice. These requirements will be quite independent of Japanese legal policies and traditions. This area has already experienced considerable growth.

Both the JFBA and the Ministry of Justice have questioned the "need" for American lawyers in Japan. The Justice Ministry faces a dilemma in their desire to permit easier access for foreign lawyers while continuing to restrict domestic entry into the profession. They would like to see need demonstrated by statements from potential users of foreign law services that their requirements are going unmet. But

[14]In New York, the ratio of suits to injured persons was 23 times the Japanese figures. Stevens, 1971, p. 674; and Stevens, 1972, pp. 1272–1273.

[15]These figures are shown in Stevens, 1971, p. 676.

[16]Haley, 1978, p. 371.

[17]Ramseyer, 1983, p. 36.

need is seldom absolute. In an economic sense, unmet need is the difference between the administratively set numbers of lawyers and the unconstrained quantity. A few simple policy changes would permit foreign lawyers to enter the market and take the risk that their services are required. Meeting these specialized needs should have very little effect, if any, on the traditional Japanese approach to law.

THE ACCOUNTING PROFESSION

Barriers to U.S. Accountants

In contrast to the legal profession, where market entry is severely curtailed, U.S. accounting firms have been free to establish branch offices in Japan. All the "Big Eight" U.S. accounting firms have offices in Tokyo, several of which rank among the top ten largest domestic accounting firms. Furthermore, nationality is not a requirement for CPAs in Japan and several Americans have been licensed to practice as "foreign CPAs." The main barrier is the unofficial Ministry of Finance policy of denying foreign accounting firms "audit corporation" status. Some U.S. accounting firms see audit corporation status as a means of competing with large Japanese accounting firms for a share of the domestic market.

Persons licensed as accountants abroad and demonstrating a substantial knowledge of Japanese accounting laws can take a special licensing examination administered by the Ministry of Finance. On obtaining certification, the foreign accountant can provide professional services on the same basis as qualified Japanese nationals. The licensing examination, however, has not been offered since 1976—ostensibly because of insufficient demand.[18] The high incomes of foreign CPAs grandfathered by this *de facto* policy is further evidence of the attractiveness of certification. Observers suggest an alternative motive for this policy, one targeted not at American accountants but rather at Japanese nationals who may attempt to enter the profession indirectly by first acquiring a CPA degree abroad and then returning to be certified as a "foreign CPA."

The chief limitation that U.S. accounting firms face is not being allowed to organize as an audit corporation, which is the common organizational form of large Japanese accounting firms. The Securities and Exchange Law requires that publicly listed companies and companies

[18]Previously, this CPA examination had been given in English as a ministerial courtesy, even though that was not required by the CPA Law.

offering public stock provide consolidated accounts audited by a member of the Japanese Institute of Certified Public Accountants (JICPA). Since 1980, several foreign firms have set up "CPA joint accounting offices" with Japanese firms that are recognized by the JICPA. However, neither the branch office nor joint accounting office form of accounting practice is considered as prestigious as an audit corporation. Several U.S. accounting firms believe that being an audit corporation would allow them to compete with large Japanese audit corporations for a share of the rapidly expanding domestic market.

Until recently, efforts by U.S. accounting firms to establish audit corporations have met with little success. Several firms had sought MOF approval for up to 10 years. Other foreign accounting firms, though, were fearful that U.S. governmental pressure on the JICPA could jeopardize their correspondent relationships with Japanese accounting firms.

In 1982, the MOF announced guidelines on how foreign accounting firms could apply for audit corporation status; these included the requirements that the audit corporation have a minimum of five Japanese CPA partners and that all equity be held in Japan. Price Waterhouse was granted permission to establish itself as an audit corporation in June 1983.

Behind the Barriers

Several U.S. accounting firms see the addition of new local clients as an important means of sales expansion, both in Japan and internationally. At stake are two growing markets: The smaller Japanese companies requiring consolidated accounts as a result of recent changes in the Japanese Commercial Code, and Japanese corporations going abroad. In the view of the U.S. companies, the MOF policy of denying them audit corporation status constrains their ability to compete with large Japanese accounting firms for this new business.

MOF policy can be seen as the outcome of complex coalitions among three groups motivated by different interests: (1) The JICPA, wanting to restrict foreign entry to preserve the monopoly incomes of its members; (2) the MOF, which desires to promote the "sound" development of the accounting profession but is caught between the conflicting interests of domestic and foreign firms; and (3) the Big Eight, themselves divided about whether to become audit corporations.

Institutional Background

By law, regulation of the accounting profession in Japan is shared by the MOF and the JICPA. Entry is controlled by the JICPA. CPAs, including audit corporations, are permitted to offer statutory audit services only upon approval of, and membership in, the JICPA.

The CPA profession in Japan is fairly small, and the supply of new CPAs is growing slowly. In 1982, there were about 6,800 registered CPA members (mostly in Tokyo)—about one-quarter the number of CPAs in the state of Illinois, and 4 percent of the number of CPAs registered in the United States. Most CPAs are sole practitioners, the remainder practice in 71 audit corporations. The Big Five Japanese accounting firms all employ over 50 CPAs.

Entry into the CPA profession is extremely difficult and restricted to about 200 CPAs a year. Applicants face three major hurdles: College graduates with an accounting degree are exempt from the first examination, a mathematics test and a thesis; a second examination administered once a year by the MOF has a passing rate of 7 to 10 percent. Successful candidates may then work as Junior CPAs in public practice. After three years of apprenticeship, they face a final professional examination with a passing rate of about 18 percent. (This rate was reported to have increased substantially in 1983.) Because applicants had roughly only a 2 percent probability of passing both examinations at pre-1983 passing rates and a somewhat higher rate thereafter, it is unlikely that the supply of new CPAs will rise rapidly enough to meet projected demand in the immediate years ahead.

Barriers to Preserve High Incomes

It is said that the JICPA is a potent obstructionist force to U.S. efforts to establish audit corporations, arguing that foreign practitioners lack the expertise necessary to function competently in Japan.[19] However, the Japanese Securities Law was modeled after the American Securities and Exchange Law and Japanese accounting principles are broadly consistent with those prevailing in the United States, reducing the force of this argument. A more plausible motive for excluding foreign firms lies in the small number of Japanese CPAs. As in the law profession, growth in the demand for services would create monopoly returns to those in the profession.

To develop estimates of accountants' incomes, we matched a sample of Japanese CPAs from the JICPA's membership roster with the list compiled by the National Tax Agency of individuals earning more than

[19]Robertson, 1982.

10 million yen (over $40,000) in 1982.[20] We selected three samples of partner and nonpartner CPA staff in Tokyo-based audit corporations of different firm sizes, and a random sample of sole practitioners in the five major wards of Tokyo.[21] We were thus able to derive estimates of the distribution of incomes of CPAs by type of accounting practice and firm size. See Table 3.

A large number of Japanese CPAs in audit corporations earn quite substantial incomes. We estimate average incomes of all partners (those with incomes above and below the 10 million yen cutoff point) ranging from $47,400 for small firms to about $60,000 for larger accounting firms. There also appear to be financial rewards for being organized as an audit corporation. The incomes of CPAs in single practice (about $30,000) on average are substantially lower than those of their audit corporation counterparts. However, because it takes several years to be promoted to partner, the audit corporation sample

Table 3

AVERAGE REPORTED INCOMES OF JAPANESE CPAs
(Partners in audit corporations)

	Largest Three Audit Corps	20-60 CPAs	5-20 CPAs	Single CPA Practice
Number of Observations	50	67	60	50
Percent with incomes greater than 10 mill. yen (about $40,000)	72	70	46	18
Estimated average income of entire group[c]	$59,700	$60,900	$47,400	$29,300

SOURCE: JICPA Membership Roster; Japanese National Tax Agency, 1982.

[a]These include Chuo (114 CPAs), Ota Tetsuzo (82 CPAs) and Tomatsu Aoki (78 CPAs).

[b]Sole proprietors drawn from the five major wards of Tokyo.

[c]Calculated using an exchange rate of 240 yen to $1 and based on the assumption of a log-normal income distribution.

[20]Japanese Institute of Certified Public Accountants, 1982; Japanese National Tax Agency, 1983.

[21]The JICPA roster does not list members' ages. However, given the usual process of promotion to partner after several years of service, we would expect most partners to be between the ages of 40 and 60, and staff CPAs to be somewhat younger. We define firm size using the total number of CPAs—partners and staff—employed in the firm's offices throughout Japan.

of partners is likely to be older than the typical CPA sole practitioner. We therefore generated a random sample of staff (rather than partner) CPAs and combined this with the partner sample (weighted by the proportions of partners and staff in the firms). The estimated average income of approximately $37,000 of all CPAs (staff and partners) in audit corporations is still considerably higher than that of sole practitioners. These estimates are imprecise because few staff CPAs have reported incomes greater than 10 million yen.

That CPAs make high incomes is apparent from comparisons with other occupations requiring at least as much training or education (see Table 2 above). Partners in audit corporations have incomes exceeding those of any other comparison group except hospital directors. The incomes of sole practitioners, which include CPAs of all ages, are comparable to those of the sample of older professors and research institute directors.

Protection of the Japanese Accounting Industry

It is unlikely that high accountant incomes were the only consideration in the MOF's policy of restricting foreign establishment of audit corporations. The MOF may view foreign entry into the domestic audit market as conflicting with its view of the sound development of the domestic profession. A modern CPA profession appeared in Japan only in 1948, mainly as a result of adopting the Securities and Exchange Law under American influence. The competence of many of the existing registered accountants at that time was barely beyond elementary bookkeeping. The MOF, over the years, has upgraded accounting standards to international levels. The MOF reportedly played an active role in establishing one of the larger Japanese accounting firms, including placing several retired MOF officers in key positions.

Several U.S. accounting firms already have accounting practices that compare to those of the largest audit corporations in Japan. Their size and international reputation would have made them strong competitors to Japanese audit corporations.

More recently, the MOF has given foreign firms greater access to the domestic market, providing guidelines under which foreign accounting firms could obtain audit corporation status. In the interim, the MOF recommended that foreign firms establish themselves as joint accounting offices with domestic firms. These moves may have reflected the MOF's desire to deflect future foreign criticism of its closed-door policies.

The Different Strategies of U.S. Accounting Firms

The Big Eight were all initially attracted to Japan to service their major U.S. corporate clients but since then have pursued different growth strategies. Important factors appear to have been the perceived benefits and costs of audit corporation status, ties with Japanese correspondent firms, and the companies' organizational structure. U.S. accountants pointed out several disadvantages of audit corporation status against which its benefits had to be weighed. As an audit corporation, they would be subject to greater scrutiny by both the MOF and JICPA and to what one accountant described as "onerous" reporting requirements mandated by law.

Close ties with correspondent Japanese firms and fear that application for audit corporation status would jeopardize that relationship also constrain the choices of many of the Big Eight firms. Price Waterhouse and Arthur Andersen, however, took a more independent route and have sought audit corporation status most actively.

Because foreign accounting firms are organized very differently from Japanese firms, few meet MOF guidelines that foreign audit corporations should have a minimum of five Japanese CPA partners *and* hold all equity in Japan. Some of the Big Eight in Japan would have had to make difficult decisions about their employment policy and their profit-sharing relationships with the parent company.

Several recent mergers between the Big Eight and their Japanese correspondent firms should improve their ability to compete for Japanese corporate business, both within Japan and abroad. A less favorable development from a U.S. perspective is the establishment of the Ace Association of accounting firms in June 1984. Led by Asahi Audit Corporation, this association includes five other accounting firms, which, with a present membership of 500 CPAs, will make it the largest accounting "firm" in Japan. An observer notes, "The establishment of the association could deter such inroads of big foreign firms."[22]

Conclusions

The authority of the MOF and the JICPA to regulate entry into the profession and the legally established capability of the MOF to "guide" the development of the industry's structure have been the primary sources of barriers to U.S. accounting firms in Japan. The JICPA effort is consistent with evidence that it is attempting to preserve high

[22]"Accounting firms joining forces led by Asahi & Co.," *The Japan Economic Journal*, June 19, 1984.

monopoly incomes of profession members. The MOF appears to be concerned more broadly with the health of its industry, although it is hard to say whether it also tacitly goes along with the accountants' goal of income-maintenance.

By promoting the development of Japanese audit companies' skills through encouraging the establishment of joint audit companies with the large U.S. companies, the MOF also opened a back door to the entry of the U.S. companies into the domestic audit market. To meet this foreign challenge as well as to satisfy increased domestic demand, the JICPA has recently increased the number of Japanese nationals passing the accounting examinations. In five years or so, the breakdown in monopoly authority brought about by the entry of foreign firms could lead to a gradual fall in accountants' incomes relative to other occupations, unless the MOF finds ways of halting the entry of foreign firms. With high-level political attention focused on barriers to service trade, however, such a retrogressive move is unlikely to be successful.

DATA COMMUNICATIONS

Context and Industry Structure

Barriers to U.S. data communications business in Japan have been high but have declined substantially in the past decade. Until the late 1970s, restrictions on transborder data flows affected the operations of U.S. firms. More recently, the most important barriers have arisen largely from the high degree of regulation of Japanese telecommunications. This sector is now undergoing rapid deregulation under the pressures of widespread local demands for decontrol and privatization. U.S. interests are among the many voices heard in the domestic Japanese debate.

Since the early days of telephone communications, public policy toward telephone systems has treated them as natural monopolies, largely because of scale economies in local switching costs. But in the 1970s, computers, digital techniques, and fast, cheap electronics technology have reduced the scale of operations needed to achieve lower costs.

A government monopoly over public telecommunications in Japan was first established in 1885. In 1952, the present Ministry of Posts and Telecommunications was established with regulatory authority over two operating companies: Nippon Telegraph and Telephone

Corporation (NTT), which had a monopoly over domestic telecommunications, and the Overseas Telegraph and Telephone Company (*Kokusai Denshin Denwa*—KDD), which had a similar role in the international area. When it appeared that voice telephone demand would level off, NTT entered the online computer services market; today it operates the largest online computer service bureau in Japan.

Value-added networks (VANs) provide an interface between the equipment of telecommunications users (terminals, computers, displays, printers) and communications networks. VANs typically lease communications lines from the basic carriers such as NTT or KDD, add their own computers and software, and perform various operations on data, such as altering transmission rates, detecting and correcting errors, using packet-switching techniques to make maximum use of channel capacities, and directing messages to the appropriate addresses. For many users, VANs permit a faster, more reliable, and more cost-effective link than could be obtained if they were simply to lease the communications and develop their own conversion and interface techniques.

Dispute over Authority and Policy

In the Japanese government, MPT has regulatory authority over the basic carriers. The Ministry of International Trade and Industry (MITI) includes among its client industries the computer and telecommunications equipment manufacturers, software and systems producers, and such telecommunications users as manufacturers and trading companies for whom cheaper and more effective telecommunications and data processing mean a more competitive position in world markets. MITI desires responsibility over VANs as part of its traditional role of supervising the computer and electronics industry. MPT, however, views VANs as part of the telecommunications sector and therefore under its regulatory authority. MITI would like to promote the interests of its industry clients by deregulation of even the basic carrier networks. MPT is moving toward greater deregulation, but not at the speed or completeness desired by MITI.

Computer Access

Until the late 1960s, the law prohibited use of leased circuits by parties other than those actually leasing the lines. When NTT entered the online computer market in 1966, it applied to MPT to establish a message-switching system to transfer financial data among a group of subscribing banks through lines that the NTT computer division

"leased" from its parent corporation. The banks did not hold the lease on the communications lines, so their third-party use was prohibited by strict interpretation of the law. MPT recognized that if these services were to be regularized, the law would have to change. MITI then sought liberalization of access to the telephone and telex networks for other computer users.

The Diet revised the telecommunications law in 1971 to permit NTT and KDD to provide online computer services and also granted freedom to other parties to use both leased lines and "public" dial-up lines for shared use and third-party use. "Message-switching" was prohibited as still being in the exclusive domain of the regulated monopolies. Narrow interpretation of this provision led to serious problems for several U.S. data-processing companies in the late 1970s and became a source of trade friction between the U.S. and Japanese governments.

In 1974, Control Data sought to lease international lines from KDD to transmit data from Japan to its five data processing computer centers in the U.S. After two years delay, KDD leased the lines, but with severe restrictions: It prohibited the transfer of data among Control Data's computer centers in the United States, based on the view that such transfer constituted message-switching, thus limiting the connection to only a single computer. Control Data argued that these data transfers took place totally within the company and in the United States, and did not constitute message-switching under the U.S. and international rules. The second KDD requirement was that Control Data replace its leased line service with KDD's "VENUS" international data network when it became operational, which would have raised telecommunications costs by substituting a usage-sensitive pricing structure for the flat-rate tariff of the leased line. Many observers considered these restrictions to be anticompetitive moves to protect future KDD data network business, as well as NTT online computer services. Control Data was forced by these restrictions to construct a large computer center in Tokyo and to operate its leased lines at only 10 percent of capacity, both of which increased the costs of its services. The remote-access computer service company Tymshare and its VAN affiliate Tymnet encountered similar problems.

After several years of government-to-government negotiations and private efforts to obtain relief, KDD agreed in 1980 that it would relax its strict interpretation of the regulation and that private-line services would continue to be available concurrently with its new data network. In late 1980, the director of MPT's Computer Communications Division noted that he wanted to settle the issue before it became a major irritant in U.S.-Japanese relations.

Moves to Liberalize Data Communications

In mid-1981, the government's Administrative Management Agency, which examines the structure and efficiency of government bodies, strongly recommended that NTT's data communications operations be financially self-sustaining and streamlined. An MPT advisory group, convened in 1980, reported at the end of 1981; two of its principal conclusions were to encourage (1) privatization, commercial incentives, and efficiency; and (2) quick action toward liberalization of the use of data communications circuits. This was the first time that an official MPT group had put forward such ideas. The government's Provisional Commission for Structural Reform followed with its report, which called for broad deregulation, including permission for private corporations to enter into public telecommunications business by building, owning, and managing their own circuits.

In October 1981, the Telecommunications Union publicly opposed NTT privatization but encouraged competition in data communications. Privately, individual labor leaders seemed willing to contemplate private management for NTT. Many observers thought that NTT was seriously overmanned by at least 100,000 jobs. To preserve the prevailing level of employment, NTT would have to move into new areas, which was not possible under its public corporation status under the old law. The greatest restriction on labor was that NTT had no independent power to set wages. Negotiations before an arbitration panel over NTT wage levels were tied up with the Japanese National Railways and the Tobacco and Salt monopoly under the Public Corporation Law. Although NTT views were considered by the wage panel, the company felt that it had lost flexibility in rapidly changing technologies and markets.

Enter the Politicians

The growth potential of telecommunications attracted the attention of the Liberal Democratic Party in the early 1980s. As the movement toward telecommunications deregulation took shape, the Tanaka faction of the LDP generally favored privatization and competition. The Miki and Suzuki factions were also solidly behind deregulation. Political views on the subject, however, were far from unanimous. The "postal group" of the "posts and telecommunications lobby," a loose assemblage of Diet representatives, strongly supported the MPT's views, which meant opposing NTT privatization and loss of MPT control over telecommunications. The power of this lobby flowed from the postmasters of the 16,000 privately owned post offices throughout the

country who were important figures in local elections. The LDP's powerful Policy Research Council included a "study group" in its Telecommunications Division, which was firmly in the hands of pro-MPT members. This group had taken over the discussion of decontrol from a subcommittee that had earlier been formed to deal with the same issues.

There were indications that the powerful postal lobby was becoming separated from those with telecommunications interests as the political leadership gradually became aware of the growth potential of new public media and telecommunications systems. The possibility of political plums were seen in the licensing and approval authority that the MPT would be granted over new media (CATV, for example) and in the ambiguity over approval standards for new networks. Where there would be choices to be made, there would also be openings for political influence.

Negotiations Between MPT and MITI

In late 1981 and early 1982, MPT and MITI entered arduous negotiations over the shape of new telecommunications laws and regulations. MPT argued strongly against full deregulation despite the demands and recommendations from its own consultative committee and many other quarters. MPT insisted on review and approval of network arrangements to ensure the adequacy of privacy and security. The rise of competition was also an issue. Both MPT and NTT recognized that full-scale VAN service would break down the NTT monopoly in several ways and break up traditional spheres of political authority. MPT was trying to maintain its control by preserving some regulatory power together with review and permission authority over new ventures. MITI, through deregulation, was attempting to promote the growth of telecommunications to advance the fortunes of its portfolio of client industries.

Negotiations between MPT and MITI proceeded with great difficulty. The law had granted MPT the responsibility over telecommunications; it had built up a vested right and privilege, a shield that logic and economics could pierce only with difficulty. By February 1982, positions had been clarified, but had also hardened. MPT announced that VAN services would not be permitted in the new legislation and that overall opening of the market on a large scale would be delayed.

With negotiations between the two ministries at an impasse and the deadline for submitting bills to the Diet fast approaching, the parties submitted their cases to the LDP Policy Board Chairman and agreed to accept his judgment. The agreed draft, which became law in

October 1982, permitted VAN services for the small and medium firms, but not for large firms.

Impediments Under the New Law

The MPT proceeded slowly under the new law. MITI's earlier suspicions about the possibly restrictive manner in which the MPT would use its report and approval authority were apparently well founded. In the summer of 1983, however, the ministry began to apply the regulations flexibly, which encouraged several major companies to enter the market. U.S. companies participated in the majority of these offerings.

Further problems in implementation arose when IBM Japan Ltd. announced in August 1983 that it planned to launch a credit card data communications service linking retail outlets with a central IBM computer system through its own communications network (based on circuits leased from NTT). Because NTT was installing a similar system, neither NTT nor its regulatory ministry MPT relished the competition from IBM. The ministry also foresaw unspecified "troubles and chaos" among card users and shop attendants if two competing services were allowed to coexist. MPT argued that the existing law would not allow it to approve the credit card system. MITI rebutted these claims by noting that the credit card system was the same as existing online banking services. However, the MPT was willing to contemplate a compromise. It would accept an IBM small-business VAN service and the credit card data processing system if IBM agreed to use the NTT VAN network. A month later, an agreement was announced whereby the credit authorization business would be completely unregulated and IBM would use the NTT VAN network to transmit data to its credit card computer processing centers. Individuals involved in these discussions noted that political considerations influenced the decision—namely, avoidance of U.S. resentment over an apparent Japanese government and business conspiracy to close the market to foreign companies.

Continuing Efforts at Deregulation

MPT had formulated a bill in mid-1983 to allow companies to operate VAN services, but only if they had less than 20 percent foreign equity. However, it dropped consideration of the draft because of strong opposition from MITI and the U.S. government. One concern of MPT was that a few large-scale foreign VAN suppliers would dominate the market. Furthermore, MPT officials saw their responsi-

bilities as overseeing "orderly market development." Free entry and exit, they said, could cause "problems and confusion" for users; also foreign-owned firms were unlikely to be responsive to MPT guidance.

A new telecommunications draft law in early 1984 classified the sector into two categories, both of which would be open to competition: (1) basic services involving ownership and operation of communications circuits; and (2) secondary services such as VANs that would use leased circuits from the basic services operators.

MPT shifted its position on foreign capital limits several times in the next few months, often because of U.S. government persuasion. At first it had required at least two-thirds domestic capital for basic service operators, and 50 percent for large-scale VANs. Because the postal ministry regarded large-scale VAN services as an all-inclusive telecommunications service, it believed that its regulation should be similar to that for basic services. Furthermore, the large VANs should fall under MPT's traditional jurisdiction over telecommunications. However, U.S. government objections, together with continuing arguments from MITI and other sources, induced MPT to suggest a compromise that authorized foreign capital shares according to restrictions in a company's home country's laws. This permitted U.S.-based companies 100 percent ownership of large-scale VAN services.

At this point, the U.S. government through its trade officials and its ambassador in Tokyo publicly and privately raised telecommunications and VAN services as a central issue in U.S.-Japanese economic relations. As negotiations within the Japanese government dragged on without resolution in a repeat of the 1982 debate, the LDP once more entered the dispute stimulated by American concerns.

Under LDP arbitration, MPT's control was somewhat reduced with "virtual liberalization" of the VAN market. Controversy did not end with this enforced mediation effort, as MITI was still concerned about future MPT implementation of the registration procedure, and the U.S. ambassador voiced some dissatisfaction over the continuation of the still seemingly closed nature of the VAN market. An editorial analysis in the prestigious *Japan Economic Journal* described the internal controversy as "nothing but a clash of naked political interests," noting that the postal ministry required notification, licensing, or registration of VAN business, anything so it could claim control over the area.[23] The planned liberalization and deregulation of this market had an immediate effect on U.S. service trade, as a dozen or so U.S. firms

[23]"Clashes Over VAN," *Japan Economic Journal*, April 10, 1984.

quickly announced VAN projects with a future revenue potential estimated to be in the billions of dollars.[24]

The forces for change in data communications are powerful and widespread. The political outcome reflected these underlying forces. The law, however, will still have to be implemented and the postal ministry will have the opportunity in countless minor actions to protect its interests. If foreign competitors look as though they may dominate the industry, political groupings that have already been formed could support a more restrictive policy. Although great strides have been made toward deregulation, the subject is not closed.

ADVERTISING

Japan's advertising industry is not regulated by any government ministry and is highly competitive. Although one firm, Dentsu, accounts for approximately 24 percent of total billings, it faces fierce competition both nationally and worldwide. With more than 2,000 firms in the industry, there is a broad distribution of business among the leading firms without high seller concentration. After Dentsu, the next nine companies have 30 percent of Japan's market.

Functionally, the industry can be divided into three parts: (1) The giants, including Dentsu and a half dozen other large agencies; (2) the foreign companies and international departments of the Japanese firms, which serve the foreign companies operating in Japan—about 5 percent of the market; and (3) about 2,000 smaller companies serving local markets and clients. U.S. companies are struggling to make a mark with the large domestic Japanese advertisers. Foreign companies have not been able to capture more than about 3 percent of the total market.

The large Japanese agencies buy media in bulk up to a year in advance and then retail it to their clients. Dentsu in particular even owns substantial shares in broadcast companies and newspapers. Dentsu can bargain for prime media space at a low price and offer the best time and space to its clients at whatever price the market will bear. This can produce healthy profits when times are good; however, in a recession, an agency may end up selling large chunks of broadcasting time or advertising space at a discount. U.S. agencies that do business the American way (buying time directly for specific clients) may end up "getting the crumbs that are left over," as one person put it. However, our interviewees also stated that this is a "business problem"

[24]Fujitsu estimated that within five years its large-scale VAN service would be generating revenues of 100-billion yen (about $430 million) per year. Yuge, 1984.

of the type found around the world; they do not perceive it as an "artificial" trade barrier.

The major problem seen by U.S. firms in Japan is developing relationships with Japanese advertisers. To overcome this business barrier, eight of the largest 15 U.S. agencies have established joint ventures with Japanese agencies. Similarly, eight of the ten largest Japanese agencies have joined with U.S. companies in the United States.

The creation of the advertisements themselves does not seem to be a barrier, despite the very strong cultural differences in the responses of Japanese and American audiences. Japanese practice is to farm out the creative production work to scores of small independent firms.[25] Foreign firms take advantage of this same system of buying local talent and sensitivities.

Given the absence of formal barriers, why then have foreign companies not been able to capture more than about 3 percent of the total market? First, their natural market segment—the foreign companies operating in Japan—constitutes only about 5 percent of total billings, more than half of which have been captured by the foreign agencies. Second, the national Japanese market minus Dentsu is only about half of the total advertising industry. The handful of foreign agencies do not have a disproportionately small share of this hotly competed business: For example, McCann Erickson-Hakuhodo ranks eighth in radio advertising and sixth in television; J. Walter Thompson is seventh in magazines. Third, it takes time for a foreign company to make progress. It has taken 25 years for McCann Erickson-Hakuhodo and J. Walter Thompson to attain their present standing in the industry. Moreover, there are now signs that vigorous competition is beginning to break down many of the traditional ties between clients and their agencies. Competitive pressures, though, will probably continue to deprive foreign advertising companies of an easy market in Japan.

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[25]Krisher, 1982, p. 72.

III. RESEARCH CONCLUSIONS AND POLICY IMPLICATIONS

MAIN CONCLUSIONS

Review of our case studies and of the scholarly literature on Japanese business and government behavior leads us to the following conclusions:

- The most important barriers we found to trade in services arise from government regulation of business.
- The U.S. government is more likely to be successful in moving Japan toward deregulation and reducing trade barriers when there are strong domestic Japanese forces for change.
- Even with internal and external pressure for change, conflicts within and among Japanese agencies can lead to interminable delays and shelving of issues.
- To resolve internal conflicts, the Liberal Democratic Party has gradually emerged as a central agent of change.
- High-level political involvement in trade issues by both sides can sometimes stimulate accommodation.
- Such episodic interventions must be accompanied by continuous and long-term interactions by government and business, which can influence events in a cumulative manner.

DOMESTIC REGULATION AS A BARRIER TO TRADE

For many years, U.S. firms and the U.S. government have urged the Japanese government to eliminate specific prohibitions against the operations of foreign firms. To a great extent, these requests have been acceded to, and U.S. firms have been granted "national treatment," but for a few lingering exceptions, mainly in the professions.[1] Experience under this regime reveals, however, that national treatment is not the solution, it is the problem. National treatment in regulated service industries acts as a barrier to trade.

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[1]National treatment requires that foreign parties be no less favorably treated than like domestic individuals or enterprises.

Regulation in Japan that was designed to protect the public from natural monopolies, financial instability, or fraud has not been without social costs. It limits entry into the industry, restricts the range of products that can be marketed, controls prices, maintains orderliness by "avoiding confusion and disruption," retards innovation, and validates cartelization. Regulation has created barriers to foreign companies that are constrained in their use of the tools of competition: prices, products, innovation, and even entry into the business. Regulation creates barriers to foreign companies that cannot take advantage of their efficiency and experience gained in external markets. In five of the six industries we examined, industry regulation is the *chief* barrier to foreign business. Although monopoly and cartel powers exist in several sectors—banking, insurance, and data communications, for example—these powers are created and maintained by the regulated nature of the industries.

Administrative guidance by Japanese government agencies is an adjunct to formal regulation as a device to constrain and direct business behavior. It too is a barrier to trade in a manner similar to outright regulation. Guidance is often used as a substitute for formal procedures as part of a general pattern of emphasizing the informal over the formal in Japanese policy formation. Administrative guidance differs from statute-based regulation; by its very nature, it is noncompulsory in the legal sense and relies on voluntary cooperation by the regulated parties. Nevertheless, it is the threat of actions that a government agency may possibly take under its legally granted authority that gives guidance the attributes of compulsion.

MITI has recognized the need for more explicit authority to back up its guidance. Under the restrictions and regulations of the old Foreign Exchange and Control Law, for example, indirect enforcement of industry guidance was possible until the late 1960s, but trade liberalization measures eliminated that lever.[2] Subsequently, MITI has unsuccessfully attempted to get the Diet to pass legislation granting it explicit authority to promote specific industries.

With the growth of deregulation in several important sectors, the compulsion behind administrative guidance may be declining. Supporting this trend is the Japan Fair Trade Commission (FTC); until recently, the FTC, as the government's promoter of competition, has taken a back seat to the regulators and controllers in the other government ministries. Lately, however, the FTC has more aggressively

[2]Upham, 1981–1982, p. 123.

attacked anticompetitive behavior promoted by other agencies.[3] The FTC, for example, won a stunning victory before the Supreme Court when it successfully challenged an oil companies' cartel pricing scheme that MITI had sponsored.[4] The Fair Trade Commission, however, is unlikely to be able to do much more than legitimize or promote the concept of reducing administrative guidance. The main effect will have to come through widespread pressure for deregulation in specific industries, which would also reduce the ability of government to back up its guidance with legally granted sanctions.

Explicit Regulation of Foreign Firms

Specific regulations directed against foreign firms have declined substantially in the past ten years and are not now a major problem. The legal services sector demonstrates the most serious exception, but even here, the source of the problem lies in the legally granted authority of a professional society to regulate the behavior of the profession. Similarly in accounting, the law grants authority to the Ministry of Finance to approve corporate audit status; years long delays, for what appears to be protectionism, have retarded the business potential of U.S. accounting firms.

Other Sources of Barriers

Cultural and taste differences between the United States and Japan are not an important source of barriers to trade. Experience, joint ventures, and subcontracting have generally been satisfactory methods for avoiding problems, although some mistakes have been made.

One problem that restricts U.S. firms' ability to break into markets is the traditional Japanese practice of maintaining long-term corporate relationships. A Japanese company is unlikely to break longstanding connections with its advertising agency, insurance company, or bank. These relationships are particularly strong within the industrial groups. Regulatory control over prices and innovative products and practices removes from a foreign company's marketing arsenal some of the most important means for altering these relationships. Why should a Japanese company switch its insurance policies from a firm with whom it has worked for years (and moreover with whom it may be associated in the same industrial family) to a foreign company that is constrained to offer the same policies and prices?

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[3]"FTC take critical view of excessive government controls," *Japan Economic Journal*, August 24, 1982.

[4]Upham, 1981–1982, p. 122.

The evidence of past behavior suggests that regulation of business behavior helps to sustain the practice of long-term relationships. However, with increased competition and the appearance of lower cost alternatives, greater attention has been paid to cost-cutting moves. It is mainly for this reason that several large firms have established their own financial subsidiaries.[5]

Potential for Protectionism

Explicit protectionist behavior was not detected in most of the industries that we examined. If protectionist goals existed, they did not have to be overt to be effective. Regulation has been put in place for many purposes: to control natural monopolies, to guarantee the safety of consumers, to protect the public from unacceptable business behavior, and to reduce uncertainties. Protectionism is usually quite secondary and peripheral to the main concerns of the regulators, the regulated, and the public. It has not been the main motive for regulation.

Nevertheless, the rapid and substantial deregulation that is taking place—chiefly in finance and telecommunications—is likely to unmask protectionist sentiments as regulatory barriers fall. An example of this is the foreign capital limit proposed for firms entering the VAN market.

The policy implications of the possible growth of explicit protectionism are somewhat different from those arising from domestic regulation. Governments generally consider domestic regulation to be a domestic matter. Foreign interference in these affairs can be a delicate issue. In the United States, where intense lobbying efforts by a bewildering variety of parties (including foreign governments and companies) is a common occurrence, such attempts to change the regulatory structure are not viewed with great alarm. However, in other countries, similar attempts to shape domestic relationships are often considered as undue interference.

It is more customary for foreign governments to attempt to prevent or reduce explicit barriers to trade than to "interfere" in domestic issues. We suspect that we shall see more outright lobbying by foreign governments in the next several years as Japanese service industries become more exposed to international competition. Because of both domestic and international pressures for greater opening of Japanese

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[5]"Banks Are Disturbed by Corporate Clients' Moves to Have Their Own Financial Subsidiaries," *Japan Economic Journal,* December 6, 1983, p. 31.

service markets, revanchist moves are unlikely to prevent substantial foreign incursions.

INTERNATIONAL PRESSURES AND DOMESTIC DEREGULATION

International negotiations that attempt to reduce trade barriers arising from domestic regulation have a better chance of succeeding when coupled with domestic demand for change. This is seen most clearly in finance and telecommunications where the forces for decontrol within Japan came about independently of any international concerns. In these cases, the U.S. involvement is an additional voice to move events in specific directions, but the clamor for change was already loud and insistent.

When domestic demand for change is quiescent, the ability of outsiders to initiate deregulation or other reductions in barriers is limited. Insurance is a good example of the absence of widespread calls for deregulation. Although it is highly regulated, with restricted opportunities for U.S. companies to market their wide range of products at competitive prices, the Ministry of Finance and the industry have easily contained pressures for change; official U.S. calls for reducing barriers would, we suspect, have little effect.

The strategic implications for diplomatic actions of the preceding argument is for the U.S. government to jump on bandwagons that already have momentum in hopes of influencing their speed and direction. Some may think it to be possible to create movement for change solely through political efforts, but these can be costly, unpredictable, and inconclusive.

Another approach is to mobilize domestic forces for change by appealing to those parties now harmed by regulation or restrictions. Promoting the active involvement of such groups cannot be counted on to introduce tidal waves of support; nevertheless, it is better to have domestic friends on one's side than to have them sitting passively on the sideliness or actively working against U.S. interests. On several occasions, the Japan Federation of Economic Organizations (*Keidanren*) has spoken out in favor of reducing service trade barriers; it has, for example, published its support of foreign lawyer liberalization and financial markets deregulation.[6] However, an American attempt to draw out a major user of international legal advice to assert the usefulness of such services produced a very lukewarm response in a Japan

[6]*Keidanren* Resolution and Proposals to Japanese Government, "Toward Strengthening and Preserving the Free Trade System," September 27, 1983.

law journal.[7] Moreover, surveys of Japanese consumers on the high price of subsidized domestic rice show them to favor continuation of present policies that support the high-cost traditional farming sector over importing cheaper foreign rice. (The *Keidanren* also supports this position.) In every regulated sector we examined, there are groups paying for the cost of monopoly prices, inefficiency, and restricted service. It may be possible at times to enlist their support for change, but countervailing forces often limit such support.

A variant of this policy is a more general approach that distributes information on the costs of barriers and identifies those who pay the higher costs. Although such a campaign is unlikely to have great short-term effects, over the longer run it could help to establish a climate of opinion that viewed regulation and barriers knowledgeably and negatively.

INTERAGENCY POLICY CONFLICT

In areas with a large potential for change, opinions on the directions that change should take are not monolithic. Opinions vary across organizations, within organizations, and over time. Most often, the parties base their views on whether they will be gainers or losers from a proposed policy. These divisions are often reflected in intragovernmental conflicts.

The stable structure of ministerial responsibilities over many business areas, the detailed guidance and *modus operandi* that have evolved, and the many parties involved in most policy decisions require ministerial bureaucrats to mediate narrow interests of organized clienteles. In such situations, Japanese bureaucrats typically seek to avoid conflict, preferring, instead, "technical and incremental solutions and agreements on narrowly defined problems."[8] Questionnaire surveys of Japanese government bureaucrats and politicians indicate that Japanese bureaucrats resent higher level political interference much more than do comparable government personnel in European countries. Japanese civil servants seem to believe that social harmony is primary and that "technocratic and accommodative decisions made by experts such as themselves can best guarantee good policy."[9]

Despite the desire of bureaucrats to control the policy process harmoniously, no policy area is under the exclusive jurisdiction of any

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[7]Sakamoto, 1983, pp. 46–47.

[8]Muramatsu and Krauss, 1984, p. 127.

[9]Ibid., p. 140.

single agency. In the words of one experienced scholar on this subject, "jurisdictional disputes appear to be the very life-blood of the Japanese bureaucracy."[10] Such behavior certainly belies the notion of a consensual approach to Japanese dispute resolution.

Because of this history of organizational conflict, several techniques have been developed to overcome the strong tendencies for bureaucratic deadlock. Extended discussions among involved parties, sometimes lasting for years, may eventually lead to solutions. In other cases, issues will be tabled for further "study," which is likely to kill further consideration without actually declaring the subject dead, but permits it to be revived if changing conditions warrant it. U.S. support of ministries favoring American views (e.g., in VAN deregulation) has been a factor in several outcomes, especially when U.S. involvement helps prevent a weak ministry from giving up prematurely. One of the more important methods of breaking bureaucratic intransigence is for the Liberal Democratic Party to assume a mediating role.

LDP AS ARBITER OF CONFLICT

Decisions over system changes that reallocate wealth, property, and authority are political. In post-1955 Japan, political leadership has been equivalent to Liberal Democratic Party leadership. Indeed, when the LDP is not a participant in policy disputes, interagency conflict is a potent barrier to regulatory change.[11]

Following a decade of stable party leadership in the Diet and government, the LDP by the mid-1960s had acquired the information and expertise to compete with the bureaucracy over many policy issues. A key event in this development occurred in 1965 when the LDP intervened in the budget process, which until then had been the almost exclusive prerogative of the Finance Ministry.[12] An additional two decades of close and continuous monitoring of governmental affairs by a flock of specialized LDP committees further enhanced its role in overseeing ministerial operations, occasionally stepping in to help resolve disputes. Party authority was reinforced by LDP approval of promotions to the higher levels of the civil service and by the move of senior ministerial officials from government to LDP Diet membership.

For a dispute to reach the LDP, the matter must be one of general electoral interest, involve potent gains or losses to political friends and

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[10]Johnson, 1977, p. 231.

[11]Horne, 1982, p. 376.

[12]Muramatsu and Krauss, 1984, pp. 143–144.

allies, or be a deep dispute between agencies that cannot be ignored.[13]

When the LDP does intervene, its behavior is far from uniform. The bureaucracy continues to maintain its authority over most matters on the basis of its demonstrated technical capabilities. For the most part, LDP participation "is limited to requests for revision of the bureaucracy's draft proposal rather than being original proposals themselves."[14] In some cases, a few top LDP politicians—especially the prime minister and his close associates—have initiated and promoted particular policies. For example, Prime Minister Nakasone attempted to push liberalization in banking and telecommunications, partly in response to U.S. requests, partly because of great domestic demand, but also because of his own personal view of a more open and deregulated future Japanese society. This policy from the top forced the resolution of issues that the bureaucracies would not solve themselves and would have preferred to put off.

The political push to settle disputes does not always flow from the top. The many specialized committees, often organized under the umbrella of the LDP's powerful Policy Affairs Research Council, may take on a leadership role over a certain area. This, however, is not always unopposed. In data communications, for example, jockeying for dominant position occurred even among the subcommittees of the Policy Affairs Research Council.

The LDP more often adjudicates than dictates policy. It will protect important electoral supporters such as small banks and businesses, and may prefer certain policy directions (perhaps because of foreign pressures), but in the areas we have reviewed, the LDP is rarely a potent initiator of change.

Apart from the prime minister and the few leaders of powerful LDP factions, power is diffused throughout the party's elite. Without political accommodations among contending participants in policy disputes, LDP intervention is not likely to do more than stimulate compromise. However, if the stakes are large enough, astute political managers may be able and willing to engineer outcomes that go beyond marginal shifts in the bureaucracies' draft proposals. Otherwise, in its day-to-day business, the LDP is not an agent for large shifts in resource allocation patterns or institutional rearrangements.

IMPLICATIONS FOR POLICY

The forces of conservatism in Japan are powerful and pervasive. The United States can be most effective in promoting its desired

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[13]Horne, 1982, p. 376.

[14]Pempel, 1974, p. 653.

changes when it ties its own preferences to domestic Japanese movements for change. In two of the areas we examined—finance and data communications—resolution of policy conflicts within Japan was speeded up several years by U.S. participation. The reverse is also true: Where there is little domestic movement, U.S. efforts are likely to be unavailing.

Policy formation takes place at several levels. Most day-to-day activity occurs among ministerial bureaucrats and business representatives. U.S. actors seeking change, especially business people directly involved in detailed planning, must be heard regularly at these levels. U.S. firms have used several approaches in promoting their interests within the Japanese government bureaucracies. Although we are not able to judge their relative efficacy, we can note certain features of each approach. Some American firms—for example, several of the securities companies—have hired Japanese nationals with experience in their business area and with a background of dealing with the regulatory agencies, usually at a lower working level. This utilitarian approach has the benefit of immediately gaining access to experience already acquired in a field; personnel are typically chosen for their business skills rather than for their political acumen, but along with the technical experience comes a working knowledge of how to get things accepted by the regulatory ministry.

A different approach adopts the Japanese tradition of "descent from heaven"—hiring a former high-level ministerial official as a ranking officer of the firm. (The Sony-Prudential insurance venture used this strategy.) Although such officials may have many years of background and experience in an area, they are not expected to have a detailed, technical competency. Rather, they are viewed as strategic assets, with knowledge of and access to present high-level officials. They are more likely to help guide a firm into new areas by both discerning what is acceptable and by helping to shape official views.

A third approach—association with a Japanese firm—combines the benefits of the first two. Association brings with it the local experience and know-how of the Japanese partner, as well as the benefit of the Japanese firm's political connections. However, a certain amount of business independence is lost.

Finally, many U.S. firms have quietly but steadily accumulated their own experience and competence, becoming over the years quite well integrated into the local scene. They have enjoyed the benefits of regulation while being limited by the constraints. Although perhaps more active in seeking change than their Japanese counterparts, they view themselves as part of the system and do few things to upset their relationships with the ministries. In sectors with great stability, such

as insurance, this pattern of behavior seems appropriate to the circumstances.

Some issues ultimately reach the LDP for disposition. LDP technical and policy committees may be key players in the formulation of policy and therefore ought to be key recipients of the expression of American interests. It would be useful for U.S. representatives—private as well as government—to inform LDP members of U.S. interests, to present information, and to keep them abreast of developments. Diet members, especially those on LDP committees dealing directly with an issue, hear from many domestic sources on all sides of an issue. Such contacts are useful for disseminating information and views, and it is also an act of courtesy to include LDP members who may become decisive figures in policymaking. One Diet member on a LDP data communications committee told us that he felt himself to be ignored when no U.S. business people addressed him with their concerns. Influence here, as well as in ministerial circles, requires continuity of attention although *ad hoc* political involvement at critical points has been useful when combined with routine exchanges of information and views.

The forces for change in public policy are most likely to arise in private institutions rather than from government ministries or the leading political party. If government agencies cannot work out a technical solution to accommodate the pressure for change, the LDP will tend to intervene when it has a direct interest in a policy area. Foreign governments and parties might create such an interest in the LDP leadership. However, it would be most difficult for external parties to stimulate a policy change when domestic forces for change are weak.

The great stability in Japanese affairs can lead to the gradual accumulation of stress in the system, with only infrequent moves to relieve the pent up forces. This has sometimes required more change than the system could absorb at one time. In the United States telecommunications deregulation has been proceeding for 25 years. Participants have been able to adjust gradually in an evolving, stress-relieving adaptation to change. In Japan, the power to resist change that resides in the authority and practices of the regulatory agencies and state-created cartels eventually required adjustments of such magnitude as to threaten important actors in major ways. The analogy to the stress-relieving nature of small earthquakes should not be lost to those familiar with Japanese history. The minor disruptions of frequent but small tremors may be easier to deal with than the chaos produced by infrequent but powerful shocks. However, when the structure of the system weakens the responsiveness of adaptive mechanisms, major shocks are predictable occurrences.

Japanese, of course, recognize these features of their country: the desire for stability, the resistance to change, the search for "fairness" in policies affecting vested interests, the difficulty in reaching consensus among gainers and losers. Recognizing the resistance of the system to modification, they often seem to accumulate desired changes and tack them on to major policy ventures. Thus, NTT privatization, telecommunication competition, and data communications liberalization were tied together in a single package. Such a strategy moves the issues to the political level and clears the bureaucracy of responsibility for outcomes. Although the technocrats in the ministries generally deplore losing control to the politicians, resolution of controversial issues by political leaders may provide welcome relief of burdens to government ministries.

Foreign intervention can play a similar role. Japanese editorial writers are fond of stating that little change occurs in their country without foreign pressures.[15] Foreign involvement, working through the political leadership, politicizes issues by drawing them out of the bureaucracies where they have been stymied by the inability to find a solution. Foreign stimulus was seen in the trust banks issue, VAN deregulation, foreign capital limits on telecommunications companies, and yen internationalization. These areas all had considerable domestic pressures for chance. Nevertheless, without foreign intervention, some of these policy changes may have been considerably delayed and others may have been resolved in ways that did not take as close account of U.S. interests. To return to the earthquake analogy, on the basis of our research, we believe that it is useful to search for faults in the system where there may be slippage, to stimulate movement and to take advantage of it when it occurs naturally, and to encourage local pressures that are aligned with U.S. interests.

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[15]The following opinion on recent negotiated liberalizations is an example of this genre of opinion: "One thing now increasingly manifest to the Japanese themselves is the pitiable lack of independence of mind to positively act in their own and, for this matter, global interest. Unless told by others, they would not do anything on their own, and when told, the initial reaction is negative, and what follows is an action taken with extreme reluctance and in a very sparing manner. What it first insisted it could not do, often proves to be easily done if pressures from abroad build up." Ishizuka, 1984, p. 6.

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