

# **Can Japan Disengage? Winners and Losers in Japan's Political Economy, and the Ties That Bind Them**

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The Japanese economy is splitting into two--or so it would seem from recent press reports.<sup>1</sup> For many years, Japan's world-class manufacturers coexisted in relative harmony with uncompetitive small enterprises, inefficient service industries, and staunchly protected farmers. But as the economy matured, the interests of the two Japans diverged: one sought free trade and the other demanded protection; one thrived on competition and the other survived on regulation. Recent developments only exacerbated the conflict of interest between the two, as the prolonged recession made the system's inefficiencies less tolerable and the appreciation of the yen increased the gap between domestic and world market prices.<sup>2</sup>

In political terms, however, the two Japans never really parted ways. Consumers pay for protection and regulation through higher prices, fewer choices, and lower financial returns, yet sympathize with the farmers and shopkeepers and workers who might be displaced by liberalization. They have certainly not rallied for liberalization, and some have even lobbied against it. Manufacturing exporters face the threat of foreign retaliation for Japan's protectionism, and pay for the high cost of services in their home market. Yet they are linked to the protected sector through business transactions and corporate networks. And the political parties have not realigned along the lines of the two Japans, despite considerable reshuffling since 1993. All the parties vie for support from protected groups such as farmers, retailers, small manufacturers, service providers, and/ or unions.

In this paper, I argue that Japan's postwar political-economic system bound the competitive and protected sectors to each other through political bargains and economic relationships, and that this legacy continues to slow the pace and shape the content of Japan's liberalization today. Given the scale of Japan's financial crisis and its economic troubles, domestic pressures for reform will remain formidable, and the government will proceed with a broad program of reform, including administrative and regulatory reform. But politicians and bureaucrats will seek to maximize the symbolic impact of reforms while still managing the liberalization process so as to minimize the harm to important domestic groups. I define liberalization broadly to include capital liberalization, trade liberalization, and regulatory reform, but focus primarily on the recent period in which the government has emphasized

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<sup>1</sup> "Two Japans: The Gulf Between Corporate Winners and Losers is Growing," *Business Week* cover story (January 27, 1997), pp. 24-28; "Nihon keizai 'nikyokuka' no shin kozo" (The Deep Structure of the Polarization of the Japanese Economy), *Ekonomisuto* (May 13, 1997), pp. 60-73.

<sup>2</sup> Katz (1997) reports that in no other country is there such a large gap in international exposure and productivity between the leading and lagging sectors.

"deregulation."<sup>3</sup> Consumers and exporters have a substantial economic interest in liberalization, and farmers and retailers have a huge stake in protection and regulation. Yet the economic conflict of interest between the two groups does not necessarily translate into political conflict, and the shifting balance of power between the two groups cannot explain the timing and substance of policy change. Consumers and exporters have not always defined their policy preferences in terms of their economic interests narrowly defined. Even when they have favored liberalization, they have not always articulated this preference in the political arena. And even when they have voiced a preference for liberalization, they have not achieved clear-cut policy victories but only complex compromises involving considerable compensation for the potential losers from liberalization.

### **The Economic Stakes in Liberalization**

According to standard economic analysis, economic liberalization should reduce prices and expand choices for consumers, lower costs for producers, and increase overall economic growth. It not only improves efficiency in the short run, but can bring more dynamic long-term benefits by stimulating business activity and innovation. And the higher the level of protection and regulation, the greater the potential benefits from reform. A May 1997 Ministry of International Trade and Industry (MITI) report estimates that by 2001 major reform could raise real economic growth by 6.0 percent, increase direct investment by 39 trillion yen, and reduce consumer prices by 3.4 percent over 1995 levels (Kusano forthcoming).

Frieden and Rogowski (1996) demonstrate how the ongoing process of internationalization might intensify domestic groups' interest in liberalization. Protection has both a distributive cost, in that it punishes consumers of a particular good in favor of its producers, and a social welfare cost, in that it distorts the allocation of resources within the economy. As international trade and capital flows expand, the gap between domestic prices of protected goods and world market prices widens, meaning that the welfare costs of protection

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<sup>3</sup> I favor the term regulatory reform over deregulation because the latter tends to blur the distinction between the introduction or promotion of competition (liberalization) and the reduction or elimination of regulation (deregulation in the literal sense) -- as if the two were necessarily associated. In fact, however, liberalization often requires more regulation, not less. In telecommunications, for example, governments often have to strengthen regulation in order to move from monopoly to effective competition. In other words, regulation can impede competition but it can also sustain or enhance it, so liberalization requires not simple deregulation but pro-competitive regulatory reform: that is, the reduction or removal of those regulations which impede regulation and the strengthening or expansion of those which enhance it.

(and hence the potential benefits from liberalization) increase. Frieden and Rogowski (1996: 34-35) note that this argument applies to structural barriers such as domestic regulation as well as to explicit trade barriers. Moreover, they hypothesize that internationalization may increase conflict between sectors, specifically between those relatively competitive on world markets, which favor liberalization, and those relatively uncompetitive, which demand protection. They also suggest that larger and more multinational firms are more likely to support liberalization than smaller and more domestic firms (also see Milner 1988).

Frances McCall Rosenbluth (1996) applies this line of analysis to the Japanese case, arguing that the Japanese government only maintained protectionist policies for as long as it did because the unusual multimember district (single non-transferable vote) electoral system favored producer groups over consumers. Then since the 1980s, she suggests, the LDP has tried to appeal more to consumers by moving toward agricultural liberalization, retail deregulation and interest rate liberalization. In reality, however, consumers were strongly opposed to agricultural liberalization, ambivalent toward retail deregulation, and decidedly uninterested in deposit interest rate deregulation. So the LDP cannot possibly have advocated these policies to please consumers. Rather, the party has done its best to design liberalization so as not to lose consumer support.

## **Consumers**

Japan's postwar economic system has fundamentally favored producers over consumers.<sup>4</sup> The financial system shifted resources from consumers to producers by maintaining deposit interest rates below market levels. Trade barriers allowed domestic producers to maintain higher prices, and prevented consumers from purchasing cheaper and/ or better products from abroad. Weak enforcement of and bountiful exemptions to antitrust laws permitted price cartels and other forms of collusion between producers. And a wide range of economic regulations impeded competition, bolstered corporate profits, and increased price levels in sectors as diverse as retail and construction (See Table 1). According to standard economic theory, each of these features implies a substantial welfare loss for consumers. And yet Japanese consumers and consumer groups have not advocated liberalization, and have often strongly opposed it. To understand consumers' distinctive policy preferences, we must look to their historical role in war

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<sup>4</sup> This section is based on Vogel (forthcoming).

mobilization and reconstruction, and their political alliances with producers, workers, and opposition political parties.

**TABLE 1**  
**Price Gap Between Goods and Services in Tokyo and Other Major Cities (1995)**  
 (Ratio of Tokyo price level over other-city price level)

	vs. New York	vs. London	vs. Paris
OVERALL	1.59	1.52	1.34
Food products	1.77	1.99	1.78
Durable goods	1.47	1.15	0.94
Clothing and footwear	1.93	1.81	1.50
Other goods	1.54	1.41	1.12
Energy and water	2.17	1.75	1.18
Transp. and communics.	1.51	1.30	1.20
Health and medicine	0.90	2.20	1.60
Education	1.02	0.71	1.26
Rent	2.06	1.59	1.76
General services	1.25	1.28	1.02

*Source: EEPA, Seikeihi chosa ni yoru kobairyoku heika oyobi naigai kakakusa no gaijyo [Purchasing Power Parity and the Domestic-Overseas Price Gap as Seen in Living Expenditure Surveys], 1996*

Japanese consumer groups have strongly opposed agricultural liberalization, one policy change which could substantially improve their economic welfare. In 1987, for example, the Consumers Federation of Japan (Shodanren), a liaison organization for fourteen of the biggest consumer groups, organized a full-fledged national campaign to oppose liberalization. It is tempting to conclude that the consumer groups must have been misrepresenting consumers at large, yet public opinion polls throughout the 1980s and 1990s show that consumers support this position. In a 1988 *Yomiuri* survey, for example, 57.1 percent of respondents supported agricultural protection, whereas only 36.8 percent opposed. And 59.4 percent opposed liberalization, whereas 32.4 percent favored it.<sup>5</sup> The consumer groups' own surveys showed similar results. A 1989 Housewives' Federation (Shufuren) survey showed that 42.2 percent of housewives opposed liberalization and 37.7 percent approved. A 1990 League of Regional

<sup>5</sup> *Yomiuri Shimbun* (November 21, 1988). Other surveys appeared in the *Yomiuri* on July 6, 1981; July 5, 1982; April 4, 1983; July 5, 1983; June 16, 1986 (eve.); February 9, 1987 (eve.); June 8, 1987 (eve.); June 6, 1988 (eve.); and November 28, 1989.

Women's Organizations (Chifuren) survey reported much stronger opposition, with 58.1 percent opposed and only 6.4 percent in favor.<sup>6</sup> The Japanese consumers' stance contrasts markedly with that of similar groups in other countries. At the 1984 conference of the International Organization of Consumer Unions (IOCU), for example, Japanese groups stood alone in refusing to support a proposition in favor of sweeping agricultural liberalization. Meanwhile, European consumer groups have strongly criticized European Community (EC) protectionism in the form of the Common Agricultural Policy (CAP).<sup>7</sup>

Japanese consumer groups have been more ambivalent on regulatory reform, but they certainly have not rallied to the cause. On deposit interest rate deregulation, a 1979 Shufuren survey found that a substantial majority within a random sample of married women reported that they preferred banks to maintain the same interest rates, and virtually none said that they wanted competition in interest rates.<sup>8</sup> When the Ministry of Finance (MOF) was trying to promote deposit interest rate liberalization in the mid 1980s, one bureaucrat desperately tried to find a consumer representative to testify before the relevant policy council. After many calls to representatives who flatly turned him down, he finally found one individual who was more sympathetic. But after some thought, this individual ultimately declined as well. "Personally I would like to see more liberalization," the consumer representative confessed, "but my organization has come out against it -- they want more regulation, not less."<sup>9</sup> Consumer groups have even resisted retail deregulation, arguing that price is not everything, and deregulation would not only hurt small retailers but could wipe out entire neighborhood shopping districts.<sup>10</sup> Once again, survey results suggest their views reflect those of the wider public: when told that the U.S. government claims that retail deregulation would help consumers, 40.9 percent disagreed and only 35.5 percent agreed.<sup>11</sup> Although consumers themselves have not embraced deregulation, other groups have increasingly stepped in to articulate what consumers should want. Economic journalists, economists (especially U.S.-trained economists), discount retailers, and U.S. negotiators have all heralded deregulation in the name of Japanese consumers (Ito 1992, Nakatani and Ota 1994).

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<sup>6</sup> Kokumin Seikatsu Sentaa (1990), p. 41. Also see poll data summarized in Prime Minister's Office (1988).

<sup>7</sup> *Tokyo Business Today* (March 1990), pp. 40-43.

<sup>8</sup> Interview with Hatsuko Yoshioka, deputy secretary general, Shufuren (August 6, 1991).

<sup>9</sup> Interview with MOF official (February 1991).

<sup>10</sup> See Takeuchi (1990), especially pp. 210-13.

<sup>11</sup> *Yomiuri Shimbun* (May 4, 1990). For consumer positions on specific regulatory issues, see Gyosei Kaikaku Iinkai (1996), pp. 300-64. Uchihashi (1995) articulates many of their concerns in his diatribe against deregulation.

Not surprisingly, Japanese consumer groups' distinctive policy preferences are rooted in their history. Through mobilization, war, and recovery, consumer groups sacrificed their own self-interest for the cause of national economic strength. They actively collaborated with the government in national campaigns to suppress consumption (to generate savings for industrial investment) and to buy Japanese products.<sup>12</sup> Moreover, most consumer groups have been historically allied in one way or another with farm groups, trade unions, the traditional leftist opposition parties, and/or environmental groups. Many of the local chapters of consumer organizations work directly with farm groups, especially the farmers' cooperatives, and thus feel bound by mutual ties of obligation. In fact, 12 percent of consumer groups are actually producer groups at the same time (EPA 1996). Other groups work closely with the traditional opposition parties. The Japan Women's Conference (*nihon fujin kaigi*), for example, is allied with the Social Democratic Party of Japan, and the New Japan Women's Association (*shin nihon fujin no kai*) with the Japan Communist Party. These groups have been especially reluctant to embrace measures which might threaten labor unions, the core constituents of these parties. Ultimately, the consumer groups' allegiance with farmers and workers is not simply a matter of reciprocal alliances but also one of identity. Japanese are less likely than Americans to distinguish their identity as consumers from their identity as producers. Many of the consumer groups themselves have embraced the notion of the *seikatsusha*, literally "lifestyle person," which fuses the notion of consumer with that of worker and citizen (Maclachlan 1997: 64-67). In addition, consumers see "weak" groups such as farmers and workers as their allies, and "strong" groups such as big businesses and foreign governments as their adversaries. In fact, they often use the very language of weak vs. strong to justify their policy positions. They contend, for example, that trade liberalization and deregulation merely serve to promote the interests of the strong at the expense of the weak. And if that is the case, then they would prefer to side with the weak.<sup>13</sup>

## **Industry**

Like consumers, Japan's manufacturing exporters have an enormous stake in liberalization. We would expect them to strongly advocate trade liberalization so as to prevent retaliatory protection by other countries, and to demand regulatory reforms to enhance competition domestically and thereby reduce their costs in areas ranging from financial services

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<sup>12</sup> Garon (1997), especially Chaps. 4 and 6.

<sup>13</sup> Interviews 1994-95. See Maclachlan (1997) for an in-depth study of Japanese consumer politics.

to telecommunications, transport, and energy. Some top executives have done just that: Shoichiro Toyoda of Toyota Motors and the Federation of Economic Organizations (Keidanren) has emerged as the most powerful reformer; while Isao Nakauchi of Daiei, a leading discount retailer, may be the most zealous. In practice, however, most corporations have also been beneficiaries of protection and regulation, and have only reluctantly supported liberalization, if at all. These corporations value the cooperative relationship between government and industry, and are wary of measures which might undermine these relations. An October 1996 *Nihon Keizai Shimbun* poll found that 82 percent of firms favored regulatory changes, but only 35 percent wanted changes in administrative guidance and only 6 percent wanted changes in the pattern of government-business cooperation (cited in Tilton 1997). Furthermore, competitive multinationals are linked to the protected sector of the economy through Japan's distinctive interfirm networks. They are tied to small manufacturers through supply networks, to wholesalers and retailers through distribution networks, to financial institutions through long-term banking relationships, and to a wide range of competitive and protected firms through industrial groups and cross-shareholding arrangements (Gerlach 1992). Even with the recession and the high yen, most firms have renegotiated their relationships with suppliers, distributors, bankers, and industrial group partners rather than abandoning them, because they feel that they gain more than they lose from these long-term relationships (interviews 1996-97). To borrow the language of historical institutionalism (Steinmo, Thelen and Longstreth 1992), institutions shape preferences. Thus corporations' view of liberalization reflects not only their own interest in maximizing short-term profits, but also the broader implications of liberalization for business partners, relations with business partners, and relations with the government. They are unlikely to advocate liberalization when they judge that this will invite retaliation or otherwise jeopardize beneficial economic or political relationships.

As Mark Elder (1998) demonstrates, Japanese exporters have not protested the protection of intermediate goods industries, such as steel and petrochemicals, even though this protection substantially increased their costs. They tolerated protection because they benefited from government protection and/ or promotion themselves, and because they were linked to the intermediate goods producers directly through business relationships and indirectly through common links to banks, trading companies, and MITI. But exporters also used this network of relationships to ensure that the costs of protection were kept within reasonable limits.



Japanese corporations most commonly articulate their policy preferences through industry associations. They feel that they wield more influence by working together, and they often prefer not to take controversial policy stands on their own for fear of public criticism or private retribution. But at this level, they face the difficulty of aggregating the sometimes disparate interests of member companies. So industry associations that incorporate both competitive and protected sectors of the economy are unlikely to support liberal reform. In some sectors, companies overcome the most obvious conflicts of interest by subdividing into smaller associations. In finance, for example, each of the major segments of the banking industry has its own industry association. In broader associations, however, leaders often have difficulty in forging a consensus on policy. "Our industry is not that heavily regulated, but we do have some regulated areas, such as radio, medical instruments, and cable television and broadcasting," reports Kazuaki Ogasawara of the Electronic Industries Association of Japan. "So on deregulation we defer to Keidanren."<sup>14</sup> Mark Tilton (1997) finds that the journals of the major automobile, electronics, telecommunications and chemical industry associations express little interest in pro-competitive reform, and the auto industry journal even stands out against tax deregulation.

Keidanren has served as the most powerful advocate of liberal reform, strongly supporting fiscal reform, agricultural liberalization, and deregulation. Yet even Keidanren has moderated its message in order to preserve good relations with the protected sectors of the economy. It has not pressed too hard for agricultural liberalization, for example, for fear of antagonizing the Nogyo and/ or hurting the LDP politically (Bullock 1997). And it has also confronted dissenters within its own ranks. For example, the oil industry association -- which not coincidentally is located within Keidanren's headquarters building -- forced Keidanren to drop oil from its widely publicized deregulation proposal of November 1994. More recently, financial institutions have pushed Keidanren to qualify its support for Prime Minister Hashimoto's "Big Bang" financial reforms.<sup>15</sup>

Like their colleagues in management, union leaders in the competitive and protected sectors of the economy have distinct interests regarding economic reform. The automobile, electronics and steel unions recognize that they stand to benefit from regulatory reforms that

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<sup>14</sup> Director, Information Systems Development Office, interviewed February 27, 1997.

<sup>15</sup> Interview with senior Keidanren official (March 1997).

would enhance competition in service industries. But they are reluctant to take a strong stand politically because they are tied to unions in protected sectors.<sup>16</sup> "We favor deregulation," explains one steel union leader, "but we still have to get along with our friends in the electricity industry unions." The steel unions all support deregulation, he notes, but they conflict with unions from more protected sectors at the level of the Japanese Trade Union Confederation (Rengo).<sup>17</sup> Yet it is precisely at the level of Rengo where the unions concentrate their political activity. Rengo has taken a highly ambivalent stance on regulatory reform, welcoming it in principle yet opposing specific measures that might result in labor dislocation. Like many other interest groups, Rengo stands "in favor in principle, yet opposed on specifics" (*soron sansei kakuron hantai*).

### **The Political Parties**

No Japanese political party has ever stood unequivocally in favor of economic liberalization, and no party is likely to do so in the foreseeable future. In part, this reflects the parties' recognition of the consumer and industry preferences outlined above. During its period of hegemony (1955-93), the Liberal Democratic Party (LDP) enjoyed an unusually broad support coalition spanning both the competitive and protected sectors, so it tried to avoid supporting policies which would blatantly sacrifice one part of the coalition in favor of another. In the early postwar years, the full range of the party's coalition -- including big businesses, small businesses, and farmers -- supported protection. The party's challenge was to find ways to support weaker sectors, such as small business and agriculture, without undermining its larger goal of promoting rapid economic growth. Japan's postwar system rested on a grand settlement in which the government pursued a high-growth economic strategy of low interest rates, tight fiscal policy, the transfer of personal savings into industrial investment, and active industrial policy; and it matched this with a political strategy in which it compensated specific constituent groups, notably farmers and small businesses, through protection, subsidies, and public works spending (Masumi 1985, Calder 1988, Woodall 1996, Bullock 1997). The party satisfied big business with its economic policy and gained diffuse electoral support through economic growth itself, but it earned "hard" votes by distributing material compensation to favored constituent groups. Although this compensation grew to be somewhat costly, it was still less threatening to the high-

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<sup>16</sup> Interviews with leaders of automobile, electronics, and steel unions (February-March 1997).

<sup>17</sup> Interview with Rikio Kozu, deputy secretary, Federation of Nippon Steel Workers' Unions (February 26, 1997).

growth economic policy than labor incorporation would have been (see Pempel and Tsunekawa 1979). The party accomplished this delicate balance through an internal division of labor in which backbenchers pressed for compensation policies while party leaders guarded the party's long-term interest in sustaining sound economic policy. More critically, the party left much of the formulation and implementation of economic policy in the hands of bureaucrats, who were relatively insulated from the demands of specific groups. In many cases, the bureaucracy was able to design compensation policies that also had some economic merit, such as transport infrastructure projects or R&D subsidies for small businesses.

By the late 1960s, party leaders began to adjust their economic strategy to broaden their political support and undercut the opposition. They strengthened environmental protection, expanded welfare programs, and boosted public works spending (Calder 1988, Curtis 1988). As government spending rose and economic growth slowed in the 1970s, Japan began to experience large budget deficits. This brought to the surface the latent conflict of interest between big business and the protected sectors, with Keidanren pushing for limits on spending and farmers, small businesses, and other favored groups defending their benefits (see Otake 1994). But given the LDP's dominance and the breadth of its coalition, it could resolve this conflict in house: through balancing within the party rather than competition with other parties. The party sought to liberalize the economy without undercutting its own support from protected groups by externalizing the pressure for change, portraying itself as the defender of its constituents against outside forces. It amplified one form of external pressure, that from the U.S. government, and it helped to create another, the Second Provisional Council on Administrative Reform (Rincho). Prime Minister Zenko Suzuki established the Rincho in 1980 with a broad mandate to promote fiscal reform, privatization, deregulation, and bureaucratic restructuring. Seizaburo Sato argues that the Rincho gave the LDP the best of all worlds: it could get the same political credit for holding the line on subsidy spending that it would get otherwise from pushing through spending increases.<sup>18</sup>

During the period of LDP hegemony, the opposition parties distinguished themselves from the LDP by pressing if anything for more protection and more regulation, not less. But since 1993, new opposition parties have emerged that could represent those groups, such as consumers and exporters, whose interests in liberalization were not represented by the LDP and

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<sup>18</sup> Personal communication.

the traditional opposition parties. Furthermore, the Diet changed the Lower House electoral system in 1994 to one purported to give parties greater incentive to differentiate themselves along policy lines. It replaced the old multi-member district (or single non-transferable vote) system with a combination of 300 single-member districts and 200 proportional representation seats in 11 regional blocs.<sup>19</sup> Some of the new parties have indeed tried to portray themselves as proponents of small government, in contrast to the LDP and the SDPJ, yet none of them has been able to break free from reliance on support from protected sectors of society (see Pempel 1997).

Morihiro Hosokawa took office as prime minister in August 1993 with a commitment to change, but with little in the way of specific policy proposals. He had founded the Japan New Party (JNP) in 1992, a full year before the LDP broke up, giving him credibility as a true reformer rather than a mere opportunist. The party fared well in the July 1993 Lower House elections, garnering 39 seats and running particularly well among young non-aligned voters such as white-collar workers in the bedroom communities surrounding Tokyo (See Table 2).

Hosokawa promptly appointed a new study group on deregulation to be headed by Keidanren Chairman Gaishi Hiraiwa. But when the study group reported in December, it essentially reproduced the bureaucracy's own list of measures already targeted for action. Hosokawa was crippled by the necessities of managing an unwieldy seven-party coalition, one that included the less-than-liberal Social Democratic Party of Japan (SDPJ), Democratic Social Party (DSP), and Clean Government Party (Komeito). Then in April 1994, he abruptly resigned after a minor scandal, and in June 1994 the LDP conspired with the SDPJ to topple the coalition.

The largest group of LDP defectors fled with the mastermind of Japan's political revolution, Ichiro Ozawa, and joined his Japan Renewal Party (Shinseito). Ozawa articulated his own policy vision in a best-selling book (Ozawa 1993), in which he advocates a more assertive foreign and defense policy, political reform, and economic liberalization. Yet it was unclear to what extent Ozawa could rally his new party, let alone the entire coalition, behind this vision. He lacked credibility on political and economic reform, for he had risen through the ranks of the old Tanaka faction, a haven of corruption and pork-barrel politics. He and his colleagues strongly supported deregulation in public, but also had to be sensitive to the political reality of competing with the LDP for financial and electoral support. That is, they would find more reliable support by promising protection and regulation than by touting liberal reform.

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<sup>19</sup> See Christensen (1996) on the implications of the new system.

Masayoshi Takemura led a smaller group of LDP defectors known as the Harbinger Party (Sakigake). Sakigake members were mostly young second-generation (*nisei*) Diet members, whose strong (inherited) political support organizations gave them considerable autonomy from their factions and the party (Otake 1996: 276-78). Most were more dovish than their Shinseito counterparts, yet more strongly committed to liberalization. They included some of the most innovative and articulate reformist politicians, but the Sakigake as a party lacked any coherent collective identity. Shusei Tanaka, director-general of the Economic Planning Agency and a key policy advisor under Hosokawa, invited massive criticism by writing an article about two Japans, one competitive and one protected. He boasts that he is the only conservative politician ever to run in his district without the support of the Federation of Agricultural Cooperatives (Nokyo). Not too surprisingly, he found his zeal for deregulation rewarded with defeat at the polls in 1996.<sup>20</sup> In June 1994, the Sakigake broke with the old coalition and joined the LDP and the SDPJ in the new coalition government. In doing so, however, it linked its fate with the two parties most closely associated with big government and the old regime of protection and subsidies. In 1996, the party's most promising young star, Yukio Hatoyama, formed yet another party (discussed below), taking most party members with him. Among Lower House Diet members, only Takemura and Hiroyuki Sonoda remained in the Sakigake after the October 1996 elections.

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<sup>20</sup> Speech at the Institute for Statistical Research Symposium on Promoting Japanese Deregulation, Tokyo, March 10, 1997.

**TABLE 2 Lower House Election Results 1990-96**  
(number of seats won by each party)

Party	February	July	October
	1990	1993	1996
Liberal Democratic Party	275	223	239
<b>TRADITIONAL OPPOSITION PARTIES</b>			
Social Democratic Party	136	70	15
Clean Government Party (Komeito)	45	51	
Democratic Socialist Party	14	15	
Japan Communist Party	16	15	26
<b>NEW OPPOSITION PARTIES</b>			
Japan New Party		35	
Japan Renewal Party (Shinseito)		55	
Harbinger Party (Sakigake)		13	2
Democratic Party of Japan			52
New Frontier Party (Shinshinto)			156
Independents and others	25	34	10

*NOTE: Party alignment as of September 1997 was LDP 251, NFP 133, DPJ 52, JCP 26, SDPJ 15, Sun Party (Taiyoto) 10, Sakigake 2, independents 11.*

In December 1994, the Shinseito, JNP, Komeito and DSP joined to form the New Frontier Party (Shinshinto). The new single-member district electoral system strongly encourages small parties to collaborate or unite, for they risk splitting the vote if they run more than one candidate per district. Smaller parties can still survive by garnering proportional representation seats, but they have little chance of winning in single-member districts. The Japan Communist Party elegantly demonstrated this in the 1996 elections, winning 25 proportional representation seats and only one single-member seat. Ozawa was critically aware of this logic, and was determined to put together a larger party before the first election under the new system. On policy, however, the Shinshinto represented an awkward union of doves with hawks, and economic liberals with socialists. Ozawa hoped that the alliance with the Komeito would bring in the highly organized support of the Soka Gakkai religious group. But the Komeito had traditionally defined itself as an ally of the weaker members of society, and its followers represent a conservative segment of the population especially unlikely to embrace liberal reform (Otake 1996: 294). Meanwhile, DSP members remained loyal to their union backers, and former Shinseito politicians from rural regions continued to promise more agricultural subsidies and

public works spending. "You can talk about deregulation in Tokyo," says one party staff member, "but not in the countryside."<sup>21</sup> Even in his urban district in Sendai, Kazuo Aichi claims that he wins few votes by appealing for liberalization and deregulation. "You have to strike a delicate balance: You must have deregulation on your platform because it is a kind of national trend. But at the same time it does not help you either. So I try to run on my personal characteristics: roots in the district, experience, trust".<sup>22</sup> Aichi left the party in July 1997, joining a growing stream of defectors that includes Hosokawa, and Tsutomu Hata and a small group of his followers (now the Sun Party). By bringing in some of the defectors, including Aichi, the LDP managed to regain a majority in the Lower House by September.

A poll of Diet members in the August 1996 *Bungei Shunju* showed Shinshinto members to be more favorable toward deregulation than their LDP colleagues, although many Shinshinto members expressed reservations as well (Table 3). Diet members were asked to choose which of two statements most closely reflected their own views: 1) Regulations on economic activity should be restricted to the protection of the weakest members of society, and should be relaxed or removed as soon as possible according to the principles of freedom and self-responsibility, or 2) The easing of regulations on economic activity should proceed gradually so as to avoid disruption, with due concern for the weaker members of society. Of Shinshinto members polled, 61 favored the more aggressive approach and 19 chose the more cautious approach. Of LDP members, 19 selected the aggressive approach and 24 preferred the gradual approach.

Hatoyama's Democratic Party of Japan (DPJ) is equally riddled with internal contradictions. Hatoyama strongly advocates small government and decentralization; co-leader Naoto Kan champions bureaucratic reform; and yet the majority of party members come from the SDPJ, with their strongest political support from public-sector trade unions. "We favor deregulation," explains one party strategist, "but we rely on the unions for support, so we may not be able to push on this too much."<sup>23</sup> Journalist Tatsumi Ito accused the DPJ of lacking any policy line whatsoever (*Bungei Shunju*, August 1996: 310-16), and Hatoyama responded with a statement of his own policy vision: one in which the government would support the weaker members of society without breeding structural dependence on state support (*Bungei Shunju*, November 1996: 112-30).

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<sup>21</sup> Interview (February 1997).

<sup>22</sup> Interview (March 6, 1997).

<sup>23</sup> Interview, Masaki Nakajima, Policy Advisor, Democratic Party of Japan, February 26, 1997.

**TABLE 3 Diet Members' Views on Deregulation**

	Aggressively Deregulate	Cautiously Deregulate	Other
Liberal Democratic Party	19	24	3
New Frontier Party (Shinshinto)	61	19	1
Social Democratic Party	9	20	
Japan Communist Party		4	9
Harbinger Party (Sakigake)	8	4	
Others	5	4	1

Source: *Bungei Shunju* (August 1996), p. 121.

By bringing in some of the Shinshinto defectors, the LDP managed to regain a majority in the Lower House by September 1997. Then in January 1998, the Shinshinto dissolved altogether, splitting into no less than six new groups. If Ozawa's group joins the LDP in a new conservative-conservative alliance (*hoho rengo*), this new alliance will continue to embrace both advocates and opponents of liberal reform. And if the DPJ, the SDPJ, and the other former-Shinshinto groups ally, they are not likely to present an economically liberal alternative. Over the long term, the logic of the new electoral system may push parties to differentiate themselves more clearly along policy lines (see Christensen 1996). Even if this happens, however, no party is likely to push for drastic liberalization, for even those groups with the greatest stake in liberalization give it only qualified support. Moreover, those groups who oppose liberalization -- farmers, workers, protected industries -- offer more reliable financial and electoral support than those who advocate it. Although urban voters may favor some liberal reforms, they remain one of the least reliable political support groups: less likely to vote than other groups and more likely to change party affiliation (Bullock 1997). And although Keidanren supports reform, it suspended political donations in 1993 and has only cautiously resumed them. Thus any party's best strategy remains to support deregulation in principle, but advocate only those specific measures where the benefits<sup>24</sup> are clear and indisputable. Other than that, most parties will try to cultivate one or more groups of core supporters ("hard" votes), and then devise an electoral strategy that combines campaign organization with personal appeal.

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<sup>24</sup> "'*Kisei kanwa suishinsho' ni henshin*" [MITI Transforms Itself into "The Ministry of Deregulation"], *Nikkei Business*, October 24, 1994, pp. 14018.



## **The Bureaucracy**

Like the political parties, government ministries are simultaneously proponents and opponents of liberalization. In general, they advocate deregulation in all areas except those under their own jurisdiction. Even within their jurisdiction, they are more zealous in trying to shape the substance of reform than in trying to stop it altogether. The clearest advocates of reform within the bureaucracy are those with the least clout, and their rivalry for the role of lead reformer has only undermined their credibility. The Management and Coordination Agency (MCA), a cabinet-level agency within the Prime Minister's Office, serves as the primary coordinator of regulatory reform programs, but it relies on a close working relationship with the individual ministries so it cannot proceed without their approval. The Economic Planning Agency (EPA), the most liberal agency in philosophy, has championed the work of academic economists who espouse deregulation, but has little role in policy formation. The Fair Trade Commission (FTC) has attempted to take advantage of the reformist mood of the 1990s to strengthen antitrust policy, and has made influential proposals on issues such as breaking up Nippon Telegraph and Telephone (NTT) and lifting the ban on holding companies. But it is notoriously weak politically, and its jurisdiction is limited to matters of competition policy. The Foreign Ministry supports trade liberalization and deregulation to ease Japan's relations with the United States and other trading partners, but it defers to MITI and the other regulatory ministries on specific issues (Kusano forthcoming).

Among the regulatory ministries, MITI has taken the strongest stand in favor of liberalization. Like the LDP, MITI represents constituencies on both sides of the debate: the beneficiaries and the victims of protection and regulation. And MITI's own organization -- with a combination of functional and industry bureaus, and a coordinating secretariat -- facilitates the internal balancing of these interests and the structuring of bargains across industries (Elder 1998). But MITI lacks credibility as a lead reformer, for it is responsible for some of the most heavily regulated industries of all, including energy and retail. Rival ministries such as the Ministry of Finance or the Ministry of Posts and Telecommunications are especially wary of allowing MITI to take the lead. They would prefer a weaker agency, such as the MCA, to play the coordinating role. In 1994, when MITI issued two reports advocating deregulation in areas outside its own jurisdiction, other ministries cried foul. The other ministries reportedly viewed this as a blatant violation of an unwritten bureaucratic code: do not stick your nose in other

ministries' business.<sup>25</sup> Even so, MITI has emerged as a particularly powerful actor in reform efforts since 1996 by virtue of its strong ties to Prime Minister Hashimoto, a former MITI minister. In fact, many analysts suspect that MITI itself is behind some of Hashimoto's reform proposals, such as those regarding the reorganization of the central government ministries.

Other regulatory ministries oversee their own bargains between industry players within their jurisdictions: sectoral (micro) bargains which are embedded in the broader (macro) political settlement discussed in the previous section. The Ministry of Finance has presided over a complex regulatory regime which assigned specific rights and duties to different types of financial institutions, such as securities houses, insurance companies, and various types of banks. Long-term credit banks, for example, performed the duty of providing long-term credit for industry, enjoyed the exclusive privilege of issuing bank debentures, and endured a prohibition on accepting retail deposits and strict limits on building new branches. The city banks, in turn, could not issue bank debentures, but could accept retail deposits and could set up many more branches. One can view this as a kind of "deal" between the ministry, the long-term credit banks, and the city banks. But this deal was embedded in a larger bargain between banks and securities houses, and that sectoral bargain was in turn embedded in a broader political settlement between big business, small business, and farmers. Likewise, the Ministry of Transport oversaw a sectoral bargain in the airline industry between three major players with distinct niches: Japan Air Lines, the international carrier; All Nippon Airways, the domestic carrier; and Toa Airways (now Japan Air System), the local carrier. This bargain was then embedded in a broader transport regime in which the ministry balanced the promotion and regulation of the airline industry with the development of road, rail and sea transport.

In practice, the government ministries have powerfully shaped the substance of liberalization because they have taken the lead in renegotiating these sectoral bargains. The ministries can play this role because they enjoy considerable discretion within the limits of their jurisdiction.<sup>26</sup> They are relatively insulated from interference from politicians, independent regulatory agencies, or the courts. Thus jurisdiction over a given sector rarely shifts from one ministry to another, or to another branch of government. This means that a ministry can serve as

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<sup>25</sup> "'*Kisei kanwa suishinsho' ni henshin*" [MITI Transforms Itself into "The Ministry of Deregulation"], *Nikkei Business*, October 24, 1994, pp. 14018.

<sup>26</sup> They are more capable of orchestrating bargains within the range of their own jurisdiction than when they must work with other ministries. On inter-ministry conflicts, see Campbell (1984) and Johnson (1989).

an effective broker between industry actors because it can enforce deals over time. In contrast, U.S. government departments could never orchestrate bargains in the same way because the arena of policy formulation constantly shifts from the departments to Congress, to independent regulatory agencies, to the courts, and to the states.

Ministries are also able to manipulate the balance of power within their jurisdiction by determining the relative representation of various societal groups in policy councils (*shingikai*) (see Schwartz 1998). Ministry officials have to structure policy change in a way that respects the norms of fairness and balance between societal players, and this means incorporating the potential losers from policy change into the process of reform itself. For regulatory reform, this means that although the potential losers cannot block reform, they can strongly influence its substance. Typically they gain compensation in the form of strategic delays or government support to help them to prepare for new competition.

In renegotiating sectoral bargains, the ministries do not simply allocate resources according to the relative political power of the constituent industries, but pursue their own agenda at the same time. They try to promote their own view of the national interest, to facilitate their own functional responsibilities, and to preserve their own power. They tend to view the national interest in terms of long-term growth over short-term efficiency, and social stability over competition as a goal in and of itself. They are especially concerned with how policy change in one area might affect other policies within their jurisdiction. MOF officials, for example, have carefully considered how financial reform proposals might affect the ministry's ability to service the national debt (see Mabuchi 1994). And of course, Japanese bureaucrats resist the devolution of authority to independent regulatory agencies, guard their discretion in implementing policy, and design reforms to maintain some leverage over industry (Vogel 1996).

### **The Pattern of Reform**

Thus the competitive and the protected sectors of the economy are linked in three ways -- through direct economic and/ or social relationships, through political coalitions, and through bureaucratic networks. These linkages moderate societal demands for liberalization and condition its substance. Japan's distinctive approach to liberalization has been characterized by slow and incremental change; elaborate political bargains, typically involving compensation for the potential losers from reform; considerable efforts to prepare industry for competition; and

continued bureaucratic monitoring and manipulation of the terms of competition. In the early years of capital and trade liberalization in the 1960s and 1970s, the Japanese government combined liberalization with active guidance and support for the private sector in developing functional substitutes for protection. The government encouraged corporations to increase cross-shareholding to insulate themselves from foreign direct investment, urged film producers to cultivate exclusive relationships with distributors, and helped auto firms to strengthen strategic partnerships with suppliers, dealers, and banks (Mason and Encarnation 1990, Dewey Ballantine 1995, Tate 1995). These practices later came to be viewed as structural barriers to trade. In more recent years, ministry officials have still sought to minimize the negative impact of liberalization on domestic industry, but they have confronted new difficulties as they have shifted from trade liberalization to regulatory reform. They have had to develop more complex political bargains to resolve conflicts of interest between different segments of industry, and to carefully shape the substance of reform so as to preserve their own authority.

The Ministry of Finance, for example, has orchestrated a complex multilayered deal to resolve the problem of financial system reform, the process of redefining the regulatory barriers between the various segments of the industry. After six years of deliberations, the ministry presented the initial blueprint for reform in 1991: it would allow financial institutions to enter each other's lines of business through separate subsidiaries. At the same time, it would enact strict regulatory "firewalls" between financial institutions and their new subsidiaries, and severely restrict the scope of business in which subsidiaries could engage (MOF 1991). Critically, the ministry left itself the discretion to determine the timing and the conditions of new entry. It then offered the first licenses to those industry players which deserved some compensation in the deal: long-term credit banks, trust banks, and securities houses. Moreover, ministry officials consciously designed the reform legislation to make it easier to restructure the industry. They included a provision allowing the long-term credit banks and the Bank of Tokyo to merge with other banks, and thereby to acquire large branch networks, without giving up the privilege of issuing bank debentures. And they inserted a clause whereby banks could enter the securities business directly if they bought out an ailing securities firm. Many commentators viewed the ministry's solution as a hopelessly muddled political compromise, but ministry officials defended their approach by way of aphorism: "bear it small, but grow it big" (*chiisaku unde, okiku sodateru*). That is, they would unravel the bargain and proceed with more

meaningful reform over the long term. And that is precisely what they have done. In December 1996, Prime Minister Hashimoto announced a bold reform package that has come to be known as Japan's "Big Bang." Among other things, the government proposes a new stage in financial system reform in which financial institutions will be able to engage in the full range of financial services by forming holding companies. Ironically, however, the ministry's drive to protect domestic financial institutions and to guard its own authority ultimately may have backfired, as overprotection has cultivated institutions unprepared for more open competition and the financial crisis has generated widespread criticism of the ministry and calls for even bolder reform. The ministry has managed to fight off a proposal to split off all three financial bureaus into a new Finance Agency, but the government does plan to subject it to the symbolic humiliation of being renamed the Treasury Ministry.

The Ministry of Transport has taken the elegantly orchestrated bargain to its absurd extreme with airline "deregulation." In 1986 it began to introduce second and sometimes third carriers on select routes through a meticulously planned series of barter in which Japan Air Lines, for example, would open a new route on a specific ANA line, and ANA would open a new route on a JAL line in exchange. Ministry officials would determine which routes could sustain competition, and how much competition they could sustain. They added new routes at specified time intervals and carefully monitored results before moving on to the next step. Furthermore, they gave special consideration to carriers fulfilling a public service function by serving routes with very low demand, such as those serving small outlying islands. These carriers were given priority to move into lucrative new routes and were protected from entry in their own most profitable routes. In response to increased pressure for regulatory reform, the ministry allowed a new carrier to enter the market in 1997, beginning with service from Tokyo to Sapporo.

In telecommunications, the Ministry of Posts and Telecommunications has been less bound by past bargains of its own creation, for it played only a modest role in the sector prior to reform. Before privatization and "deregulation" in 1985, NTT was the dominant force in the sector as the monopoly carrier, the primary sponsor of R&D, and a regulator in its own right. In fact, MPT officials consciously designed the reforms to reassert their proper authority over NTT. Under the new regime, the ministry has closely controlled price and service changes by both NTT and its new competitors so as to allow the competitors to grow without allowing NTT to

become too complacent. From 1985 through 1993, NTT gradually lowered its rates from 400 to 180 yen for a three-minute call from Tokyo to Osaka. The three new carriers initially held a 40 yen price advantage over NTT for most calls, but the MPT then allowed NTT to cut the gap to 20 yen in 1992 and 10 yen in 1993. The ministry then overhauled the price structure in 1994, creating new larger local dialing areas with higher initial call rates. Meanwhile, the ministry took up its own version of industrial policy, funneling funds to the new competitors through the Japan Development Bank (JDB), devising a new program to provide low-interest loans for infrastructure projects, and increasing funding for its own laboratories. MPT officials have treated the incumbent international carrier, Kokusai Denshin Denwa (KDD), much more gently than NTT because KDD does not have NTT's massive local network or its ability to combine local and long-distance service -- and also because they enjoy a more cooperative relationship with KDD. They allowed KDD to lower its calling rates more quickly to counter its own new challengers, and they kept NTT out of the international market altogether. Then in the fall of 1996, Prime Minister Hashimoto and other top political leaders began to argue that NTT should be allowed into the international service market so that Japan could have a national champion strong enough to take on British Telecom or AT&T. Hashimoto, the MPT, and NTT then worked out a delicate compromise whereby NTT would be allowed into the international market, but would be broken up into one long-distance carrier and two regional carriers, although the three units would remain joined within a single holding company structure.

In more politicized sectors, such as retail and agriculture, reform has entailed tampering with political settlements as well as bureaucratic bargains. Politicians have intervened more directly to ensure proper compensation for their political constituents, although bureaucrats have still fine-tuned the final bargains. In retail, MITI announced an initial proposal for reforming the Large-Scale Retail Store Law in 1989, and the U.S. government greatly intensified the pressure for reform through the Strategic Impediments Initiative (SII) talks. U.S. negotiators charged that the law closed out both American retailers and domestic discounters which might offer more foreign goods than the mom-and-pop stores. In addition, the high cost of distributing goods through this system eroded the price advantage of many foreign goods (Schoppa 1997: 155-63). The LDP relied heavily on small merchants for political support, so it was determined to find a solution which would not cost it this support (Kusano 1992). The government phased in reforms gradually from 1990 through 1994, streamlining the approval process for large stores but still

allowing the small merchants themselves to exercise considerable control (Upham 1996). In practice, local regulatory boards have required most large store operators to reduce planned floorspace before accepting their proposals. MITI itself was a major beneficiary of the reforms, as it increased its leverage over the retail sector and acquired a new budget line of 10 billion a year to support the modernization of local shopping districts (Schoppa 1997: 174-80).

The Japanese government confronted one of its stickiest political dilemmas in late 1993 when it agreed to open its rice market, albeit very partially. It faced intense international pressure to concede so as not to derail the Uruguay Round of multilateral trade talks, and yet it faced powerful opposition from farmers and consumer groups. Even though the ruling coalition at the time excluded the LDP, the party most reliant on the farm vote, it included SDPJ politicians committed to supporting farmers and many other politicians from rural districts who were reluctant to cross the Nokyo. Bullock (1997) argues that the government developed an ingenious solution which conceded to international pressure without decreasing support for rice farmers or undermining the Ministry of Agriculture, Forestry, and Fisheries' (MAFF) regulatory authority. It got the U.S. government to drop its insistence on tariffication and agree to a minimum access plan whereby Japan would allow imports equivalent to 4-8 percent of total consumption. The ministry itself would administer the deal through a revitalized Food Control System, the traditional mechanism for controlling the distribution of agricultural products. It would import rice at world market prices, sell it at prices close to domestic prices, and then use the profits to subsidize farmers as compensation for liberalization, to invest in productivity improvements, and to increase rice stockpiles. Then with the LDP back in power, the Diet passed a mammoth 6 trillion yen package of additional rural public works and agricultural subsidies in October 1994.<sup>27</sup>

### **Can Japan Become a Liberal Market Economy?**

In recent years, domestic pressure for policy change has dramatically increased. The prolonged recession has demolished one of the main pillars in the postwar system, stable economic growth, prompting opinion leaders to challenge hallowed postwar institutions and call for drastic reforms (Pempel 1997). Meanwhile, the bureaucracy has become mired in a series of

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<sup>27</sup> Carlile's (1997) analysis of construction "deregulation" also fits the pattern described here: LDP politicians and Construction Ministry bureaucrats redefined "deregulation" to mean relaxing land-use regulations and construction standards, selling government land to private developers, and creating new public-private mega-projects. As a result, politicians found new ways to appeal to constituents despite fiscal retrenchment, and bureaucrats expanded jurisdiction and increased regulatory powers over industry. Also see Otake (1994) and Woodall (1996).

scandals, leading commentators to openly question its leadership. Actors outside the classic iron triangle of party, bureaucracy, and big business have emerged as some of the most vocal proponents of reform. American-trained economists have championed bold deregulation, and maverick discount retailers and rebel taxi companies have tried to capitalize on the mood of the moment to push for further reforms. The media has fueled a perception of dire crisis, weighing in strongly in favor of reform (Kusano forthcoming). Within this climate, the major political parties all pledged bold reform in the October 1996 general elections. They paid slightly more attention to policy issues than they had in past elections, but advocated similar policies, focusing primarily on economic reforms to reinvigorate the economy and reduce government regulation. The dynamics of this competition pushed the LDP to pledge bolder reform than it might otherwise have done, leaving Prime Minister Hashimoto in the awkward position of having to deliver on his promises. The perception of crisis now makes it almost impossible to oppose reform outright. Thus the natural proponents of reform may restrain their enthusiasm, but the opponents must also moderate their dissent. Farmers and unions and regulated industries must focus on shaping the terms of liberalization rather than opposing it altogether. The crisis atmosphere creates political space in which the process of renegotiating settlements and bargains becomes slightly easier. The potential losers will continue to shape the terms of their own defeat, but they may have to settle for less compensation than they might expect under more normal circumstances. And with the spread of financial crisis throughout Asia in late 1997, the spectacular failure of Hokkaido Takushoku Bank and Yamaichi Securities, and deepening concerns about the health of the Japanese economy, the calls for bold action have only increased.

Even so, Japan is not likely to converge on the Anglo-American liberal market model. Japan's approach to regulatory reform to date contrasts markedly to that of the United States or Britain, where government authorities have aggressively promoted competition without trying to limit new market entry or to prevent the exit of inefficient firms; they have separated regulatory functions from industrial sponsorship by delegating these functions to independent regulatory authorities; and they have limited bureaucratic discretion by codifying regulation and formalizing the regulatory process (Vogel 1996). Even as Japan liberalizes, ironically, its trajectory of liberalization is powerfully conditioned by the legacy of developmentalism. I have argued here that Japan's high-growth strategy was institutionalized in terms of economic and political ties between consumers and producers and between competitive and protected



industries, and in sectoral bargains and national political settlements that slowed the pace and shaped the substance of reform. Ultimately, however, Japan's developmental system has shaped its approach to reform in other ways as well. That is, the system was characterized by a particular constellation of interrelated political bargains, policies, ideas and institutions. The high-growth strategy was not only institutionalized in the form of political bargains, but it produced a policy momentum which is not easily reversed; it was reinforced by an economic ideology which is not easily unrooted; and it became embodied in standard practices and behavior which are not easily abandoned. Thus we may find that the dramatic reforms of the 1990s -- like those of the late 1940s and the 1970s -- end up being more momentous in form than in substance, as earlier institutions and practices reassert themselves in new forms.<sup>28</sup>

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<sup>28</sup> See Hiwatari (1996) on adaptations in the 1970s.

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