A RAND NOTE

CASE STUDIES OF U.S. SERVICE TRADE IN JAPAN

Arthur J. Alexander, Hong W. Tan

September 1984

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This Note is a compilation of case studies on U.S. service trade in Japan. It is a companion to a Rand Report: Arthur J. Alexander and Hong W. Tan, *Barriers to U.S. Service Trade in Japan*, R-3175, July 1984. The Report synthesizes and integrates the findings of the case studies and draws policy conclusions. This Note, in contrast, is intended to provide a fuller development of the cases for the interested reader. The case studies and analyses make use of information through June 1984. Because of the rapidly changing character of several of the industries examined, the detailed exposition is likely to become quickly dated. Consequently, the authors have tried to focus on the more fundamental issues in order to maintain relevance over a larger period.

The Note is directed at government officials, business people, and scholars with research and policy interests in U.S.-Japan trade in services. The study on which the Note is based is part of The Rand Corporation's research program in international economic policy.
SUMMARY

This Note describes and examines the sources of barriers to U.S. trade in Japan in several service industries. We used a case-study research strategy that combined the following elements: (1) interviews, primarily in Japan, with 30 companies in six service industries; (2) interviews with Japanese government officials in the agencies and ministries with regulatory responsibilities over our case-study sectors; (3) discussions with U.S. government trade officials; (4) review of trade journals and scholarly studies; (5) collection and analysis of independent data. The case studies were on banking and securities, insurance, law, accounting, data communications, and advertising.

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

- The most important barriers we found to trade in services arise from government regulation of business.
- The United States government is more likely to be successful in moving Japan toward deregulation and reducing trade barriers when there are strong domestic forces for change in Japan.
- Even with internal and external pressure for change, conflicts within and among Japanese agencies can lead to interminable delays and shelving of issues.
- In order to resolve internal conflicts, the Liberal Democratic Party has gradually emerged as a central arbiter of change.
- High-level political involvement in trade issues by both sides can sometimes stimulate accommodation.
- However, 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.
To a great extent, U.S. firms over the past ten years have been granted "national treatment" in Japan, except for a few lingering exceptions—mainly in the professions. The most important barrier we found is general regulation of specific industries. Regulation limits entry into the industry; restricts the range of products; controls prices; retards innovation; and validates cartelization. In all but one of our case studies, industry regulation is the chief impediment to trade. (Advertising is the exception.) 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 such domestic demand for change. The ability of outsiders to initiate deregulation is limited in the absence of widespread domestic support.

When the impetus for change grows, opinions on its proper direction are not monolithic. Views are based on whether parties will be gainers or losers under alternative policies, and consensus is difficult to achieve. 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 Liberal Democratic Party (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, and continuity of U.S. interests and attention is required at both the bureau and LDP levels. We believe that a mixed strategy of routine exchanges of information and views, combined with rarer political interventions, will influence events in an undramatic but cumulative manner.
ACKNOWLEDGMENTS

Our first debt is to the management and staff of the thirty 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. Our Rand colleague Adele Palmer performed the same function in catching lapses in logical thinking and economic analysis. We also wish to note the efforts of our research assistant, Joan Schwartz, who 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.
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I. PURPOSE, CONCLUSIONS, AND METHODS

Purpose and Conclusions. Since the end of World War II, the governments of the world's trading nations have worked at encouraging international trade by removing or reducing a wide array of impediments that hindered the movement of goods and services. Among the more important impediments are those imposed by governments themselves. Tariff-reduction was the focus of attention for thirty years. More recently, the very success of this policy raised other trade impediments to the fore—the so-called "nontariff trade barriers." This Note is concerned primarily with nontariff trade barriers to U.S. trade with Japan in services. We define barriers as those impediments or inhibiting factors to U.S. sale of services in Japan that derive directly from Japanese government policy. Other kinds of impediments, of course, may exist, such as those flowing from unfamiliar culture and language. These, too, will be considered, but the principal thrust of the investigation is on government behavior.

U.S. business and government people engaged in trade or trade negotiations with Japan often possess only a partial view of the important actors with whom they deal—their motivations, the interactions among them, and the forces guiding their behavior. The central purpose of this study has been to produce a better understanding of these matters by first ascertaining whether or not significant barriers exist, then by describing the barriers to trade in Japan in several service areas, and finally by examining the sources of these barriers. To do this, we conducted case studies of six service industries that deal primarily with other businesses. This Note presents the results of the case studies. A companion Report synthesizes the results of the case studies and introduces additional analyses to generate a number of policy conclusions.¹

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 the sources of trade impediments is that policy actions to remove them depend on the type of behavior that gives rise to the impediments in the first place. Different explanations of the sources of behavior call for different policies. The possible sources that we actively considered while conducting the case studies included the following: (1) specific rules and regulations directed explicitly against foreign operations; (2) monopolized or cartelized industries that act to keep out new entrants, including foreigners; (3) regulatory agencies or supervisory ministries that may have enacted a web of regulatory constraints that reduce business possibilities; (4) Japanese culture and tastes that are so different from those normally encountered by American businesses that they act as a trade barrier; and (5) ineffective marketing and management of American companies that has reduced their probability of success in the Japanese marketplace.

The principal conclusion of the study is that the most important barrier we found to U.S. trade in business services in Japan is general regulation of specific industries. Regulation limits entry into the industry; it restricts the range of products; controls prices; and retards innovation. In several areas, law and regulation permit and validate cartelization or monopolistic restraints that, among other things, restrict trade. In five of the six case studies, industry regulation is the chief barrier to trade.

In finance and data communications, law and regulation severely limited the activities of both Japanese and foreign companies. Since American companies have been particularly innovative in these two areas, recent moves toward deregulation should encourage expansion of U.S. business. Legal services and accounting are controlled by professional organizations under rights granted by law. (In accounting, this control is shared with the government's Ministry of Finance.) Law has been highly restrictive of foreign entry; accounting has been more open, and the Finance Ministry is removing some significant administrative barriers that will allow broader market access to U.S. accounting firms.
Insurance is tightly regulated under the law by a combination of government and industry organizations. The entry and business activity of foreign firms have been closely controlled, with little evidence of deregulation in the near future. Advertising is unregulated and competitive. U.S. firms, especially those with the longest history in Japan, have done comparatively well, but foreign advertising agencies as a whole have gained only a very small share of the market.

Powerful internal economic forces are breaking down the regulatory barriers in finance and data communication, and to a lesser degree in accounting. In legal services and insurance, the forces for change are weaker and the web of regulatory constraints more stable. U.S. policy has been most effective when it works with domestic forces for change in Japan. Our policy conclusions can be summarized as follows: ²

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

Research Approach. In order to determine which of the hypotheses (if any) is most consistent with actual behavior, or is more important than

²A fuller discussion of these points can be found in the companion report to this Note: Arthur J. Alexander and Hong W. Tan, Barriers to U.S. Service Trade in Japan, R-3175, The Rand Corporation.
the others, we used a multi-pronged research strategy to probe for answers. Any simple 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 U.S., 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 conducted interviews with close to thirty companies spread over the six sectors of study. With some companies, we held several interviews over a period of six to twelve months to ascertain the changes that were occurring. At least two companies in each industry were interviewed in order to check the perceptions of one with those of another company in the same field.

Discussions were held with the 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, and the Japan Federation of Bar Associations.

The trade press was very useful in providing chronologies of events and some analysis. The academic literature, in contrast, was rather sparse in its treatment of the subject of trade in services and the particular industries of interest. Although our conclusions, by and large, are based on only six case studies and must be rather subjective, nevertheless, we feel that in most cases our approach gave us a fairly complete view of the subject. Although one could quibble about many of the details, our general findings came through clearly.

The Case Studies. The case studies were on the following industries: banking, insurance, law, accounting, data communications, and advertising. These sectors represent a mix of characteristics that generates a wide variety of behavior. Advertising is competitive and
unregulated with few nonbusiness barriers. However, long-term ties between advertisers and agencies and within industrial groups restrict the sources of business to a foreign agency. Law and accounting are both regulated professions; the legal profession is regulated under the law by the independent but nonetheless 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 virtually impossible, whereas 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 over interest rates, financial instruments, and financial structure, rather than from explicit restrictions against foreign companies. However, the economic forces for change and liberalization are powerful, and significant deregulation has occurred in the past ten years. Data communications had been 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.

In summary, the cases include one competitive, unregulated industry (advertising), two professions (law and accounting), three financial services (insurance, banking, and securities), and one technology-based industry (data communications). In three areas—data communications, banking, and securities—the domestic forces for change are powerful; in the other industries, however, the most insistent voice for change comes
from external sources. Regulatory responsibilities may overlap across several agencies. We find the Ministry of International Trade and Industry (MITI) competing with the Ministry of Posts and Telecommunications (MPT) over data communications; MPT and the Ministry of Finance (MOF) in dispute over the postal savings system; the MOF's Banking Bureau at odds with its sibling Securities Bureau; and the Ministry of Justice struggling with the independent bar association over foreign lawyers. Above these disputes sits the adjudicating authority of the ruling Liberal Democratic Party (LDP). These industries therefore offer a rich combination of variations in behavior and motivations.
II. BANKING AND SECURITIES

INSTITUTIONAL SETTING

The Nature of Barriers to U.S. Banking. Financial markets in Japan have been undergoing rapid change in the direction of deregulation, liberalization, and internationalization since the late 1970s. It would not be possible to describe in the space of a few pages the many steps in this process, the various factors, and the complex considerations behind each move. Instead, we shall lay out the basic structure of the financial system, the forces for change, and the sources of opposition to change. These factors will then be illustrated by a specific case study. This procedure may be of more utility than a snapshot view that is certain to be quickly out of date.

U.S. banks and other financial companies in Japan have operated under three classes of barriers or constraints. One type arises from regulations specifically directed toward foreign companies. These have gradually been eliminated, and by the mid-1980s, U.S. financial companies are generally accorded "national treatment." The second class of constraints is the general system of financial regulation and control that has bounded every aspect of financial life: from industry structure, 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. The third type of barrier is a sub-set of the general regulations that affect foreign financial actors differentially. These include such restrictions as foreign exchange controls and foreign-based lending and borrowing restrictions that tend to affect foreign institutions more acutely than their domestic Japanese counterparts because of the nature of their respective businesses.

Before proceeding, it is important to note that both the United States and Japan have highly regulated financial markets. Despite significant deregulation in the U.S. since the 1970s, the American industry can still best be described as regulated. Japanese efforts at deregulation started at a later date than in the U.S. and from a more
controlled initial level. Therefore, despite considerable opening and decontrol in Japan since the late 1970s, many observers on both sides of the Pacific are impatient with the results so far achieved. However, the Japanese process has proceeded from a tightly partitioned industry structure with a considerable number of politically active potential losers created by any deregulation. A final point to note is that the Japanese system of government administration historically has conferred great detailed authority to ministry bureaucrats; in areas where regulation has been customary, "guidance," rather than due process or reliance on market forces, is the norm, in contrast to U.S. practice. Efforts to change this administrative approach run into deeply ingrained patterns of behavior—among the bureaucrats especially, but also among those they supervise. Thus deregulation of banking in Japan is bound to proceed at a different pace and in different directions than it has in the United States.

**Structure of the Financial System.** The present structure of the Japanese financial system grew out of the reorganization and rationalization that took place in the 1930s and early World War II period. The 1927 Bank Law, for example, which provided the legislative framework of the system, remained largely intact until 1981. The U.S. occupation did not reverse prewar trends, but its policies affected financial markets in fundamental ways: It increased compartmentalization by prohibiting banks from operating in the securities sector; dissolution of the zaibatsu (industrial groups) accelerated the role of banks as corporate lenders; the reorganization of specialized banks into long-term credit banks and trust banks created exclusive credit markets; and legislation established a balanced budget principle for the central government. The end of the occupation left the financial institutions more specialized than in pre-war Japan. The industry structure was much the same in 1980 as it was at the end of the occupation, regulation effectively having barred new domestic banking entrants.¹

Specialization extends to types of financial instruments, clients, and geographic concentration. The 13 city banks are large commercial institutions with close ties to the corporate sector. Sixty-seven regional banks service smaller corporations and local governments in their geographic areas. The three long-term credit banks provide long-term financing to industry and monopolize this end of the market; they form a powerful interest group that opposes general development of long-term corporate bond financing. Trust banks (seven) provide medium-term corporate financing and together with insurance companies (and one city bank, Daiwa Bank) have had exclusive access to trust funds of insurance companies, pension funds, and individuals. The Postal Savings System is supervised by the Ministry of Posts and Telecommunications. With 22,000 branches nationwide, it forms a powerful political force with the support of the postal employees and privately owned post offices throughout the country.\(^2\) The Postal Savings Banks take in deposits from individuals at interest rates that are higher than alternative savings rates at banks and channel the funds to the Ministry of Finance (MOF), which uses them for national investment purposes. Smaller financial institutes include agricultural cooperatives (4564), credit associations (462), credit cooperatives (483), and labor credit associations. These institutions each serve highly defined groups of clients (agriculture and labor, for example). The foreign sector included 74 banks in 1983 with a 3 percent share of total bank lending, but less than 1 percent of bank deposits.

The 250 securities companies have been given exclusive rights by law in the underwriting and trading of bonds and equities. Four companies dominate the sector, with 50 percent of all share trading on the Tokyo Stock Exchange in 1981. These companies are also active in international markets and have used the opportunities presented by more liberal foreign regulation to move into the banking business abroad.

**Regulation to the 1970s.** Most aspects of financial activities in banking and securities have been controlled by the MOF. It has regulated the number of branch banks, the types of financial products,

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and most interest rates. In securities, it managed the expansion of the branch network, the rules for bond issues, the character of the bond market, and bond interest rates.\textsuperscript{3} The Foreign Exchange Control Law of 1949 embodied the principle that all foreign exchange and capital transactions were subject to MOF control unless specifically exempted.\textsuperscript{4}

Within the MOF, the Banking Bureau and Securities Bureau regulate their respective industries, with interest rates falling under the Banking Bureau. The International Finance Bureau is responsible for international financial policy and regulation; it has gradually grown in status and influence in parallel with Japan's activities in the world economy. The Financial Bureau manages government bonds. With the rapid growth in government debt since the early 1970s, this bureau has also become increasingly important.

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 placed increased emphasis on deregulated interest rates and a growing role for market behavior. It has believed that greater responsiveness of the money supply to BOJ policy levers could only be obtained by more sensitive market mechanisms unblunted by the guidance of regulatory agencies.

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. Policy issues that overlap MOF bureaus are likely to end up in conflict that the Ministry Secretariat is called upon to handle. But the bureaus are often powerful enough to ignore the Secretariat; in such cases, discussions are likely to break down and policy proposals be dropped.\textsuperscript{5}

\textsuperscript{3}Horne, \textit{op. cit.}, p. 25.
\textsuperscript{5}This section draws on the dissertation by Horne (\textit{op. cit.}, pp. 368-370), which examined six finance policy cases in great detail.
As a result of the strict control over financial markets, in the 1970s the short-term capital and money markets were largely undeveloped; interest rates were inflexible, set below market levels, and regulated by decree; nonprice competition was widespread; city banks' chronic indebtedness to the BOJ allowed the Bank to implement policy through administrative guidance; and the Japanese financial system was isolated from international financial markets. However, during the 1970s, events were in train to destabilize this carefully administered system.

FORCES FOR CHANGE

The 1970s produced a series of changes that, taken together, drastically shifted the balance of accommodations that had evolved in the financial sector in the post-war era. These changes included: (1) fundamental changes in the flow of funds—most notably the rise of the central government as a major borrower; (2) macroeconomic conditions of reduced growth and greater attention to the control of inflation; (3) the spread of corporate activities abroad, which led to increased foreign yen holdings, more active foreign exchange markets, and increased demand for improved financial services; (4) the expansion of Japanese banking and securities activities abroad, which provided learning and experience under looser regulatory guidelines; and (5) the maturation and saturation of many areas of banking in Japan under the existing rules and system of operation.6

Until 1965, the central government maintained a strict policy of balancing its budget. Beginning in 1965, it began to run a relatively small deficit, which until 1970 remained under $1 billion. The recession following the 1973 oil price shocks drove the deficit to almost $18 billion by 1975, and to $62 billion by 1979, where it remained for the next four years. The rapidly expanding government bond issues used to finance the debt had a considerable and lasting effect on financial institutions. During the recessionary period of 1974-78, government bonds at first gave the banks a profitable outlet for surplus

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6Horne, op. cit., p. 377. Most analysts point to the growth of government demand for funds as a central factor in financial market transformations.
funds. However, when corporate demand rose in 1978, it conflicted with the enormous growth in government demand for funds. In order to finance its debt, the government had to make it liquid and competitive. Medium-term (two to four years) bonds were issued at market rates; by 1982, these tradable instruments accounted for 50 percent of new government debt. Ten-year bonds were purchased by underwriting syndicates at negotiated rates whose terms became considerably more flexible, especially compared to the past when the government could specify the rate it was willing to pay. In the late 1980s, a great deal of the government debt of the 1970s and early 1980s will have to be refinanced. The impact of this government demand for funds will be in addition to any current deficits in the government budget during this period. This massive financing effort will lead to further deregulation of interest rates and increased marketability of government debt instruments. If this refinancing is spread throughout the term spectrum from short-term to long-term borrowing, there will be competition with short-term savings, which until now have been subject to regulated interest rates. If savings interest rates are deregulated to meet this competition, it could have widespread effects throughout the banking sector as banks compete for funds on the basis of price.

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 Bank sought to develop methods other than verbal guidance to implement monetary policy; to do this, it sought control over a deregulated short-term government bill market as a means of implementing an open market mechanism for controlling the money supply. Because it has not yet achieved all its goals, the Bank of Japan is a continuing proponent of financial market liberalization at the short end of the government debt market. In particular, it is seeking a full-fledged treasury bill market. Treasury bills, issued in a large-scale debt refinancing effort, could also be the short-term instrument the BOJ is seeking. If such a market were instituted, it would accelerate the decontrol of short-term government rates and bank rates.
The growth in government use of funds in the 1970s was accompanied by a decline in the corporate share of financial flows. In terms of direct securities (instruments issued by the ultimate borrower—e.g., bonds, stocks, and loan certificates) the corporate share fell from 70 percent in the 1950s and 1960s to about 30 percent in the latter half of the 1970s. The government share rose from 10 to 20 percent to almost 50 percent in these same years. Accompanying this decline in the share of corporate demand was a greater tendency for corporations to invest part of their available funds in negotiable securities. This trend signified the entry of corporate treasurers as demanders of maximum returns and minimum regulation in financial markets, marking a change from past behavior when corporations were the chief beneficiaries of artificially low interest rates and the government-designated recipients of banking funds.

Another important trend during the 1970s was the increased share of the postal savings system in its holdings of the assets of the personal sector. In 1965, this share stood under 13 percent; by 1980, it had jumped to more than 21 percent—mainly at the expense of banks. In terms of deposits, the share held by the postal savings system rose from 19 percent to 33 percent. Since the postal savings system was underwritten by the Ministry of Posts and Telecommunications (MPT), it was not required to show a profit; political considerations led to the setting of interest rates on deposits that were above market rates. The growing importance of this administered sector engendered continuous conflict between MOF and MPT. The MOF, however, was not seeking outright deregulation of post office deposit rates, but rather control over this institution that was raising havoc with its client banks. The continued existence of this regulated sector remains an impediment to further deregulation of the market.

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9Another reason for mixed MOF views of postal savings was that the funds raised from this source were a significant input to the government's capital investment budget.
Slower economic growth produced a greater degree of interest sensitivity of the private sector as interest payments assumed relatively greater importance than capital gains in rate-of-return estimates. This has led to comparisons among rates-of-returns by potential depositors, with the banks sometimes finding themselves as the losers in this comparison. There were additional reasons for reduced flow of funds to the banking sector. The aging of the population generated an enormous growth of savings in pension funds, which became an attractive target to banks and other financial institutions. These funds, however, according to law and regulation, could only be managed by trust banks and insurance companies. In the 1980s, pressures began developing to relax the rules segregating the trust business from other banking affairs and several ventures involving foreign partners attempted to break down these barriers. (This will be treated in greater detail below.) Similarly, the banks were increasingly attracted to the possibilities of the securities business in order to compensate for the decline in direct corporate bank borrowing. The securities companies, which saw that increasing the liquidity of securities would enhance their attractiveness to the public, worked at developing schemes to convert securities holdings into deposit-like accounts, using links with foreign banks as a vehicle to achieve these ends. These attempts to break down the barriers between banks, trust companies, and securities companies continue to be debated.

Finally, we will note that the impact of the foreign sector increased very rapidly during the 1970s. The holdings of yen outside Japan shot up with the oil price increases, but the greatly increased volume of Japanese trade around the world also was a factor. In terms of foreign capital, long-term and short-term assets held by Japanese abroad increased by more than three-and-a-half times between 1973 and 1979; liabilities increased at the same rate. By 1979, the private sector held more than $93 billion in foreign assets (both short- 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. Because of the fluidity of financial instruments, deregulation in one sector was bound to affect
transactions elsewhere. As deregulation proceeded domestically, the demand for foreign transactions deregulation was insistently heard from domestic sources such as corporate borrowers and from foreign governments and financial institutions. Deregulation of the foreign sector, however, had potential feedback effects domestically. For example, deregulating the Euroyen market by allowing Japanese companies to raise yen funds abroad would effectively bypass domestic controls and regulated interest rates in domestic borrowing. The strength of the demands for deregulation in the foreign sector was powerfully fueled by the successful participation of Japan in the international economic system. The industrial countries, stimulated by their persistent balance of payment deficits with Japan, were now asking for a quid pro quo.

OPPONENTS TO CHANGE

We can identify three categories of opponents to change: (1) those who have been granted exclusive rights over some class of business and who would face increased competition with deregulation; (2) those who have been protected by regulation from their own higher costs due to inefficiencies or absence of scale economies; and (3) the regulatory agencies of the above. These categories, in short, identify the losers from deregulation. Other relevant considerations will be discussed briefly before returning to these three categories.

In our interviews, we heard repeated comments on the necessity of avoiding disruptions, uncertainties, confusion, and needless changes in practices and routines. If change were indeed required, it should proceed in a step-by-step fashion, piecemeal, gradually, in an evolutionary way. At times, these statements are clearly self-serving, as when use of the term, "avoid confusion in the marketplace" really means "prevent competitors from undercutting my price," and such phrases can be found in support of regulation throughout the world. However, the goal in Japan of preserving order is so commonly accepted, especially in financial matters, that otherwise unacceptable behavior can be made more palatable by flavoring it with the alternative of chaos. Despite the occasional use of these concepts as rationalization, the usage seems quite often to be genuine. We were thus reminded on
more than one occasion of the 1923 Kanto earthquake when it required more than a decade for insurance companies to pay off their claims, or the financial disruptions of the 1930s, or the business chaos following World War II. Discussions of financial system deregulation were similarly hedged by concerns for the need to proceed cautiously and to avoid disruptions. Although we recognize that there are often many other good reasons for avoiding change, we also believe that these desires for orderliness contribute an independent conservative force to the system.

In many of the steps toward financial system deregulation, there are gainers and losers. Not unexpectedly, the losers fight against the change and are likely to be labeled as conservative, foot-dragging, or anti-deregulation. Few of the financial institutions, however, can unequivocally be called liberal or conservative. Their behavior will often depend on the circumstances of a particular issue. 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).10 On the Euroyen bond question, however, the city banks oppose large-scale liberalization because it could virtually dismantle the long-term interest rate structure11 and because domestic corporate financing would shrink drastically.12 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 benefited from its ability to extract long-term loans at less than market rates, has fought deregulation of the government borrowing rate. This, then, is the legacy of past regulation and rigid separation of financial functions. 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. When, for example, 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 a quid-pro-quo expansion of overseas bank lending and sale of foreign bonds in order to gain the acquiescence of the banks. Most disputes of this type eventually require political resolution, as the settlement of disputes between gainers and losers in system changes is a political act.

The second category of potential losers under deregulation are the high-cost providers of financial services. The so-called "convoy" method of protection whereby regulated prices are set to cover the costs of the least efficient member of the industry has characterized the banking industry. In particular, it is doubtful that many of the regional banks could survive in their present form (i.e., without merger or takeover) if domestic banking were deregulated. It is also feared that the introduction of widespread telecommunications into banking will weaken the small banks that are not of sufficient size to efficiently invest in such systems. Smaller banking customers could also be hurt if they had to pay a market rate of interest that is likely to be higher than the low mandated rates they now face. Undoubtedly, decontrol would affect the structure of banking and perhaps raise the costs to some sectors, but at the same time others would gain from lower costs and higher efficiency. Again the problem has political overtones along with many complex technical problems.

The final set of losers includes the government ministries who now control and regulate the financial system. Although their jobs are unlikely to disappear in the next decade or so, they will certainly find themselves acting in a system that substitutes market regulation for
bureaucratic control. Many of the bitter inter-governmental disputes over deregulation have had large doses of turf protection as prominent elements. The desire of the ministries to retain authority over the financial life of the country and their frequent inability to resolve the issues among themselves supply a conservative anchor to the movement toward deregulation.

**Price, Product, and Institutional Deregulation.** Since World War II, the Ministry of Finance--through laws, regulation, and guidance--has controlled the price of financial instruments, the kinds of instruments that are permitted to be marketed, and the institutional structure of financial markets. Deregulation of each of these three areas encounters different patterns of acceptance and opposition.

Interest rate deregulation and the introduction of new financial instruments alter the relative attractiveness of different financial assets. Whether done in a single deregulatory orgy, or in careful step-by-step moves, there is a likelihood of massive movements of funds from one asset (and hence, one type of institution) to another. This problem has been dealt with in several ways--for example, by erecting new barriers to restrict such flows, or by removing restrictions on newly disadvantaged assets. Such cases included: negotiable certificates of deposit that were first introduced with minimum denominations of Y500 million (about $2 million), which restricted the number of participants in the market; and permission to participate in Euroyen convertible bonds that was limited to 108 companies, thus protecting the loan business of domestic Japanese banks.\(^{13}\)

A possible example of government response to interest rate deregulation and the introduction of new financial instruments may be found in the government's refinancing of its debt in the latter half of the 1980s, which could well run into similar problems of large and rapid movements of assets if negotiable short-term government bills are introduced. If interest rates on savings accounts continue to be controlled, there could be shifts of savings out of the banks and into government bills. If savings rates are decontrolled, the competing rates of the postal savings system will then arise as a problem. Based

on the logic of past responses, a solution would involve some decontrol of savings rates, some restrictions on the holding of short-term government debt, and some accommodation between the MOF and the Postal Ministry on postal savings rates. Such an outcome will require the intervention of the Liberal Democratic Party leadership; the necessity of refinancing of the government debt will provide the stimulus to seek a compromise.

In general, although the problems of decontrol of price and product are serious enough, the forces for change are large and pressing, the gains are clear, and the regulators have been clever enough to work out compromises that have not seriously disrupted the various financial actors. Breaking down institutional barriers, however, is a different matter. Long-protected vested interests are harmed, and the forces for change often do not have the same potency as those behind price and product deregulation. The attempt by the Morgan Guaranty Trust Co. and Nomura Securities to form a joint venture to manage trust funds is a case in point that we shall examine in some detail. First announced in July 1983, this proposal ran afoul of two institutional barriers: a securities company participation in the banking business; and the entrance of newcomers into the hitherto 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 tried to maintain strict separation since the mid-1950s.14 (The law appeared to be clearer on the issue of prohibiting securities companies' entry into trust business.) Second, several Japanese banks were engaged in trust business in the U.S., so the principle of reciprocity entered the discussion. And, third, the U.S. government raised the proposal at high political levels as a symbol of Japanese barriers to financial services. Nevertheless, approval of this proposal

14 "Morgan Guaranty and Nomura to Form Trust Company. . .," Japan Economic Journal, July 12, 1983. The Daiwa Bank had refused to go along with MOF guidance in the 1950s and retained its trust business.
would have been a major step in dismantling the entire compartmentalized financial structure. In fact, many observers saw this particular proposal as being merely a side-show to the main events—the attempted movement of the city banks into the trust business, and the capturing of banking services by securities companies. That the city banks had such goals in mind seemed to be demonstrated by their moving into trust business in the U.S., despite MOF's urging of the banks to toe domestic guidelines in their international operations.\textsuperscript{15} These suspicions were confirmed when the four leading city banks filed requests in February 1984 for approval of investment consultant subsidiaries that could move into the trust business if the Morgan-Nomura plan were approved by the MOF. Depending on how approvals might be implemented, the banks were contemplating tie-ups with either foreign banks or domestic security companies.\textsuperscript{16} The securities companies, for their part, were said to be promoting their own interests by capitalizing on U.S. pressures to accelerate financial deregulation. According to one commentator, Nomura's trust business plan "is one typical tactic to make use of foreign pressures."\textsuperscript{17}

In the meantime, the governor of the Bank of Japan indicated a positive stand on the proposed Morgan-Nomura plan. In calling for a thorough review of banking policy, he particularly singled out the so-called "convoy formula" under which smaller and weaker banks were protected from competitive forces.\textsuperscript{18} Even the MOF conceded that opening corporate pension funds to competition would increase the rate of return earned by the funds;\textsuperscript{19} however, they feared that as many as half of the

seven trust banks would run into financial management problems under such a regime.

With public support for deregulation growing, the trust banks mounted a strong lobbying effort to preserve the status quo, using as one counterattack the threat to promote U.S. pressures to deregulate securities commission fees in Japan. The trust banks were also able to gain the support of the Federation of Economic Organizations (Keidanren), which called for the government not to yield to U.S. pressures and to carefully study such major changes in the financial system. The trust banks had a natural ally in the MOF, which believed that the proposed venture would affect the foundation of the nation's financial system, and that "confusion in the trust banking business due to sudden liberalization must be avoided."

The MOF attempted to confine discussion of the matter to narrow, technical issues. When a subcommittee of financial officials was formed with participants from the U.S. and Japanese governments, the MOF desire was to restrict membership to its people and U.S. Treasury officials. However, it reluctantly bowed to government demands to expand membership to include State Department and Foreign Ministry representatives when U.S. Secretary of State Shultz complained that financial system discussions had been exclusively under the jurisdiction of monetary officials. The MOF was concerned that if it did not agree to broadening the discussion, leadership on the issue would be removed entirely from its hands. The trust banks and the MOF were in for a further shock when high U.S. officials publicly called for U.S. bank participation in Japanese trust business, and raised the issue at the highest political levels in Japan. This move increased the worries of the MOF technical staff that it was losing control to the political leadership.

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further concern of the MOF was that it could be difficult to back up administrative guidance against banks going into the trust business when there was no prohibition against this from a legal standpoint. MOF officials expressed concern over potential trouble if an American company filed a lawsuit against the Japanese government.\(^\text{24}\)

After attempting to balance the variety of internal and external concerns, the MOF essentially put off a final resolution when it reported to the Prime Minister in early March 1984 that it had decided to allow itself two or three years to consider whether to approve the Morgan-Nomura venture. Disclosure of this policy came as something of a surprise as stories had been circulating that a restricted form of approval would be forthcoming. The stated MOF policy was thought to have mainly reflected the trust banks’ \"vehement opposition to allowing outsiders into an area carefully preserved for them under legal protection.\"\(^\text{25}\) It was reported, though, that some circles in the ministry favored approval of foreign banks’ applications, reflecting the principle of reciprocity.

Despite the attempt by the MOF to shelve the problem for several years—a move that had been resorted to in the past with other unresolvable conflicts—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. An interview of Treasury Secretary Regan with a Japanese newspaper, for example, was interpreted as giving the Morgan-Nomura issue \"broader meaning and a stronger political appeal as a matter that affects the two countries’ economic relations in general.\"\(^\text{26}\) U.S.-Japanese financial negotiations kept the trust fund issue alive despite the MOF decision (or lack of decision) to shelve it. In May 1984, it was reported that the MOF had notified Nomura that its application had been turned down because entry of a securities firm into a banking sector \"would have


\(^{25}\)\"Financial Ministry Postpones OK to Nomura-Morgan Plan; Says It’s \textquoteleft\textquoteleft Long-Range Issue,\textquoteright\textquoteright\ \textit{Japan Economic Journal}, March 20, 1984.

serious impact on the nation's financial order." However, only four weeks later, 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." The trust market problem was described as having been the major point of contention in the negotiations. Although details of implementation were to be worked out in the following months, 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. The Trust Companies' Association of Japan called the decision "regrettable."

Within weeks of the announcement of trust business liberalization, Security Pacific Corporation of the U.S. and the Sumitomo Trust and Banking Company announced agreement to enter into trust business and other wide-ranging matters. Seven of the largest U.S. banks and four European banks were planning to follow Security Pacific's lead by tying up with Japanese trust banks; the U.S. banks included Citibank, Bankers Trust, Morgan Guaranty, Chase Manhattan, and Manufacturers Hanover. A possible reason for the MOF permitting foreign banks to join with trust banks, but not with city banks or securities companies, was to strengthen the management and efficiency of the trust banks through their joint efforts with the American banks so that they could better compete in a more open market in the future. The logic of the situation suggests that this break in the trust companies' monopoly over the potentially lucrative pension fund business will not be confined to foreign banks. Although reciprocity and political pressure were important catalysts to change in allowing foreign banks to enter the market, now that the barriers have fallen, there is little reason to keep the city banks out of the trust fund business. If the city banks' investment consultant subsidiaries are then allowed to engage in trust fund business, the securities companies will be able to claim that they

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have become disadvantaged by banks nibbling away at their traditional investment functions. Thus, the divisions between banks, trust business, and securities will be once more open for review.

This case illustrates the great difficulty of achieving institutional deregulation, primarily because it attacks protected privileges. Without the active and vigorous attention of the U.S. government, the issue would have been set aside for years. Indeed, the solution that was finally arrived at, while permissive to foreign banks, grants nothing to domestic banks, although later developments could very well lead to further domestic deregulation. In addition, it should be noted that reciprocity and the fact that foreign banks were not legally prohibited from the trust business were important points in arriving at a conclusion favorable to U.S. banks. Finally, the removal of the regulatory barrier will apparently make a difference to U.S. banking activity in Japan with the impending entry of the largest U.S. banks into the Japanese trust business.

CONCLUSIONS

Explicit regulatory barriers against foreign firms have adversely affected U.S. financial organizations in Japan in the past, but most of these have gradually been removed. However, with the reduction of restrictions on foreign firms, general regulation of the industry had become the chief problem. One such prohibition, for example, was an MOF guideline that only members of the "big four" Japanese securities companies could be the lead manager of a new securities issue. However, Japanese companies were also not allowed to be a lead manager if they were not one of the big four. General regulations, though, may also have differential effects on foreign companies. Thus, since foreign banks and securities companies are more strongly oriented toward international capital markets, the strict regulation of international financial flows has had a disproportionate effect on them. U.S. financial companies that we interviewed claimed that, on the whole, they were basically accorded national treatment. In fact, that was their problem. The regulation and control of financial affairs prohibited them from offering the products and prices that they wished to bring to the Tokyo market. As the manager of a large U.S. securities company in
Tokyo told us, "There are two things we can sell in Tokyo, stocks and bonds, and a list two pages long of products we can sell in New York that we cannot sell in Tokyo." As for the influence of organized cartels and monopoly within the financial sector, regulation itself generates the equivalent of a protected cartel, which acts as a barrier to trade. The exclusive rights granted in the past retard deregulation because of the harm it would cause to the privileged groups--and there are few groups without some privileges."
III. THE INSURANCE INDUSTRY

BARRIERS TO U.S. FIRMS

In 1980, insurance companies outside the Eastern Bloc countries underwrote policies totaling $435 billion. The U.S. stake in this market is large: Nearly half of world premium volume originates in the U.S., and another $6 billion is written by U.S. firms abroad. Of this foreign component, 66 percent originates in Europe, 20 percent in the Far East, 11 percent in Latin America, and the remainder in the Middle East and Africa.¹

U.S. penetration of the Japanese market, the second largest national insurance market in the world, is relatively minor.² In 1979, U.S. insurance companies in Japan produced just over $350 million in premiums, or about one percent of the combined Japanese life and nonlife insurance market. However, the U.S. companies dominate the foreign share of the Japanese insurance market. In the nonlife insurance sector, 40 foreign insurance companies account for less than 3 percent of total premiums; 20 Japanese firms account for the remainder. Of the foreign market share, fully 82 percent is dominated by 11 U.S. insurance companies of AIU and AFIA. In the life insurance sector, 6 foreign firms—all U.S.—have 0.7 percent of the premium income of private companies, but this share should be considered significant given their relatively recent arrival on the scene (since 1973).

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, a process involving numerous modifications to the proposed plan and products to be offered. Also, because there is no statutory

¹ International Insurance Advisory Council (IIAC) of the U.S. Chamber of Commerce, as reported in Jay Dowling, "Insurance Industry Goes Global," Business America, November 1, 1982.
² With 11.6 percent of world insurance premiums, Japan is second after the U.S., but only barely. West Germany—a country with half Japan's population—accounts for 10.5 percent of world insurance premiums.
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.\footnote{The OECD's \textit{Code of Liberalization of Current Invisible Operation} obliges the competent authorities to "decide on each application for authorization by an insurer from another Member State not later than six months from the date on which that application has been completed in all particulars." This requirement, however, is seldom binding since technically applications are not considered "complete" until proposed plans are modified to the satisfaction of the MOF.} These long delays notwithstanding, a number of foreign insurance firms have been approved while no new licenses have been issued to domestic companies since 1951.

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 a combination of ministerial guidance toward standardization and competition. It is this strict uniformity of premium rates and policy forms that 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 merit; for example, having a widespread distribution network in the life insurance sector or long-standing business ties in the nonlife sector.

In the following sections, we first provide an overview of the Japanese insurance industry, the regulatory environment, and its consequences for product innovations and industry structure. Next, we draw out the implications of these regulations for U.S. insurance firms, and consider some of the forces for change in the industry.

AN OVERVIEW OF THE JAPANESE INSURANCE INDUSTRY

The insurance industry in Japan is supervised by the Banking Bureau of the Ministry of Finance (MOF). Several key laws provide the MOF with sweeping regulatory authority over all aspects of the insurance industry's operations. The \textit{Insurance Business Law} separates the industry into life insurance and nonlife insurance sectors, and
prohibits the concurrent carrying of both life and nonlife insurance by any one company. In addition, it provides for tariff arrangements and other cartelized rate-setting among insurance companies and exemption from the Anti-Monopoly Law. Under the Law Concerning Non-Life Insurance Rating Organizations, two ratings organizations fix tariff rates for marine and fire, and automobile insurance under the supervision of the MOF. A third law gives the MOF control over the registration of both life assurance solicitors and nonlife insurance agents and their commission structure. The Law Concerning Foreign Insurers applies the Insurance Business Law to foreign insurance companies on an equal basis with domestic firms.\(^4\)

The stated policy of the MOF is to protect the Japanese public by promoting the sound development of the insurance industry. In essence, this has meant concerted regulation and guidance of the industry to minimize the potentially disruptive effects of "excessive competition" over product and price, and to ensure the profitability (and survival) of all firms in the industry. The MOF has been able to do this through the control of new entry into the industry, the standardization of premium rates and policies, the approval of new products, and regulation of the distribution system. While the industry has enjoyed rapid growth and profitability under these policies, it has undoubtedly been at the expense of higher premium rates and a more limited choice of insurance products for consumers.

Restrictions on Entry of New Firms. The MOF's policies towards the insurance industry have been to restrict entry of new domestic firms and to promote the growth of a limited number of existing companies. Following World War II, twenty Japanese life insurance companies resumed operations. This number did not change over the next 35 years. In the nonlife sector, with two exceptions, no new Japanese firms were added to the twenty domestic companies after 1951. An earthquake reinsurance company entered under a special law, and an Okinawan firm became registered in Japan following Okinawa's reversion in 1972. These 20 Japanese life and 22 nonlife insurance companies contrast sharply to the more than 1,800 and 3,000 firms in the same fields in the U.S.

\(^4\) A detailed discussion of these laws is contained in an informative market information report, "The Japanese Insurance Industry," prepared by the American Embassy, Tokyo, July 1981.
Though the MOF has restricted entry of any new domestic insurance companies, it has over the recent past licensed about one new foreign company a year in each sector. In the nonlife sector, 40 foreign insurance firms have been licensed since 1949 at a rate of about one a year. In life insurance, licensing of foreign insurance firms did not begin until 1973 when the industry was liberalized to allow 100 percent foreign ownership of capital. Even then, licensing approval was conditioned on the foreign firm introducing some kind of "novelty" into the market, either in terms of policy features or sales method. To date, only a handful of foreign firms--all U.S. companies--have been able to meet this criterion.

In recent years, the MOF has relaxed the application of an explicit novelty criteria for licensing life insurance companies. The only criterion cited by the Ministry is "to provide the Japanese public with better service and a greater choice of insurance types." This policy change appears to have come about because of criticisms that application of the novelty criterion was incompatible with the equitable treatment clause in the Law Concerning Foreign insurers. Political considerations may also have been important, as evidenced by the timing of MOF approvals of the Sony-Prudential and Combined Insurance applications just before the 1979 Tokyo Summit meetings.

The application for MOF approval of entry is a complex and lengthy procedure, often lasting several years. In addition to meeting particular financial and asset requirements, foreign firms are required to provide (with MOF guidance) comprehensive descriptions of their proposed products and detailed business plans for the next five years. The final result is a license holding the applicant to behave as outlined in a document drawn up by itself.

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5 Ibid., p. 8.
6 There is a minimum statutory deposit requirement to the foreign insurer of at least ten million yen before commencing business. In addition, the foreign insurer is required to hold assets in Japan corresponding to the liability reserve of life insurance contracts (in the case of life insurers), or a sum corresponding to the unearned portion of premiums, less reinsurance premiums (in the case of nonlife insurers).
Standardization of Product and Price. In both sectors, products and rates are generally standardized. The nonlife companies set rates in a cartelized arrangement that is sanctioned by law and supervised by the MOF. All nonlife companies are required to belong to the two ratings associations under the Law Concerning Non-Life Insurance Ratings Organizations. Fire and automobile insurance rates are fixed by these ratings organizations while marine rates are agreed upon by member companies based on the spirit of "harmonization of competition and cooperation." In the life insurance sector, each company sets its own premium rates, but partly because of administrative guidance toward standardization and partly because of competition, rates tend to settle on the same level.

Furthermore, 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 prior to marketing. This gives the rest of the industry an opportunity to turn down a product if it is thought to be disruptive of the market—or to imitate the idea if it looks attractive. As such, new products are worked out by all the companies and put on the market at the same time, following approval by the Ministry. In essence, then, both life and nonlife firms in Japan are writing uniform products at uniform rates.

Finally, in keeping with the MOF's "no drop-out policy", rates are typically set at levels bearable even for the weakest firm in the industry. By one industry estimate, premium rates in Japan today are between 10 to 30 percent higher than international levels. This assertion finds some support in the substantially lower rates on similar products offered by noninsurance groups outside the jurisdiction of the MOF (more on this later).

Consequences of Regulation. It is clear that regulation of the Japanese insurance industry has provided benefits to insurance companies. In contrast to the U.S. industry, with its aggressive rate cutting and highly innovative policies, the Japanese industry presents a
serene landscape. Because of cartel-supported premium rates, Japan is also the only insurance market where insurance underwriting, rather than fund investments, is profitable. These benefits of regulation, however, have not been without costs.

Because the standardization of price and product eliminates the possibility of competition in these dimensions, companies compete on the basis of aggressively expanding sales volume. In the life insurance sector, nearly 80 percent of all life policies are sold by female part-timers, mostly housewives. Being neither well-trained nor committed to a long-time job, the sales force is characterized by high turnover, which results in high cancellation rates of insurance contracts and high production costs. In the nonlife area, similar problems with high production costs are also encountered because of the low professionalism of the sales force.

Arguably, standardization of rates and policies, and the simultaneous marketing of new products by all firms, have also inhibited the incentives of domestic insurers to innovate. The MOF's use of the "novelty" criterion in licensing foreign life insurance companies, or its statements that foreign nonlife insurance companies should "play a stimulating role in inducing the principle of competition in the market" attest to the Ministry's recognition of this problem. In this respect, foreign firms have played an important role in stimulating competition through diversification of insurance products and sales systems.

The Ministry's "no drop out" policy has manifested itself in a widening gap between large insurance companies and their smaller competitors. Rates set at levels to ensure the survival of even the smallest companies have generated huge profits among larger firms for whom scale economies appear to be important. Table 1 shows the average cost of generating new business faced by Japanese insurance firms of different size. By these crude measures, the largest firms appear to have a cost advantage of about 40 percent compared to the smallest firms. Because of standardized rates, larger firms are able to generate large surpluses which are then ploughed back into expanding the sales force. This would tend to further widen the gap between the largest and smallest insurance firms.
Table 1
COST OF GENERATING NEW BUSINESS:
JAPANESE LIFE AND NONLIFE INSURANCE COMPANIES (1979)

<table>
<thead>
<tr>
<th>Firm Size (by Volume of New Business)</th>
<th>Life Insurance(a)</th>
<th>Nonlife Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 5 companies</td>
<td>22.4</td>
<td>384</td>
</tr>
<tr>
<td>2nd 5 companies</td>
<td>23.4</td>
<td>484</td>
</tr>
<tr>
<td>3rd 5 companies</td>
<td>26.8</td>
<td>550</td>
</tr>
<tr>
<td>Bottom 5 companies</td>
<td>40.6</td>
<td>640</td>
</tr>
</tbody>
</table>

NOTE: For life insurance, cost is expressed as the operating expenses (in 1,000 yen) associated with 1 million yen of new business. For nonlife insurance, cost is the cost (in 1,000 yen) of generating 1 billion yen in new business.
(a) Excluding Seibu-Allstate Life Insurance Co.

These problems have been recognized and have been addressed by the Insurance Council, an advisory body to the MOF. In a report submitted to the MOF in 1979, the Council emphasized the need for professionalization of the sales force, and specialization of products, sales methods, and locale so that the smallest firms can survive. The MOF has urged better education and training for the sales force. In the nonlife area, there have been recent reforms to upgrade the sales force through graduated commissions based on ability and performance. The Council even alluded to the possibility of mergers within the domestic industry as a last measure to be resorted to in the eventuality of a rationalization of management. While this has not yet happened, two domestic insurance companies have recently experienced financial difficulties, one in life and the other in the nonlife sector.8

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8 Interestingly, the response of the industry was to send in management teams from the largest insurance companies to help these troubled firms reorganize. The intent was to avoid any adverse repercussions of a business failure on the industry.
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. They are applied equally to both foreign and domestic companies. In some instances, foreign insurers are actually at an advantage compared to Japanese firms. For example, the MOF has allowed a slow (but steady) growth in the number of foreign firms licensed to underwrite life and nonlife insurance business, but has prohibited the entry of new domestic companies. Unlike Japanese insurers, foreign firms can use English language policy forms and write higher earthquake indemnity. The "novelty" feature, which had been construed as an unequal application of the Insurance Business Law to foreign firms, has recently been removed as a criterion for entry into the life insurance business. National treatment, as such, is not the issue for U.S. insurers in Japan.

The highly regulated environment in the Japanese insurance market is the main problem confronting U.S. firms. U.S. firms would like to offer new and diversified products but face several regulatory constraints. Before marketing, new products must first be approved by the rest of the industry (and the MOF), who may either turn down the product if it is thought to be disruptive of the market, or imitate the idea if it looks attractive. Nonetheless, U.S. firms have continued to push for MOF approval of a large number of new products even though the

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9 To be sure, some regulations affect foreign companies more than domestic firms. For example, certain kinds of policies (such as pure endowment or annuity policies) can only be written by companies posting an annual profit. For a foreign company just breaking into the market, this requirement prohibits it from selling these products. This issue can become more serious in the future when the prohibited types of policies are expected to show rapid growth in a market that is otherwise fairly well saturated.

10 Japanese law restricts domestic insurers from writing earthquake insurance on greater than 15 percent of the insured's assets. Foreign insurers, on the other hand, can write up to 60 percent earthquake indemnity because of their internationally diversified asset portfolios and their ability to reinsure abroad.

11 Statements made to the U.S. Executive Branch Mission on U.S.-Japan Trade, September 1983, by a representative of the American insurance industry in Japan generally reflect this view.
potential gains from doing so are dissipated by imitative policies
issued by Japanese competitors. 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. Examples include the
highly successful cancer insurance policies (introduced by American
Family Life Assurance) or term insurance with traffic accident benefits
(offered by Combined Insurance Co.) where U.S. insurers received
marketing approval before any domestic company.

However, a large number of other new products that are widely used
in the U.S. have repeatedly been submitted (unsuccessfully) for MOF
approval. These include types of insurance such as "business
interruption" policies, "package policies" that group several policies
rather than requiring separate ones for each risk, and policies that
reduce rates through deductibles (self-insurance) or loss-prevention
efforts.\(^{12}\) Undoubtedly, the approval of such products and the lower
rates they permit would win a larger share of the insurance market for
foreign insurers.\(^{13}\)

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). In part, this was motivated
by problems foreign firms had in attracting sales personnel. In an
environment in which foreign firms are compelled to sell essentially the
same products as those sold by domestic firms, agents are seldom
motivated to become the exclusive agents of foreign firms because of
their small market share. Further, given the tariff-regulated market
and prohibition on the use of rebates, agents are not able to negotiate
better terms with foreign insurance companies. U.S. firms have

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\(^{12}\) In its application for a license, for example, Lumberman's
Mutual Casualty proposed to offer lower premiums to clients in return
for fire loss-prevention efforts. The MOF turned down this offer, but
approved its license on condition that Lumberman's Mutual joined the
rating association, which meant that it had to use the established
tariff rates.

\(^{13}\) "Japan's Service Industries Still Hide Behind Barriers," *Asian
therefore eschewed the traditional Japanese reliance on a part-time female sales force and, instead, have sought to attract male college graduates with promises of training and future management positions. Nonetheless, attraction of an adequate sales force remains a problem.

The effects of standardized products and rates are felt most strongly by U.S. firms in corporate lines of nonlife insurance. Because of standardization, things other than cost or policy merit become the principal consideration in insurance placement. Through a variety of means, Japanese insurance companies have formed close ties to client firms. Many of the major Japanese insurers, for example, belong to keiretsu, groups of related industrial or business firms centered (usually) around a financial institution. Tokio Marine and Fire, for example, is part of the Mitsubishi group while Yasuda Marine and Fire is affiliated with Mitsui. Because of long-standing business ties, interlocking stock holdings, and other financial services (e.g., for export financing), most keiretsu firms typically insure with the group's insurance company, and rarely change insurers. Few nonaffiliated domestic insurers are able to break into this market, let alone foreign firms. Also, Japanese insurers hold a much larger share of their assets in the forms of loans to the corporate sector. The use of insurance contracts as part of a deal for a firm's obtaining a loan is a form of tied sale. However, in areas of special expertise, U.S. firms have been able to use their worldwide network of affiliated insurance companies to provide, for example, political risk and other insurance coverage for Japanese firms going abroad.

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15 INA Life Insurance has reportedly abandoned efforts to develop its own sales force and, instead, has tied up with Yasuda Fire and Marine, a company with a nationwide sales force of over 46,000 persons.
16 In a 1978 survey of the top 1,000 Japanese companies, about 50 percent of respondents reported that insurance was placed on the basis of close working relationships between insured and insurer(s). About 26 percent was tied to insurer's holding of company stock, 21 percent because it was an affiliated company, and over 6 percent because of fund raising from the insurance company. Further, the survey found little evidence of turnover—about 5 percent—except in cases of bad service and high premiums. Yasushi Morimiya, "The Japanese Approach to Risk Treatment," *Risk Management*, November 1981.
17 For example, a U.S. insurer in Tokyo can provide a Japanese
However, where keiretsu ties are weak or nonexistent, foreign insurance companies have held their own. This higher acceptance by individual consumers and new, postwar companies is reflected in the fact that automobile, accident, and transit lines of business make up a higher fraction of the business written by U.S. insurance companies than by Japanese insurance companies. In contrast, the corporate lines of insurance such as fire, marine hull and cargo, and casualty, constitute less than one-quarter of the premiums written by the American AIU companies as compared to an industry average of about 50 percent.

**Forces for Change.** Forces for change are present in the system, but are not yet strong enough to call forth a major policy reexamination. The most potent of these are the lower-priced insurance schemes authorized by other ministries for their constituents. The Ministry of Posts and Telecommunications, for example, is promoting highly successful industrial life insurance and annuity policies through its nationwide network of post offices. The Ministry of Agriculture has permitted agricultural cooperatives to offer mutual life insurance policies at premiums considerably below the rates authorized by the MOF. In the nonlife area, the Ministry of Labor has permitted a labor federation to develop automobile insurance at rates 40 percent below those offered by nonlife insurance companies.\(^{16}\) Not only are these alternative insurance schemes drawing business away from the MOF supervised industry, but they also demonstrate the lower prices and different products that the present regulatory climate is not permitting.

Developments in other financial sectors could also have repercussions on the ability of insurance companies to compete for the growing pension fund market. Nurtured in an environment of high premium rates, insurance companies have traditionally placed more emphasis on

corporation going abroad with insurance coverage through what is called "fronting." By taking advantage of lower rates prevailing abroad, the U.S. insurer provides the company with a lower-cost policy through an affiliate in the destination country, but then reinsures the policy back to Tokyo.

\(^{16}\) This automobile insurance policy could potentially siphon off from the regulated market close to 12 million policies, the estimated membership nationwide of the labor federation.
profits from underwriting than on the returns from asset investments, as compared to their counterparts in the U.S.\(^19\) As the sharp distinctions between financial sectors have broken down, several large city banks (Fuji, Sumitomo, Mitsubishi and Sanwa) have moved to enter the trust field.\(^20\) Foreign banks may soon follow suit. Competition from these new, more aggressive asset managers could draw away an important source of business from insurance companies. This diversion of pension funds could be exacerbated further as the Postal Insurance and Pension Funds begin investing in high yielding stocks and foreign bonds.\(^21\)

Changes will likely be in the direction of lower rates and a greater flexibility in the kinds of products offered, but not in the near term. Few small firms who, to date, have been kept afloat by high cartelized prices, would survive a deregulation of the industry. Recognizing this, the MOF has only permitted a limited relaxation of rate standardization. In a move designed to help smaller firms, the MOF has allowed dividend rates to vary according to ability-to-pay, but has not permitted variability in premium rates.\(^22\) The MOF is also reportedly considering a "general agency system," not unlike that in the U.S., where higher commissions are paid to general agents to encourage them to train sales agents to solicit at a given rate. This would enable small insurance companies to expand business into more remote areas of the country without the large fixed cost of setting up branch offices. Approval of such a general agent system should also benefit

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\(^{19}\) The necessity for improved managerial efficiency and methods of asset management by insurance companies is reflected in statements by the director of the MOF's first insurance division, as reported in the *Far Eastern Economic Review*, March 24, 1983.


\(^{21}\) In May 1983, the postal insurance and pension funds management law was revised to authorize purchases of foreign bonds. Previously, these Post Office funds had been channeled into low-interest loans to various government bodies.

\(^{22}\) This change may be of doubtful benefit to smaller, less profitable life insurance companies. Since cost and coverage are uniform throughout the industry, consumers may (accurately) perceive policies offering low dividends as unattractive and switch to higher-yielding alternatives.
U.S. insurance companies. Finally, since June 1983, insurance firms have been allowed to diversify into more lucrative noninsurance areas; several life insurance companies have responded by setting up leasing affiliates.\textsuperscript{23}

In conclusion, although forces for change are present they do not as yet represent a crisis to the insurance industry. So far, the financial difficulties of small insurance companies have been headed off by a combination of limited policy changes by the MOF and by the cooperative efforts of larger insurance companies. However, with increased competition from insurance alternatives outside the regulated industry and from other financial institutions, a major policy reexamination is inevitable, especially if combined with other forces for change such as consumerism, or industrial buyers looking for better prices and products, or international pressure.

Restrictions to trade have arisen from regulation of the industry, limiting price and product flexibility and guaranteeing the profits of the existing members. A few specific regulations have a disproportionately adverse effect on foreign companies. The business practice of giving insurance business to a member of an industrial group limits access of U.S. insurance companies to broad sectors of the market; however, with less regulation, foreign firms could better compete for this business on the basis of innovative policies and lower prices. Local culture has not been a barrier as the foreign companies have demonstrated the ability to conceive of and introduce products and marketing strategies that have been very successful.

\textsuperscript{23} Nippon Life, and four other major insurance companies, are reported to have started leasing operations. \textit{Japan Economic Journal}, May 22, 1984.
IV. THE LEGAL PROFESSION

BARRIERS TO U.S. LAWYERS

In this chapter, we first describe the Japanese laws, regulations, and treaties—and their interpretation—that create the formal or legalistic barriers to foreign lawyers in Japan. We then look behind the barriers to seek their sources.

Japanese barriers to foreign lawyers are indeed formidable. Both foreign lawyers and foreign law firms (employing either Japanese nationals or foreigners) have been prohibited. Since 1955, only one new foreign law firm has been allowed to operate in Japan. Interpretations of the Attorneys Law by the Supreme Court secretariat and by the Japanese Federation of Bar Associations (JFBA) have prevented foreign lawyers from becoming members of the bar and from setting up a practice to advise on foreign law. However, a group of foreign lawyers known as "trainees"—mainly American—act as consultants on U.S. law at Japanese law firms or corporations, but cannot independently put themselves forward 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 and ad-hoc visits to Japan by foreign lawyers to advise on specific issues (contract negotiations, for example) have been allowed, although this practice has also been constrained by Japanese government treatment of visa requests by attorneys. Since early 1978, following the granting of a visa to a member of the New York firm of Millbank Tweed permitting establishment of a Tokyo office, the Ministry of Justice and JFBA requested the government not to issue long-term residence visas to visiting attorneys. This action has been extended to applications for short-term commercial visas by U.S. lawyers, who have been required to submit letters of invitation from clients in Japan and to make sworn undertakings not to take depositions or to establish offices in Japan. Such applications sometimes result in delays of several weeks. Often the visas are valid only for a single visit, not to exceed 30 or 60 days, as compared with the normal commercial visa limit of 48 months.
LEGAL PROVISIONS GOVERNING FOREIGN LAWYERS

Practicing Attorneys Law. The present Japanese Attorneys Law, enacted in 1949, eliminated Japanese nationality as a prerequisite for qualification as an attorney, provided that an individual could meet the prescribed technical requirements; i.e., a foreigner could be recognized as a fully qualified practitioner, equivalent to a Japanese national. The law also established a special rule for foreign lawyers (Article 7) for those unable or unwilling to become a fully qualified member of the Japanese bar.¹ The treatment of foreign lawyers was similar to a draft law introduced in 1929, which was subsequently enacted in modified form in 1933. It provided that a person qualified to become an attorney in a foreign country may conduct legal affairs in regard to aliens or foreign law upon obtaining the recognition of the Japanese Supreme Court. However, in 1955, Article 7 was repealed by an amendment to the Attorneys Law in a private member's bill in the Diet.

Repeal of Article 7, though, still permitted an alien to become an attorney through the same procedures as a Japanese citizen. In 1956, however, an additional barrier was introduced. Because a passing candidate of the legal examination becomes a legal apprentice for two years while studying at the Legal Training and Research Institute administered by the Supreme Court, and because the apprentice is also paid a salary during this training period, this payment has been construed as compensation from the national treasury, equivalent to the salary of judges; the Supreme Court has held that one must be a Japanese citizen to receive such compensation. Since 1956, official public announcements recruiting legal apprentices list Japanese nationality as one of the requirements--"in spite of the fact that there is no express provision in any law or regulation justifying this action."²

One other passage—a very narrow one—is open to a foreigner to become a fully qualified attorney. An individual who has served five years or more as an assistant or full professor in a university department of law, or graduate school engaged in the study of law, is deemed to be qualified to practice law. The one American who has

²Ibid., p. 30.
applied to the JFBA under these provisions had his application denied on the grounds that he taught common law courses, whereas (it was asserted) the unstated intention of the law was for the teaching of Japanese law courses. However, a Japanese applicant with similar credentials to those of the American was approved. This same American then registered as a lawyer in Okinawa, which at the time was about to revert to Japanese authority. As part of the reversion process, foreign lawyers in Okinawa were screened by a committee, which included JFBA representatives, for permission to practice in Japan. It has been reported that the screening committee was told that unless it rejected the American's application, the Bar Association's representatives would reject all the other applicants; the American application was subsequently rejected by the screening committee and the ten others accepted.

The effective barriers to foreigners to becoming fully qualified members of the bar, and the repeal of Article 7 that expressly permitted the limited practice of foreign law by qualified foreign lawyers, however, does not completely shut the door to foreign lawyers. Article 72 of the Attorneys Law, which limits the activities of those who are not attorneys (foreigners or nationals), primarily prohibits handling legal affairs concerning Japanese legal "cases": that is, those matters that have crystallized into a Japanese case before a court or administrative agency. "It is not a broad blanket prohibition of the conduct of all attorney affairs." The JFBA, however, interprets Article 72 as prohibiting all legal advice by foreigners, partly on the ground that all matters may, at some time in the future, become a litigious case. In 1973, the JFBA issued a set of "Standards" that characterized "all aliens not permitted to engage in attorney affairs in Japan (regardless of whether or not they are qualified as attorneys abroad)" as "unqualified aliens."

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Ibid., p. 32.

"Standards Concerning the Prevention of Non-Attorney Activities by Foreigners," 1972; quoted in Ibid., p. 36.
Although the bar association's interpretation of Article 72 is not legally binding and has not been tested before a court or other official body, the JFBA has persuaded the Japanese government to implement the policy implicit in the "Standards" by denial or restriction of visas to American attorneys coming to Japan for business purposes. ¹ A letter (dated December 1, 1980--two and a half years following application for a visa) from the Japanese Embassy in Washington to a U.S. law firm clearly sets forth the Japanese government views on the visa issue:

The question whether a visa should be issued to Mr. X is not simply a matter of procedure; it raises the question of whether foreign attorneys should be allowed to practice in our country, and this is a basic and crucial question concerning the nature of the Japanese bar system. We have felt accordingly that it is necessary for the Japanese Government to work out a reasonable conclusion on this matter, paying due consideration to the intent of the Japanese Federation of Bar Associations and that this way of approaching the problem is desirable both for the United States and Japan.

Our government has been doing its utmost to move matters toward a conclusion, but until such time as a conclusion can be reached it has been decided that it will be best to freeze the status quo with regard to this problem and, accordingly, to withhold judgment on this particular application.

Japanese government policy has congealed around this position for more than five years. Although there is some indication of movement, it has been glacial.

**Treaty of Friendship, Commerce, and Navigation.** The Japanese government's visa policy, according to some interpretations, violates the Treaty of Friendship, Commerce, and Navigation between the United States and Japan, which entered into force in 1953. Furthermore, it is held that the Treaty dominates restrictive provisions of the Japanese Attorneys Act, regardless of the interpretation of its articles on foreign lawyers. Several kinds of activities seem to be permitted to U.S. lawyers under the Treaty. First, under Article VII, which grants "national treatment" to U.S. individuals and companies with respect to "all types of commercial, industrial, financial, and other business

activities," American lawyers should be permitted to perform those services that Japanese citizens who are not attorneys may perform without violating the Attorneys Act: for example, business and financial consulting, negotiations, and the preparation of contracts and other commercial affairs.

Second, Article VIII (Paragraph 1) of the Treaty states that U.S. companies and individuals shall be permitted to engage "accountants and other technical experts, executive personnel, attorneys, agents and other specialists of their choice." That is, U.S. businesses in Japan may use U.S. attorneys in the course of their activities. Moreover, the second sentence of this paragraph extends the permitted activity to experts, "regardless of the extent to which they may have qualified for the practice of a profession within the territory" of Japan in connection with the operation of their enterprises, "and enterprises in which they have a financial interest" within Japan. Such activities, therefore, are not limited to those conducted internally within the American client; they include external contacts with parties with whom the client deals. However, in connection with the Attorneys Law, foreign lawyers may not involve themselves in affairs that have become "cases" before a court or in other activities (such as representations before government agencies) clearly reserved to members of the bar.

The second paragraph of Article VIII specifies that nationality may not be imposed as a requirement for practicing a profession "upon compliance with the requirements regarding qualification, residence and competence that are applicable to nationals." This Article would allow U.S. citizens to become members of the Japanese bar if they could pass the examinations and meet the other qualifications imposed upon Japanese--and Japanese would be treated similarly in the U.S. under the reciprocity provisions of the Treaty. At the time of passage, however, the U.S. Senate ratified the Treaty without the reciprocity clause because it wanted to maintain nationality restrictions on lawyers permitted to practice before U.S. courts. In order to preserve some sort of reciprocity and "mutuality" in the treatment of lawyers, the

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6"National treatment" requires that treatment of the foreign party be no less favorable than that accorded to like individuals or enterprises controlled by nationals and companies of the domestic party.
Japanese government offered reciprocity to the District of Columbia, but the offer was refused. When it was again refused by American Samoa, pressure developed in the Diet to close off the unreciprocated rights of Americans in Japan, and—according to one source—the 1955 amendment (discussed above) to the Attorneys Act was passed. Matters remained static until 1973, when the U.S. Supreme Court held that nationality requirements infringed the 14th Amendment of the United States Constitution. Following this decision, a substantial number of foreigners, including Japanese, have become qualified attorneys in many U.S. jurisdictions by passing the local bar examinations. In addition, New York state adopted liberalized rules in 1974 for licensing foreign lawyers as legal consultants without examination in New York. This shift in the weight of reciprocity now makes Japan the lagging partner of the Treaty.

BEHIND THE BARRIERS

Several motives have been put forward to explain the near total exclusion of American law firms and American lawyers operating as independent legal experts in Japan. We shall focus here on two possible motives that have often been cited and that are reasonably plausible: (1) preservation of monopoly incomes—the result of high barriers to entry into the profession that are enforced by regulation and law; and (2) preservation of a Japanese approach to conflict and the law. Before addressing these matters, however, it is necessary to lay out the institutional environment of the Japanese legal system.

Institutional Setting. The structure of the legal services sector is quite different in Japan from that in the United States, though more akin to Continental European patterns. Attorneys (those admitted to the bar) confine their attention primarily to lawsuits—although this is changing somewhat in the international legal arena. Attorneys play a minor role in advice-giving to corporations on matters such as contracts or more general legal and business practices. Detailed legal advice is often available to large firms from their own legal departments who

\(^7\)In re Griffiths, 413 U.S. 717 (1973).

\(^8\)Other states have moved in this direction also, but none as far as New York.
employ not attorneys, but legal paraprofessionals, who are usually educated in undergraduate law faculties. Since these individuals may specialize in particular areas (contracts or regulations, for example) in a particular company's field of operations, they are considered by many to be superior in their skills to many Japanese attorneys for these functions. With approximately 30,000 undergraduate law graduates per year, there is no shortage of educated people to staff the corporations' legal departments.

Another type of legal paraprofessional is the legal scrivener, who drafts court and government documents and registers transactions. Moreover, in many small towns, the legal scrivener may be the only local person with a legal background. In these localities, and even in large urban areas, they are a source of much informal judicial advice. A survey of court cases indicated that many litigants had obtained advice from legal scriveners rather than from lawyers before going to court.

Among the legal professionals are the patent attorneys and tax attorneys. Patent attorneys are examined and admitted to a specialized Patent Attorneys Association and can represent clients before a Patent Officer; however, they cannot appear in a court for their clients, and their careers are quite different from those of lawyers. Tax attorneys, also, must pass special examinations, but practicing attorneys and public accountants are ipso facto qualified as tax attorneys.

Foreign attorneys, as noted above, occupy an anomalous position in the legal structure. A small number of foreigners, mainly Americans, who were admitted to the Japanese bar after the Second World War continue to practice. In addition, about a hundred young foreign trainees work for Japanese law firms for periods of up to a few years. Also, foreign lawyers residing abroad make short-term ad hoc visits to advise on particular cases. What has been denied to them has been the opportunity to establish a long-term presence.

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11Cited in ibid., p. 260.
As the above description of the legal structure demonstrates, the bar associations supervise only a small part (albeit, the core) of the legal service area—and we have not even mentioned above the many arbitration boards and other formal and informal dispute-resolving agencies and mechanisms. American lawyers in Japan—as in the U.S.—perform many of the tasks regularly done by those outside the core group of attorneys. Nevertheless, in order to be approved to engage in regular legal business—of whatever kind—the assent of the bar association is necessary. The Japanese Federation of Bar Associations (JFBA) is an autonomous body that, under authority of law, licenses and supervises Japanese lawyers. All lawyers are required to belong to the JFBA, which is not under the jurisdiction of any ministry or court. The Ministry of Justice, however, includes a section that is responsible for the entire judiciary system and that also acts as governmental liaison with the JFBA. Because of its independence and authority, the JFBA has a great deal of persuasive and coercive power over its membership that it exerts through several specialized governing committees. Thus, if a Japanese law firm were to cooperate with foreign lawyers in a manner repugnant to a group within the JFBA, the organization could discipline or otherwise harass the Japanese firm through one of its committees. It should be noted here that a committee composed of a small number of members is likely to have stronger opinions on a subject than the JFBA membership as a whole. Indeed, this seems to be the case for the "Committee on the Unlicensed Practice of Foreign Lawyers."

Entry into the ranks of fully qualified attorneys is highly restrictive. Undergraduate law faculties in the major universities have annually graduated more than 30,000 students in recent years. These law graduates face several alternatives. They can enter general management jobs in the main stream of corporate or government bureaucracies; they can join the legal departments of large companies; or they can take the bar examination—the first step toward qualification as an attorney. In recent years, 25,000 to 30,000 applicants per year have taken the

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12 This statement is based on the presumption that individuals interested in a subject will make a vigorous effort to be placed on committees dealing with that subject.
national law examination. Of these, fewer than two 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 over
this same period. The number of candidates passed and admitted to the
training institute is administratively determined and bears no
relationship to demand or supply conditions.

The annual intake of 500 candidates go on to become judges and
public procurators, as well as private attorneys. Approximately 10-15
percent enter training for the bench, 10-15 percent become procurators,
and the remainder become attorneys. Thus, the well-known fact of the
relatively small numbers of lawyers in Japan--about 12,000 or one for
every 10,000 Japanese compared with one for every 350 in the
U.S.--results entirely from official decree.

This phenomenon of legally sanctioned restrictions and barriers to
entry into the legal profession lies at the heart of the two
explanations for the barriers to foreign lawyers that we shall explore.
If the demand for lawyers has grown over the years, whereas the supply
has remained fixed, legally supported barriers to entry would create
monopoly returns to those in the profession. Such evidence would offer
prima facie support for the proposition that the present members of the
profession are attempting to preserve their resulting high monopoly
incomes by maintaining the barriers. However, another argument for
maintaining the status quo has also been made, and since it is
consistent with many studies on Japanese life, it also warrants
consideration: The limited entry into the legal profession is said to
preserve a socially valued constraint on the litigiousness or "law
consciousness" of the Japanese people. Monopoly incomes may result from
these constraints, but they are secondary to the primary goal. In crude
terms, the explanations come down to "income" and "culture." It is to
these arguments that we now turn.

Barriers to Preserve High Incomes Among Japanese Attorneys. The
key to judging whether high incomes actually exist--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.

One piece of pertinent evidence is the number of candidates for the legal examination. Table 2 shows the number taking and passing the examinations since 1961. Because of the large numbers taking the examinations in recent years, the test is given in two phases. The first phase is composed of multiple-choice questions; those passing this phase go on to longer, written-essay responses to questions. The number passing the first phase is governed by the logistical consideration of the number of essays that a fixed board of examiners can read in the

Table 2

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Applicants</th>
<th>Number Passing Multiple Choice Test</th>
<th>Number Passing Final Exam</th>
</tr>
</thead>
<tbody>
<tr>
<td>1961</td>
<td>10,921</td>
<td>2,092</td>
<td>380</td>
</tr>
<tr>
<td>1962</td>
<td>10,802</td>
<td>1,931</td>
<td>459</td>
</tr>
<tr>
<td>1963</td>
<td>11,725</td>
<td>2,030</td>
<td>456</td>
</tr>
<tr>
<td>1964</td>
<td>12,728</td>
<td>2,017</td>
<td>508</td>
</tr>
<tr>
<td>1965</td>
<td>13,681</td>
<td>2,258</td>
<td>528</td>
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<tr>
<td>1966</td>
<td>14,687</td>
<td>2,225</td>
<td>554</td>
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<tr>
<td>1967</td>
<td>14,460</td>
<td>2,244</td>
<td>537</td>
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<tr>
<td>1968</td>
<td>17,727</td>
<td>2,322</td>
<td>525</td>
</tr>
<tr>
<td>1969</td>
<td>18,453</td>
<td>2,326</td>
<td>501</td>
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<tr>
<td>1970</td>
<td>20,160</td>
<td>2,157</td>
<td>507</td>
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<tr>
<td>1971</td>
<td>22,336</td>
<td>2,821</td>
<td>533</td>
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<tr>
<td>1972</td>
<td>23,425</td>
<td>2,407</td>
<td>537</td>
</tr>
<tr>
<td>1973</td>
<td>25,259</td>
<td>2,484</td>
<td>537</td>
</tr>
<tr>
<td>1974</td>
<td>26,708</td>
<td>2,419</td>
<td>491</td>
</tr>
<tr>
<td>1975</td>
<td>27,791</td>
<td>2,343</td>
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<td>1976</td>
<td>29,088</td>
<td>3,152</td>
<td>465</td>
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<td>1977</td>
<td>29,214</td>
<td>3,229</td>
<td>465</td>
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<tr>
<td>1978</td>
<td>29,390</td>
<td>3,618</td>
<td>485</td>
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<tr>
<td>1979</td>
<td>28,622</td>
<td>4,167</td>
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<td>1980</td>
<td>28,656</td>
<td>4,404</td>
<td>486</td>
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<tr>
<td>1981</td>
<td>27,816</td>
<td>4,181</td>
<td>446</td>
</tr>
<tr>
<td>1982</td>
<td>26,317</td>
<td>3,809</td>
<td>457</td>
</tr>
<tr>
<td>1983</td>
<td>25,138</td>
<td>4,008</td>
<td>448</td>
</tr>
</tbody>
</table>

second phase; and the number passed in the second phase is determined by
the number of openings in the legal institute. That fewer than 2
percent of the candidates have passed the 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. If the tests are taken when the applicant is
still in university or shortly after graduation, little would be lost in
this gamble. However, a significant number of people devote several
years to preparation, taking and retaking the exams—a substantial
investment in lost time and income. In recent years, the average age at
passing has been almost 28 years—indicating an average postgraduate
cram period of about six years. This investment by thousands of
students in years of time and study when the passing rate is less than 2
percent suggests an expected return that makes the gamble worthwhile—
especially when this delay means that their place in the bureaucratic
promotion queue is severely, and perhaps permanently, affected.

Some part of the increase in legal examination applicants can be
explained by the enormous growth in the number of university students in
Japan since 1950—because of demographic trends toward more university-
age youths and because of higher proportions of young people attending
university. Table 3 shows the number of college and university
students, the applicants to the legal examination, and the ratio of
applicants to the total number of students. This ratio has grown by 30
percent from 1950-55 to 1975-80. If the earlier ratio prevailed in
1980, some 7000 fewer applicants would have taken the legal examination
in the later years. Apparently, something more than demographics is
behind the attractiveness of the national legal examinations.

A high income could justify these trends. We were able to combine
several sources of information to develop income figures for practicing
attorneys. A number of analytical problems, though, had to be dealt
with. Attorneys' practices vary greatly; they range from large cities
to small towns; from solo-practitioner to law firms of 20 or more
attorneys; from routine legal matters to complex international financial
arrangements. We conjectured that those attorneys who would most likely
be affected by competition from foreign lawyers would be those in Tokyo
Table 3
STUDENTS ENROLLED IN JAPANESE COLLEGES AND UNIVERSITIES AND APPLICANTS TO LEGAL EXAMINATION

<table>
<thead>
<tr>
<th>Year</th>
<th>Students Enrolled</th>
<th>Applicants to Legal Examination</th>
<th>Ratio, Applicants/Students</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950</td>
<td>222,000</td>
<td>2,806</td>
<td>.0126</td>
</tr>
<tr>
<td>1955</td>
<td>503,700</td>
<td>6,347</td>
<td>.0126</td>
</tr>
<tr>
<td>1960</td>
<td>601,500</td>
<td>8,363</td>
<td>.0139</td>
</tr>
<tr>
<td>1965</td>
<td>895,500</td>
<td>13,644</td>
<td>.0152</td>
</tr>
<tr>
<td>1970</td>
<td>1,344,400</td>
<td>20,160</td>
<td>.0150</td>
</tr>
<tr>
<td>1975</td>
<td>1,652,000</td>
<td>27,791</td>
<td>.0168</td>
</tr>
<tr>
<td>1980</td>
<td>1,741,500</td>
<td>28,656</td>
<td>.0165</td>
</tr>
</tbody>
</table>

SOURCE: Students enrolled, colleges and universities, regular course: Statistics Bureau, Prime Minister's Office, Japan Statistical Yearbook, 1982, Table 419, p. 628.

firms specializing in a foreign clientele. We therefore sought a list of such attorneys. The Martindale-Hubbell Law Directory, which publishes listings in English of firms and their professional staff and which is aimed primarily at the foreign community, was the primary source.\(^{13}\) We matched the names of attorneys in Tokyo firms listed in the Martindale-Hubbell Law Directory to 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 (approximately $40,000 in 1982).\(^{14}\) From this linkage we were able to estimate the distribution of incomes of Tokyo lawyers advertising to the international community and to compare these with other lawyers and other occupations.

\(^{13}\)Martindale-Hubbell is essentially a book of advertisements; firms pay a fee in order to be listed in it. Since it is in English and directed at an international readership, a firm with a purely domestic practice would have no reason to list itself.

For comparison purposes, we chose a random sample of about 200 Tokyo attorneys from the directory of the Japan Federation of Bar Associations (JFBA). We also analyzed a 1977 list of about 80 lawyers who had signed a petition calling for action against the practices of foreign legal consultants. Our statistical sample comprised those petition-signers who were also listed in the Martindale-Hubbell directory. Some analytical problems, however, are associated with the use of the petition list: The small number of observations precludes confidence in some statistical inferences; the petition was often not signed by senior members of law firms; and five years elapsed between the signing of the petition and the year for which income information was collected.

Both the Martindale-Hubbell and JFBA directories provide information on the age of the listed attorneys. Account can therefore be taken of the influence of age on income. (Foreign training and education are listed in Martindale-Hubbell, but not in the JFBA directory.) However, we only have income information for those reporting over 10 million yen per year. Nevertheless, from the information that is available, it is possible to make statistical inferences about the remainder of the distribution.

Table 4 summarizes the age, experience, and income of the three samples. Several striking points emerge from these figures. The age distributions of the random and international practice groups indicate that the international firms have a higher proportion of younger attorneys, most likely because of the rapid growth of the field. The petition subsample has more foreign experience than the international practice group, from which it is drawn. Examination of the petition signers' ages in 1977, the year of the petition, indicates that more

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15 The rules for inclusion in our sample from the Martindale-Hubbell source were that an attorney must be a "member" or "associate" of a listed firm and also a member of a Japanese bar association. This ruled out attorneys described as "Of Counsel", foreign bar members, and members of the Patent Attorneys Association (who were not also members of an attorneys' bar association).

16 This estimate is based on an assumption of a log-normal distribution of income.
Table 4  
INCOME AND FOREIGN EXPERIENCE BY AGE OF TOKYO ATTORNEYS, 1982

<table>
<thead>
<tr>
<th>Item</th>
<th>Sample Group</th>
<th>20-39</th>
<th>40-49</th>
<th>50 and Older</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of observations</td>
<td>Random</td>
<td>72</td>
<td>38</td>
<td>81</td>
<td>191</td>
</tr>
<tr>
<td></td>
<td>International</td>
<td>174</td>
<td>78</td>
<td>74</td>
<td>326</td>
</tr>
<tr>
<td></td>
<td>Petitioners</td>
<td>27</td>
<td>25</td>
<td>5</td>
<td>57</td>
</tr>
<tr>
<td>% in age group</td>
<td>Random</td>
<td>38</td>
<td>20</td>
<td>42</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>International</td>
<td>53</td>
<td>24</td>
<td>23</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>Petitioners</td>
<td>47</td>
<td>44</td>
<td>9</td>
<td>100</td>
</tr>
<tr>
<td>% with foreign experience or training</td>
<td>Random</td>
<td>(b)</td>
<td>(b)</td>
<td>(b)</td>
<td>(b)</td>
</tr>
<tr>
<td></td>
<td>International</td>
<td>40</td>
<td>64</td>
<td>42</td>
<td>46</td>
</tr>
<tr>
<td></td>
<td>Petitioners</td>
<td>67</td>
<td>80</td>
<td>40</td>
<td>70</td>
</tr>
<tr>
<td>% with income greater than $40,000</td>
<td>Random</td>
<td>0</td>
<td>8</td>
<td>17</td>
<td>9</td>
</tr>
<tr>
<td></td>
<td>International</td>
<td>9</td>
<td>50</td>
<td>62</td>
<td>31</td>
</tr>
<tr>
<td></td>
<td>Petitioners</td>
<td>15</td>
<td>68</td>
<td>100</td>
<td>46</td>
</tr>
<tr>
<td>Estimated average income</td>
<td>Random</td>
<td>(a)</td>
<td>(a)</td>
<td>26,800</td>
<td></td>
</tr>
<tr>
<td></td>
<td>International</td>
<td>16,600</td>
<td>64,500</td>
<td>121,300</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Petitioners</td>
<td>(a)</td>
<td>69,000</td>
<td>(a)</td>
<td></td>
</tr>
</tbody>
</table>

NOTES: For sources and methods, see text. An exchange rate of 240 yen = 1 dollar is assumed.

(a) Estimates unreliable because of small number of observations.
(b) Foreign experience and training information unavailable.

than three-fourths (77 percent) were then under forty years old. This concentration in the younger age group suggests that the younger members with foreign experience, but without established clienteles and reputations, had the most to fear from the competition of foreign lawyers.

The most important finding in Table 4 relates to income. Tokyo attorneys in international practice earn incomes substantially higher than the random group of attorneys; for those over 50 years old, this amounts to almost a five-fold difference. Among this older group of international practice attorneys, 62 percent earned incomes greater than $40,000, and the estimated average annual income for this entire
subsample is more than $120,000. Before comparing these figures to
incomes of other occupations, it should be noted that the Tax Agency
permits 30 percent of attorneys' gross income to be deducted as presumed
business expenses. Knowledgeable people believe that this allowance
more than covers costs.

Income comparisons across occupations as tests of market
imperfections must contend with numerous problems; two complications
that may be operative in the cases examined here include market
disequilibria caused by lagged responses to economic forces, and
differences in the distributions of skills and capabilities within and
between occupations. We took account of several possibly confounding
effects, but the results reported here should be assessed as indicative,
rather than as demonstrating a case beyond a reasonable doubt.

In seeking comparisons between the incomes of attorneys and other
occupations, we selected those that required at least as much training
and education. In order to reduce training and other human capital
investment effects that particularly influence earnings at early career
stages and that vary across occupations, we focused on incomes at the
peak earnings ages--i.e., among fifty-year olds. This procedure also
eliminates income differences among occupations that arise from
different age distributions. In addition, in order to strengthen our
test of the proposition that entry restrictions lead to high monopoly
incomes, we chose, for comparison, occupations from among the highest-
income groups listed in the published survey. These are shown in Table
5. The results are striking. Attorneys in international practice over
50 years of age earned higher average incomes than any of the comparison
groups: 75 percent higher than the highest listed income and up to four
times greater than other high-income occupations. Equally surprising is
the finding that even the attorneys in the random sample earned average
incomes comparable to the high-income professional occupations.\textsuperscript{17}

It is clear from the above that the legal profession is bifurcated
along domestic and international corporate lines.\textsuperscript{18} It also appears

\textsuperscript{17}It should be noted that entry into the ranks of physicians is
also highly restricted.

\textsuperscript{18}A study of the legal profession in Chicago also noted a distinct
bifurcation along corporate law and noncorporate law lines. Those
engaged in corporate law tended to be graduates of the top law schools,
that the core of the opposition to foreign lawyers comes from those Japanese attorneys with foreign experience and training or with an international legal background gained in Japan who are earning very high incomes from their specialized knowledge. Furthermore, the claims of the Justice Ministry and of the JFBA that there is not a "need" for more lawyers is clearly not supported by the income figures of those in the international practice group; the demonstrated existence of "excess demand" is weaker for the random sample, the incomes of which are equivalent to those of alternative high-salary occupations.

That this field of the law is attractive is supported by examination of the trend in numbers of Tokyo lawyers listed in Martindale-Hubbell over the years. The growth in the number of listed firms and their members is remarkable. As shown in Table 6, from 1960 to 1982, the number of firms has increased by almost five times, and the number of lawyers by eight times.\textsuperscript{19} The rapid growth of this sector of the legal market suggests a growth in demand that, despite the

\begin{table}
\centering
\caption{Income Comparisons of Attorneys and Selected Professions}
\begin{tabular}{lll}
\hline
Occupation & Average Age & Annual Income 1982 dollars \\
\hline
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 \\
\hline
\end{tabular}
\end{table}

\textsuperscript{19}The rules for inclusion in Table 6 are the same as those noted above for inclusion in the sample of international practice attorneys.
considerable flow of lawyers into the area, still is constrained by supply conditions and by the lead times and investments required for international legal training.

The preponderance of evidence presented above indicates that the legal profession enjoys good incomes, and that the international practice sector does very well, indeed.\footnote{One possible explanation for the high incomes of Japanese international practice lawyers is that they possess high levels of skills and competency that are required by the complexities of international legal issues, and that they are appropriately compensated for these skills. One test of this, which we have not performed, would be to calculate the ratio of Japanese international lawyers' incomes to the incomes of a competitive control group; this ratio would then be compared with a similarly calculated U.S. ratio. Since entry into the legal profession is relatively open in the U.S., the U.S. ratio would reflect unconstrained, market-determined effects. A higher ratio in Japan would be consistent with monopoly incomes due to barriers.} This evidence is consistent with the proposition that competition from foreign lawyers is disliked because it would tend to diminish the high incomes of those already in the profession, especially since many of them have had to pay a high entry fee of several years preparation. Whether a sufficiently large number of foreign lawyers would enter into practice to influence prevailing income levels must remain an open question. Evidently, enough members of the Japanese bar association believe that there would be substantial harm in even a single American lawyer opening an office. Perhaps as many as a hundred U.S. lawyers would be attracted to Japan. These would include those who have worked as trainees in Japanese law
firms over the years and have thereby indicated a "taste" for Japanese life. Such individuals may be attracted to career opportunities in Tokyo, even if incomes were less than they could earn in New York or elsewhere. With about a hundred trainees in residence at any one time for periods of about two years, the total number of American lawyers with Japanese experience—including many with Japanese language abilities—would be many times as great. Since fewer than 400 Japanese lawyers are in international practice, an inflow of foreign lawyers could be a substantial percentage of all those now in the field—with commensurate effects on incomes.

**Barriers to Preserve a Japanese Legal Culture.** The opposition to foreign lawyers in Japan may also stem from fear of the introduction of foreign legal philosophies into the country. The argument, in brief, is that the Japanese legal system is the result of very deeply and widely held beliefs among the Japanese people favoring a minimal role of law in resolving conflict and the priority of social obligations in the hierarchy of social values. Put simplistically, the Japanese desire to resolve conflict in ways that preserve social harmony, and place collective rights above individual rights. In this set of beliefs, 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. Numerous studies, as well as personal experience, confirm that Japanese people avoid open confrontation and have constructed mechanisms in many areas of private and public life to avert face-to-face conflict. One could therefore argue that the Japanese fear the entry of foreign lawyers because of the damage they could do to the existing, carefully balanced system. As the American Bar Association was told in discussions with the JFBA: "The foreign lawyer matter relates to the legal and cultural system of each country, and is not a trade matter."\(^2^1\)

This argument is supported by reference to the relatively small number of lawyers in Japan, by the small number of judges per capita, and by the infrequency with which Japanese go to court. We have already seen above, though, that the number of judges and lawyers is an

administratively determined figure that bears little relation to general notions of demand.\textsuperscript{22} Concerning the frequency of court cases, one study places Japan midway in a table of civil cases, with 1,257 per 100,000 population, compared with 172 for South Korea and 307 for Finland at the bottom of the list, and 5,277 for Australia at the top.\textsuperscript{23} (The United States is not listed, but if figures for California cited by Haley were indicative of nationwide behavior, they would place the United States 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 relatively small number of lawyers and judges powerfully restricts the accessibility of the legal system to potential litigants. Indeed, a large number of cases are "self-argued," without benefit of legal counsel. In one-third of all appellate hearings in high courts, either the plaintiff or the defendant argued his own case without the advice of an attorney. A survey of self-argued cases revealed that three of the four main reasons given for not using attorneys had to do with their small numbers.\textsuperscript{24}

That much of this is of administrative origin can be seen from the fact that in the pre-World War II period, the absolute number of cases was higher than in the 1970s; the per-capita number was more than two and a half times greater.\textsuperscript{25} Furthermore, the number per capita of Japanese taking the legal examination in 1975 was actually greater than that of Americans taking a bar examination. The startling difference between the two countries is that in the United States 66 percent passed, but only 1.7 percent in Japan.\textsuperscript{26}

\textsuperscript{22}Since many legal issues are handled by paralegal practitioners and others, the comparison of lawyer populations is not a full test of the supply of legal experts.
\textsuperscript{24}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, \textit{op. cit.}, p. 260.
\textsuperscript{25}Haley, \textit{op. cit.}, Fig. 2, p. 372.
\textsuperscript{26}"1981 Bar Examination Statistics," \textit{The Bar Examiner}, 1981, pp. 25-30. More than 75 percent of first-time test-takers passed in 1981, and 32 percent of the repeaters (23 percent of all applicants). The total passing figure in the U.S. was 66 percent.
Despite strongly held beliefs concerning the impropriety of using the legal system to settle disputes, and despite the high costs imposed on potential litigants by the restricted size of the system, 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 increased by 240 percent.27 Since other types of civil suits handled by the Tokyo District Court increased by only about 10 percent in the same period, one is forced to ask whether "law consciousness" has for some reason been heightened in traffic accidents, but not in contract disputes or the other types of actions. An explanation for these differences is that judgment awards and settlement amounts in traffic injury cases increased sharply from 1963 to 1969—the median award doubling for personal injuries and tripling for deaths.28 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 solely laid to a low level of "law consciousness."

Haley argues that institutional barriers to the use of the legal system have reflected, since before the Meiji Period, a desire by the ruling elite to "maintain a paternalistic order based on a hierarchical submission to authority."29 Despite a series of statutes enacted in the 1920s and 1930s that required conciliation and that were intended to reduce the power of the courts, lawsuits continued to increase until the immediate pre-war period—as one would expect with a growing and increasingly complex industrial society. The desire by today's governing elite, it has been argued, to continue to emphasize the consensual and nonlitigious nature of the Japanese tradition embodies

28These figures are shown in Stevens (1971), op. cit., p. 676.
29Haley, op. cit., p. 371.
attempt 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." Government preferences therefore reinforce social values by restricting access to the courts--perhaps as much from a belief that society should adhere closer to social norms of conflict avoidance--as from a desire to keep people and corporations subordinate to government.

Postwar governments' strategy of leadership through "administrative guidance" would be much more difficult to pursue if actions could be challenged in the courts. Administrative guidance--an "extra-legal" system of governance--depends on the simultaneous existence of several conditions: A weak pursuit of due process; and a system of sanctions through the use of government powers to punish noncompliance with administrative requests. Preservation of a low level of "law consciousness" through controlling access to the legal system by restricting the number of lawyers and judges helps maintain the first condition; and government regulation of business and industry provides the sources of government sanctions against those who refuse guidance. The second of these conditions is becoming markedly weaker as deregulation proceeds through major portions of the Japanese economy. The growth of certain social forces is weakening the first condition: urbanization; the decline of social sanctions; increased complexity of transactions; the internationalization of economic activity. These are accompanied by pressures in the legal system: crowded court calendars; delays; inadequate legal representation. The foreign-lawyer issue may have been accelerated by external interests, but it is part of a larger flow of change in the Japanese legal system.

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31 Surveys of parties to personal civil disputes "failed to reveal any informal pressure at all" on automobile drivers, landlords, or lessees "to perform their obligations... Moreover, there no longer exists any informal machinery which is recognized as legitimate by a large majority of the members of the community for settling civil disputes through mediation." Cited by Tanaka, *op. cit.*, p. 263.
The data presented by Haley and others are consistent with the notion that policies and measures introduced by Japanese governments in both the pre- and postwar periods have successfully reduced the level of legal activity below that seen in many other countries, and below that experienced in Japan at other times. That the Japanese people would be considerably more legally active without these barriers seems clear. What is less clear is whether the Japanese people prefer these "distortions" to the alternative of a more open, litigious, legal society. The Japanese people may prefer to keep those alternatives closed.

POLICY ISSUES

As Tokyo becomes a center of international trade and finance, the demand for skilled international lawyers experienced in the complexities of negotiating, financing, and drawing up the instruments for multinational projects will grow apace. 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 operating in the U.S. and world-wide require specialized legal advice; these requirements will be quite independent of Japanese legal policies and traditions. As has been demonstrated by the movement of firms and lawyers into the international arena as well as by their incomes, this area has already experienced considerable growth. Both the JFBA and the Ministry of Justice, however, have questioned the "need" for American lawyers in Japan. Discussions with Ministry officials suggest that they would like to see need demonstrated by statements from potential users of foreign law services that their requirements are going unmet. This is not necessary. Need is seldom absolute. In an economic sense, unmet need is the difference between the administratively set level of supply and the market solution that would prevail if supply were allowed to expand in response to the motivation of higher income. In an unconstrained situation, the number of lawyers and the services they would provide would rise, and their price would fall--if there were "unmet needs."
However, the meeting of these specialized needs does not require a dismantling of the Japanese system. A few simple policy changes would permit foreign lawyers to enter the market and take the risk of there being a demand for their services or not. Their entry should have very little effect, if any, on the traditional Japanese approach to law. Their natural areas of counsel and expertise would be in niches quite apart from the general practice of Japanese law.

The simplest change to accomplish this would involve Ministry of Justice interpretation of Article 72 on foreign lawyers. Solid legal opinion has stated that the JFBA interpretation is too narrow and rigid. Since the Ministry of Justice is responsible for prosecuting violations of Article 72, it could passively reinterpret the law by refusing to recognize "violations." The Ministry of Justice, however, has consistently refused to countenance this possibility without the concurrence of the JFBA.

A second method for opening the door would be a recognition under the Treaty of Friendship, Navigation, and Commerce of reciprocity with the U.S. or with specific states in which foreign lawyers are licensed; U.S. nationals admitted to the bar in such jurisdictions would have reciprocal rights in Japan. Since a treaty dominates statute, interpretation or amendment of the Attorneys Law could be avoided. In any event, ending of visa restrictions is a required step. This is a move that technically involves neither the JFBA nor the Ministry of Justice. Realistically, however, such a shift could not take place without consultation with and some kind of acquiescence--passive, active, or forced--by these organizations.

If the Ministry of Justice did not want to antagonize the JFBA by reinterpreting Article 72, the matter could be settled in the Diet, where an amendment to the law could achieve the same end. In effect, this would transfer the onus from the Ministry to the politicians. 32 The Ministry would then simply carry out the law as passed by the Diet.

32 Unlike the U.S. Congress, few Diet members are lawyers.
The final policy that we consider is a long-term process of discussion with the Bar Associations for the purpose of mutual education. If this were successful, change would flow from the bottom up. However, as a single mode for achieving change, this is unlikely to be effective. Since the mid-1950s, the JFBA has been the single most successful organization in placing barriers before foreign lawyers. Through their own policies and through their influence on the government, the Bar Association has virtually eliminated the practice of law by foreigners. However, not all JFBA members hold identical views on the subject. Throughout the early 1980s, the JFBA leadership with the support of the Justice Ministry has been trying to lead the organization into an accommodation that would permit the foreign lawyers to practice. These moves have been supported by the powerful Federation of Economic Organizations (Keidanren), which called for "allowing foreign lawyers to open offices and practice law in Japan."³³ Although other groups may perhaps be induced to call for liberalization, nevertheless, a vigorous lobby within the Bar Association stubbornly opposes such a move. Two successive Secretary Generals of the JFBA and two successive officials of the Justice Ministry had set themselves the goal of solving the foreign lawyer issue. None of them has so far met with success. In fact, the JFBA has been described as being "in complete disarray over the whole matter."³⁴ Nevertheless, the forces for liberalization are at work, but these can take years to work themselves out. Without external pressure, there is little likelihood of autonomous change.

In summary, the authority to regulate and control entry into the profession has been granted by law to a professional organization, the JFBA. To the extent that the preservation of both high incomes and a Japanese legal culture are central policies of the profession, they are made possible by domestic regulatory practices. Neither of these goals—one economic, the other cultural—could be advanced without the regulatory capabilities exercised by a key actor in the legal sector.

V. THE ACCOUNTING PROFESSION

BARRIERS TO U.S. ACCOUNTANTS

Foreign accountants, in general, have been accorded more favorable treatment in Japan than members of other professions. 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, and indeed have done quite well—ranking among the largest accounting offices in Japan. Furthermore, nationality is not a requirement for the practice of the CPA profession in Japan and a number of 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" (kansa hojin) status. Some, but not all, 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.

All the "Big Eight" U.S. accounting firms have established offices in Tokyo to service their major U.S. corporate clients in Japan. No restrictions are placed on opening branch offices; several of the larger U.S. accounting firms maintain a second office in Osaka, the second largest metropolis. In terms of number of CPAs employed, several of the Big Eight rank with the top ten domestic accounting firms in size. Price Waterhouse, with 107 CPAs, ranks second only to the largest Japanese accounting firm—Chuo Audit Corporation—which employs 114 CPAs. Many of the Big Eight also have close correspondent ties with

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1 See Sec. IV, "The Legal Profession."
2 These conditions accord with the major provisions of the 1953 Treaty of Friendship, Commerce and Navigation. Article VIII (paragraph 1) stipulates that American companies in Japan are free to engage "accountants and other technical experts . . . of their choice." The second paragraph of the same article specifies that nationality may not be imposed as a requirement for practicing a profession "upon compliance with the requirements regarding qualifications, residence and competence that are applicable to nationals."
3 These figures were obtained from the Japanese Institute of Certified Public Accountants, Membership List (Kai-in Neibo), April 1982.
Japanese accounting firms and work with them to satisfy the domestic and foreign auditing requirements of each other's clients.

A number of American accountants have been licensed to offer their professional services in Japan under Article 16 of the Certified Public Accountant Law of 1948. This "Special Exception for Persons Qualified as Foreign CPA" provides that persons licensed as accountants in foreign jurisdictions and demonstrating a substantial knowledge of Japanese accounting laws, can take a special licensing examination administered by the Ministry of Finance (MOF). Upon passing the exam, and subject to approval of the Japanese Institute of CPAs (JICPA), their names may be included on the List of Foreign CPAs (Gaikoku Koninkaikeishi Meiho). 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 foreign demand. This explanation is not very convincing, given the relative simplicity of the licensing exam and the economic rewards associated with being a "foreign CPA." That certification is attractive is evidenced by high incomes of foreign CPAs grandfathered by this de facto policy (see Section II). Observers suggest an alternative motive for this policy, one targeted not at American accountants but rather at Japanese nationals. Japanese failing the extremely competitive Japanese CPA examination may attempt to enter the profession indirectly by first acquiring a CPA degree abroad and then returning to be certified as a "foreign CPA." Nonetheless, U.S. accountants interviewed (who had all passed the examination for foreigners prior to 1976) did not feel that this was an important barrier to their own operations in Japan. Other foreign CPAs desiring certification, though, may not necessarily share this view.

Grandfathered CPAs, whose monopoly incomes reside in maintenance of the status quo, clearly have a vested interest in downplaying the importance of the certification exam.

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4 Previously, this CPA examination had been given in English as a ministerial courtesy even though this was not required by the CPA Law.
5 The membership roster of foreign CPAs provides some support for this view: Several individuals are listed who appear to be of Japanese nationality.
The chief limitation that U.S. accounting firms face has been 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 offering public stock issues provide consolidated accounts audited by a member of the JICPA. As branch offices, foreign accounting firms cannot use their name to sign audit reports and must therefore work closely with Japanese accounting firms to meet JICPA audit requirements. A number of foreign firms have set up "CPA joint accounting offices" (kyodo gimusho), which are recognized by the JICPA, and can now sign statutory audits under the name of the joint office. Neither the branch office nor joint accounting office form of accounting practice is considered as prestigious or as flexible as an audit corporation, which Japanese companies perceive as being associated with greater resources and reliability. Several U.S. accounting firms believe that the enhanced prestige and independence of being an audit corporation would allow them to compete with large Japanese audit corporations for a share of the rapidly expanding domestic market. The unofficial Ministry of Finance policy of denying them audit corporation status is seen as a "nontariff barrier" to their operations in Japan.

Audit corporation status would also offer U.S. accountants tax benefits as compared with alternative forms of accounting practice. Neither branch offices nor joint accounting offices are recognized as legal entities for tax purposes. As such, foreign accountants are subject to a withholding tax of up to 20 percent on individual earnings even though many may actually be partners and share in the profits of the firm. They would be relieved of this withholding obligation as partners in an audit corporation.

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6 JICPA recognition of foreign joint accounting offices did not come until 1980. Since then, four foreign accounting firms have established joint offices: Price Waterhouse, Arthur Andersen, Deloitte Haskins, and more recently, Arthur Young.

7 Partnerships, the customary form of accounting practice in the U.S., are not recognized as legal entities under Japanese tax law. However, senior members of Japanese firms are referred to as "representative partners."
Until recently, efforts by U.S. accounting firms to establish audit corporations have met with little success. Price Waterhouse had reportedly sought Ministry of Finance approval for its application for almost 10 years. In 1978-1979, the U.S. Government actively pressed a request on behalf of Arthur Andersen in its ongoing efforts to establish an audit corporation. However, the complaint was withdrawn in 1979, apparently at the behest of the U.S. accounting industry. In part, foreign accounting firms were fearful that governmental pressure on the JICPA would jeopardize their correspondent relationships with Japanese accounting firms. A desire to avoid the closer supervision of the Ministry of Finance, which would have accompanied audit corporation status, may have been another factor. Similar concerns were voiced in a more recent industry request to the American Chamber of Commerce in Japan not to raise the audit corporation issue in their survey of U.S.-Japan trade problems.

In 1982, the MOF announced a set of guidelines on how foreign accounting firms could apply for audit corporation status. These guidelines included the requirements that the audit corporation have a minimum of five Japanese CPA partners and that all equity be held in Japan. Following these announcements, Price Waterhouse renewed its application and was granted permission to establish itself as an audit corporation beginning in June 1983. However, in accordance with JICPA regulations that "big names" not be used, Price Waterhouse practices under the name of Aoyama Audit Corporation, A Member of Price Waterhouse International.

BEHIND THE BARRIERS

For foreign accounting firms in Japan, the issue is the right to establish themselves as an audit corporation capable of competing with Japanese accounting firms. Through joint audits, the Big Eight already service the corporate clients of Japanese accounting firms going abroad. 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: first, the smaller Japanese companies requiring consolidated accounts as a result of recent
changes in the Japanese Commercial Code; and second, Japanese corporations going abroad, either to establish subsidiaries or to raise funds in international capital markets. In the view of the U.S. companies, the MOF policy of denying them audit corporation status effectively constrains their ability to compete with large Japanese accounting firms for this new business.

This MOF policy—and its recent evolution to allow Price Waterhouse audit corporation status—can be seen as outcomes of complex coalitions between three groups of actors motivated by different interests: (1) the JICPA, wanting to restrict foreign entry to preserve the monopoly incomes of its members; (2) the MOF, to promote the sound development of the accounting profession, but caught between the conflicting interests of domestic and foreign accounting firms; and (3) the Big Eight, themselves divided about whether or not to become audit corporations. Before exploring these explanations, we first describe the institutional environment of the Japanese accounting industry.

Institutional Background

Regulation of the accounting profession in Japan is shared by both the Ministry of Finance (MOF) and the Japanese Institute of Certified Public Accountants (JICPA) under the provisions of the CPA Law of 1948. The MOF sets accounting and audit standards with input from the JICPA, provides guidelines on audit fees, and administers the CPA examinations. In addition, the MOF is empowered under the CPA Law to review and approve applications for audit corporation status. Entry into the CPA profession, however, 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 provisions in the Securities and Exchange Law and the Commercial Code are the mainstay of CPAs. The Securities and Exchange Law requires that publicly listed companies (kabushiki kaisha) and those

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More precisely, this function is performed by the Enterprise Accounting Deliberation Council of the MOF. Composed of CPAs, scholars, representatives of employer organizations, and officials of the Ministry of Finance, this body is responsible for formulating recommendations on accounting principles and standards. In addition, this body negotiates guidelines on the fees that audit corporations can charge clients.
selling securities in a public offering provide consolidated accounts audited by a member of the JICPA. This requirement also applies to foreign corporations listed on the Tokyo stock market. Up until 1974, the Commercial Code also required audited accounts from companies with paid-in capital of 1 billion yen or total liabilities greater than 20 billion yen. Effective 1985, the Commercial Code will lower its reporting requirements from firms capitalized at 1 billion yen or more to 500 million yen, which should greatly increase demand for the services of CPAs and audit corporations. In addition, demand for international tax, legal, and management consulting services should also grow as increasing numbers of Japanese corporations go abroad.

The CPA profession in Japan, on the other hand, is relatively small and the supply of new CPAs is only growing slowly. In 1982, there were about 6800 registered CPA members, most of them in the Tokyo metropolitan area. This figure, about one-quarter the number of CPAs in the state of Illinois, contrasts with over 180,000 CPAs registered in the United States. About 5,560 Japanese CPAs are sole practitioners; the remainder are engaged in practice in 71 audit corporations. As shown in Table 7, some of these audit corporations are large, and the Big Five Japanese accounting firms (Chuo, Ota Tetsuzo, Showa, Asahi, and Tomatsu Aoki) all employ over 50 CPAs.

Entry into the CPA profession is extremely difficult; it is restricted to about 200 CPAs a year. Applicants face three major hurdles in qualifying as a CPA. College graduates with an accounting degree are exempt from the first examination, which is made up of a mathematics test and a thesis. Applicants are then eligible to take a second examination administered once a year by the MOF. This exam is extremely competitive and the passing rate is estimated at between 7 and 10 percent. Successful candidates are then eligible to work as Junior CPAs in public practice. After three years of apprenticeship—one year of on-the-job training and two years of practical experience—Junior CPAs face a final professional examination, which tests their competence in four areas: auditing, financial analysis, accounting practices, and a

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9 As noted earlier, joint accounting offices are a third form of accounting practice. These offices, however, are not recognized as legal entities and CPAs here are treated as sole practitioners.
Table 7
DISTRIBUTION OF JAPANESE CPAS AND ACCOUNTING FIRMS

<table>
<thead>
<tr>
<th>Number of CPAs per Firm</th>
<th>Number of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>5-10</td>
<td>47</td>
</tr>
<tr>
<td>11-20</td>
<td>12</td>
</tr>
<tr>
<td>21-40</td>
<td>4</td>
</tr>
<tr>
<td>41-60</td>
<td>2</td>
</tr>
<tr>
<td>61-80</td>
<td>4</td>
</tr>
<tr>
<td>81-100</td>
<td>1</td>
</tr>
<tr>
<td>100+</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>71</td>
</tr>
</tbody>
</table>

CPAs who are:
Sole proprietors ................. 5,560
Employed in audit corporations ... 1,143


thesis. This exam is conducted twice a year with a passing rate of about 18 percent at each sitting. And while the passing rate on this exam has reportedly been increased--to about 60 percent in 1983--in anticipation of changes in the Commercial Code, it is unlikely that the supply of new CPAs will rise rapidly enough to meet projected demand in the immediate years ahead.10

Barriers to Preserve Monopoly Incomes

It is said that the JICPA is a potent obstructionist force in U.S. efforts to establish audit corporations. The JICPA has argued that foreign practitioners lack the expertise necessary to function competently in Japan.11 However, the 1951 Japanese Securities Law was modeled after the 1934 American Securities and Exchange Law and Japanese

10 This point is easily demonstrated. At pre-1983 passing rates for both examinations, a person aspiring to become a CPA would only have a 4 percent probability (.10 x .36) of doing so. After 1983, the overall probability only rises marginally, to 6 percent (.10 x .60).
11 As reported by Darío Robertson, East Asian Executive Reports, October 1982, in reference to statements in the JICPA publication, The CPA Profession in Japan.
accounting principles are (with a few exceptions) broadly consistent with those prevailing in the U.S. An alternative, and more plausible, motive for excluding foreign accounts firms lies in the small number of Japanese CPAs noted above. Given a relatively fixed supply of CPAs, growth in the demand for audit services would create monopoly returns to those in the profession. One could therefore make a *prima facie* case that those in the profession are attempting to preserve their monopoly incomes by maintaining barriers to entry. Entry of foreign firms into the purely domestic accounting business would clearly serve to dilute the monopoly incomes of JICPA members.

The key to judging whether high monopoly incomes exist—whether there is something to be protected—lies in ascertaining whether the incomes of CPAs are higher than those of alternative occupations with similar skill and educational requirements. It is to these income comparisons that we now turn.

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 10 million yen (over $40,000) in 1982.\textsuperscript{12} For this exercise, we selected three stratified samples of representative partners in Tokyo-based audit corporations of different firm sizes.\textsuperscript{13} Firm size is measured by the number of practicing CPAs in the firm as listed in the JICPA membership roster. For comparison, we also picked a random sample of sole practitioners in the five major wards of Tokyo. By matching the names (and addresses) of these CPAs with the Tax Agency's list of high-income individuals, we were able to derive estimates of the distribution of incomes of CPA partners by type of accounting practice and firm size.


\textsuperscript{13} The JICPA roster lists the names, status (representative partner or staff), and address of members of each audit corporation. No other information, such as age, is included. However, given the usual process of promotion to partner after several years of service, we would expect most representative partners to be between the ages of 40 and 60. We define firm size using the total number of CPAs—both representative partners and staff—employed in the firm's offices throughout Japan.
Table 8

AVERAGE REPORTED INCOMES OF JAPANESE CPA'S

<table>
<thead>
<tr>
<th>Item</th>
<th>Biggest 3 Audit Corp. (a)</th>
<th>20-60 CPAs</th>
<th>5-20 CPAs</th>
<th>Single CPA Practice (b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of observations</td>
<td>50</td>
<td>67</td>
<td>60</td>
<td>50</td>
</tr>
<tr>
<td>Percent with incomes greater than 10 mill. yen (about $40,000)</td>
<td>72</td>
<td>70</td>
<td>46</td>
<td>18</td>
</tr>
<tr>
<td>Estimated average income of entire group (c) (d)</td>
<td>$59,700</td>
<td>$60,900</td>
<td>$47,400</td>
<td>$29,300</td>
</tr>
</tbody>
</table>

(a) These include Chuo (114 CPAs), Ota Tetsuzo (82 CPAs) and Tomatsu Aoki (78 CPAs).
(b) Sole proprietors drawn from the 5 major wards of Tokyo.
(c) Calculated using an exchange rate of 240 yen to $1.
(d) Based on the assumption of a log-normal income distribution.


Table 8 summarizes our estimates of the incomes of CPA partners in the four samples. These figures suggest several important points. First, it is clear that a significant number of Japanese CPAs in audit corporations earn quite substantial incomes. For example, just under 50 percent of CPAs in the smallest firm size category are considered to have "high incomes," a proportion that rises to between 70 and 72 percent in audit corporations with over 20 CPAs. Second, when we include those with incomes under 10 million yen, we estimate the average incomes of all partners at between $47,400 for small firms and about $60,000 for larger accounting firms.\(^1\) The third point to note is that there appear to be financial rewards in being organized as an audit corporation. The incomes of CPAs in single practice (about $30,000)

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\(^{1}\) To derive estimates of average income, we assume that incomes are log-normally distributed and make inferences about the remainder of the distribution earning less than the cutoff.
appear, on average, to be substantially lower than those of their audit corporation counterparts. Part of these income disparities may simply reflect age differences in the two samples: Because it takes several years to be promoted to partner, we would expect the audit corporation samples to be older, on average, than the typical CPA sole practitioner. To make the samples more comparable, we repeated the income calculations including a stratified sample of younger staff CPAs. These new estimates suggest that in audit corporations, CPAs of all ages earn approximately $37,000 annually. However, we cannot be confident of the statistical reliability of these estimates because of the small number of staff CPAs sampled. Finally, there is evidence (not shown in the table) that grandfathered foreign CPAs also earn high monopoly incomes. Of the 14 licensed foreign accountants listed in the JICPA Membership Roster, eight reported incomes that averaged $154,500.\textsuperscript{15}

That members of the CPA profession make high incomes is apparent from comparisons with other occupations requiring at least as much training or education. Table 9 lists several of the highest-paying occupations in Japan together with their average incomes. The average ages of people in these occupations—between 45 and 58—indicate that we have selected those at the peak of their earnings career. The results are striking. Partners in audit corporations earn high incomes, exceeding those of any other comparison group except hospital directors. The incomes of sole practitioners, which include CPAs of all ages, compare favorably with those of the older sample of professors and research institute directors. Japanese attorneys in international law practice, on average, have higher incomes than CPA partners, but this is perhaps not surprising given the even higher barriers to entering the legal profession and the almost total exclusion of any competing foreign law firms from Japan since 1955.

\textsuperscript{15} No attempt was made to estimate the distribution of incomes of the remaining six foreign CPAs. Since none of the licensed "foreign CPAs" (that we were able to match) reported incomes of less than $95,000, or two and a half times the Tax Agency's cutoff income, one could therefore argue that those we cannot link with income figures are individuals whose names are probably wrongly recorded, are no longer domiciled in Japan, or are paying foreign taxes.
### Table 9
INCOME COMPARISONS OF CPA'S AND OTHER SELECTED OCCUPATIONS

<table>
<thead>
<tr>
<th>Occupation</th>
<th>Average Age</th>
<th>Income in 1982 $</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPAs (a)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Partner, largest audit corporations</td>
<td>&gt;50</td>
<td>59,700</td>
</tr>
<tr>
<td>Partner, audit corporation with 20-60 CPAs</td>
<td>&gt;50</td>
<td>60,900</td>
</tr>
<tr>
<td>Partner, audit corporation with 5-20 CPAs</td>
<td>&gt;50</td>
<td>47,400</td>
</tr>
<tr>
<td>CPA, sole practice</td>
<td>&gt;30</td>
<td>29,300</td>
</tr>
<tr>
<td>Partner and staff, all audit corporations</td>
<td>&gt;30</td>
<td>37,000</td>
</tr>
<tr>
<td>Other Occupations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hospital director</td>
<td>58</td>
<td>69,600</td>
</tr>
<tr>
<td>Chief of medical department</td>
<td>45</td>
<td>42,200</td>
</tr>
<tr>
<td>Research institute director</td>
<td>51</td>
<td>28,300</td>
</tr>
<tr>
<td>University professor</td>
<td>55</td>
<td>24,500</td>
</tr>
<tr>
<td>Attorney, Tokyo, international practice</td>
<td>40-50</td>
<td>64,500</td>
</tr>
<tr>
<td>Attorney, Tokyo, international practice</td>
<td>&gt;50</td>
<td>121,300</td>
</tr>
<tr>
<td>Attorney, Tokyo, random sample</td>
<td>&gt;50</td>
<td>26,800</td>
</tr>
</tbody>
</table>

(a) We assume that most partners are above 50 by virtue of their position in audit corporations. However, sole practitioners can be of any age.

The evidence of high CPA incomes, especially among partners in audit corporations, is consistent with the proposition that the JICPA has sought to preserve the high incomes of its members by keeping foreign firms out of the domestic audit market. However, given the power wielded by the MOF, it is unlikely that JICPA interests were the only consideration in the MOF's policy of restricting foreign establishment of audit corporations. The MOF may view foreign entry into the purely domestic audit market as conflicting with its interests in the sound development of the domestic accounting profession. It is to this issue that we now turn.
Protection of the Domestic Accounting Industry

The motives of the Ministry of Finance (and the bureau regulating the accounting profession in particular) are difficult to pinpoint without hard data. However, public statements by MOF officials often include themes such as "sound development of the industry" and "preventing disorderly markets." These statements, if interpreted as reflecting MOF objectives, do provide insights into MOF policies towards both domestic and foreign accounting firms.

The protectionist policies of the MOF may have had their basis in the relative newness of the industry, i.e., an "infant industry" argument. The CPA profession did not appear in Japan until 1948. Then, it was the result of adopting the Securities and Exchange Law under American influence. Prior to this, under the Registered Accountant Law of 1927, there were some 25,000 registered accountants (keirishi) but fewer than 200 had entered the profession by examination for competence. The others were graduates of vocational schools (senmon-gakko) and therefore, under the 1927 Law, exempt from the professional exam. Inevitably, the competence of many of them beyond elementary bookkeeping, as well as their professionalism, was low. Many of these accountants continue to practice today under a grandfather clause which accompanied the abolition of the Registered Accountant Law in 1968. Thus, even in the early 1970s, Henderson wrote that "... accounting services of the competence and integrity required in English have been difficult to find outside the half-dozen foreign firms that have established branch offices in Tokyo." Since that writing, steps have been taken by the MOF to upgrade accounting standards to international levels.

One of these measures has been to actively encourage the development of new forms of accounting practice not unlike those of the Big Eight. Under a new clause in the CPA Law, five or more registered CPAs can organize themselves into an audit corporation (kansa hojin). The MOF's intent was to develop a larger, and presumably more capable, form of accounting practice. Traditional accounting firms tend to be

dominated by individual older CPAs (dai-sensei) who are retained by companies usually on the basis of long-standing personal ties. The audit work, however, is usually farm out to junior CPAs.\(^{17}\) These traditional practices are viewed as inimical to the development of a more professional industry; also, since the dai-sensei have few built-in incentives to retire, the promotion of younger and, it is argued, more competent CPAs is hindered. The MOF has reportedly played an active role in establishing Tomatsu Aoki Audit Corporation, one of the Big Five Japanese accounting firms. This included the placement of several retired MOF officers in key positions in the firm. It is unclear how effective MOF efforts at organizational change have been: A number of audit corporations are still organized around auditing offices (kansa shitsu) run by dai-sensei, sharing a common name but exchanging neither expertise nor personnel.

Under these circumstances, the MOF may have viewed foreign establishment of audit corporations as potentially disruptive to the development of the domestic accounting profession. Several U.S. accounting firms already have accounting practices that compare with those of the largest audit corporations in Japan. Table 10 ranks Japanese audit corporations and the Big Eight by number of practicing Japanese (and foreign) CPAs. With 107 CPAs, Price Waterhouse is a close second to first-ranked Chuo Audit Corporation. In ninth, eleventh, and twelfth place are Peat Marwick (60 CPAs), Arthur Andersen (47 CPAs), and Deloitte Haskins (39 CPAs), respectively. Their size and international reputation would have made these foreign accounting firms strong competitors for Japanese audit corporations.

More recently, the MOF has moved to give foreign accounting firms greater access to the domestic market. In 1980, the MOF indicated that it would announce guidelines under which foreign accounting firms could obtain audit corporation status. In the interim, the MOF recommended that foreign accounting firms first establish themselves as joint accounting offices and register with the JICPA. With JICPA recognition, foreign accounting firms can now sign off on statutory audits under the

\(^{17}\) For example, Henderson notes that in 1967, only 37 percent of the registered CPAs were involved in providing audit services to the 2000 odd companies requiring audited accounts. The remainder presumably worked for these fortunate CPAs or did other work such as tax service.
Table 10
RANKING OF ACCOUNTING FIRMS BY NUMBER OF CPA'S

<table>
<thead>
<tr>
<th>Accounting Firm</th>
<th>Nationality</th>
<th>Number of CPA's</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Chuo</td>
<td>Japan</td>
<td>114</td>
</tr>
<tr>
<td>2. Price Waterhouse</td>
<td>U.S.</td>
<td>107</td>
</tr>
<tr>
<td>3. Ota Tetsuzo</td>
<td>Japan</td>
<td>82</td>
</tr>
<tr>
<td>4. Tomatsu Aoki</td>
<td>Japan</td>
<td>78</td>
</tr>
<tr>
<td>5. Dai-ichi</td>
<td>Japan</td>
<td>66</td>
</tr>
<tr>
<td>6. Asahi</td>
<td>Japan</td>
<td>61</td>
</tr>
<tr>
<td>7. Peat Marwick</td>
<td>U.S.</td>
<td>60</td>
</tr>
<tr>
<td>8. Showa</td>
<td>Japan</td>
<td>54</td>
</tr>
<tr>
<td>9. Arthur Andersen</td>
<td>U.S.</td>
<td>47</td>
</tr>
<tr>
<td>10. Tojo</td>
<td>Japan</td>
<td>45</td>
</tr>
<tr>
<td>11. Arthur Young</td>
<td>U.S.</td>
<td>43</td>
</tr>
<tr>
<td>12. Deloitte Haskins</td>
<td>U.S.</td>
<td>39</td>
</tr>
<tr>
<td>17. Coopers &amp; Lybrand</td>
<td>U.S.</td>
<td>15</td>
</tr>
<tr>
<td>18. Ernst &amp; Whinney</td>
<td>U.S.</td>
<td>15</td>
</tr>
</tbody>
</table>

SOURCE: 1982 Membership Roster of the JICPA.

name of the joint office. These moves, coming after U.S. Government efforts to press Arthur Andersen's case, may reflect a desire on the part of the MOF to deflect future foreign criticism of its closed-door policies. It is unclear how many of the Big Eight will now seek audit corporation status; several have already merged with their Japanese correspondent firms and are unlikely to establish themselves as independent entities. These developments, and the motives of the Big Eight accounting firms, are explored below.

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 with regard to seeking audit corporation status. Several factors appear to have been important: (1) the perceived benefits and costs of audit corporation status, (2) ties with Japanese correspondent firms, and (3) the companies' organizational structure. Each of these factors has either produced incentives to seek audit corporation status or severely constrained those choices.
In interviews, U.S. accountants pointed out several disadvantages of audit corporation status against which its benefits—greater prestige, exemption from withholding tax—had to be weighed. First, 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. Second, they would have to follow audit fee guidelines set out by the MOF's Enterprise Accounting Deliberation Council. One foreign accountant estimated these fees to be about 25 percent lower than those charged by foreign accounting firms.\(^\text{18}\) Third, while foreign accountants would be exempt from withholding tax, they would no longer be able to deduct entertainment expenses from income. Yet another disadvantage of audit corporations is the restriction on offering both audit and tax services, though most accountants skirt this restriction by setting up independent tax offices. Not surprisingly, few foreign accounting firms relish giving up the considerable freedom they now exercise.

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. In establishing themselves in Japan, many of the Big Eight sought correspondent ties with local firms to develop a domestic client base. These correspondent relationships are listed in Table 11. Others—Price Waterhouse and Arthur Andersen—took a more independent route; Price Waterhouse, for example, bought out an existing practice of a U.K. accounting firm and was therefore less dependent on referrals from Japanese accounting firms. Not surprisingly, it is these two U.S. accounting firms that have sought audit corporation status most actively. Arthur Andersen took its case to the International Trade Administration of the Commerce Department in 1978, but dropped the complaint under pressure from other U.S. accounting firms in Japan.

\(^{18}\) Because the employer associations dominate the determination of fee guidelines, fees are set at levels that are lower than what some foreign accountants feel are required to prepare adequate audits. However, other U.S. accountants believed that there is enough flexibility in the guidelines so as not to be a constraint on fees that may be charged.
Table 11
CORRESPONDENT TIES BETWEEN U.S. AND JAPANESE ACCOUNTING FIRMS

<table>
<thead>
<tr>
<th>U.S. Big 8</th>
<th>Japanese Big 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price Waterhouse</td>
<td>--</td>
</tr>
<tr>
<td>Peat Marwick</td>
<td>Showa Audit Corporation</td>
</tr>
<tr>
<td>Arthur Andersen</td>
<td>--</td>
</tr>
<tr>
<td>Arthur Young</td>
<td>Asahi Audit Corporation</td>
</tr>
<tr>
<td>Deloitte Haskins</td>
<td>Ota Tetsuzo Audit Corporation</td>
</tr>
<tr>
<td>Touche Ross</td>
<td>Tomatsu Aoki Audit Corporation</td>
</tr>
<tr>
<td>Coopers &amp; Lybrand</td>
<td>Chuo Audit Corporation</td>
</tr>
<tr>
<td>Ernst &amp; Whitney</td>
<td>(3 smaller audit corporations)</td>
</tr>
</tbody>
</table>


The organizational structure of foreign accounting firms—both internally and in relation to the parent company—may have been another contributing factor. Because foreign accounting firms are organized very differently from Japanese firms, few meet all MOF guidelines, namely, that foreign audit corporations should have a minimum of five Japanese CPA partners and hold all equity in Japan. Peat Marwick, for example, has no Japanese partners for tax purposes and all CPAs are treated as "employees" of the company. Arthur Young and Arthur Andersen both have more than 5 Japanese partners, but only part of their equity is held in Japan and profits are shared worldwide. In contrast, Price Waterhouse and Deloitte Haskins are both run as independent profit centers and thus meet MOF guidelines. It is clear, then, that some of the Big Eight in Japan would have had to make difficult decisions about restructuring their profit-sharing relationships with the parent company. It is unclear how much an impact this had in reducing incentives to seek audit corporation status.

These three factors noted above provide insights into the different responses of Big Eight to recent MOF initiatives. On MOF's suggestion, some firms—Price Waterhouse, Arthur Andersen, and Deloitte Haskins—set up joint accounting offices as the first step in getting JICPA recognition. These were primarily firms that did not have close correspondent ties with Japanese audit corporations. Price Waterhouse
then applied for, and was given, audit corporation status in June 1983, apparently because it had the required number of Japanese partners (16 CPAs) and equity independence from the parent company. No other firms were approved in the year that followed, leading to considerable uncertainty about whether Price Waterhouse's approval constituted a one-time exception or a major departure from previous MOF policy. The latter appears to be the case: With MOF approval imminent, both Arthur Andersen and Deloitte Haskins plan to establish an audit corporation by the end of 1984. Arthur Andersen has recently reorganized itself as a joint accounting office, and may now also seek to establish an audit corporation in Japan.

Two recent developments are likely to affect the competitive position of the Big Eight firms in Japan. First, several 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. These include mergers between Touche Ross and Tomatsu Aoki, and Coopers & Lybrand and Chuo; both audit corporations are now Japanese divisions of the U.S. accounting firms. Others, such as Ernst & Whinney, have dissolved existing correspondent ties and established new and potentially more beneficial ones. When merger negotiations between Deloitte Haskins and Ota Tetsuzo broke down, Ernst & Whinney stepped in and merged with Ota Tetsuzo in March 1984. In doing this, Ernst & Whinney gave up its ties with Shinko and two other small Japanese accounting firms, but gained the partnership of the third largest audit corporation in Japan (see Table 10).

A second, and less favorable, development from a U.S. perspective is the establishment of the Ace Association of accounting firms this June. 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. In the long run,

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the association plans to recruit 1200 CPAs, which will account for 17 percent of all CPAs in Japan, and control 30 offices domestically and 10 abroad. Reportedly, the major activities planned by the association include cooperation in conducting audits at home and abroad, development of manuals for computerized accounting, promotion of talent and skills, and exchange of information on corporate accounting and management. In reference to the mergers between the Big Eight and Japanese accounting firms, observers note that, "The establishment of the association could deter such inroads of big foreign firms."  

Conclusions

The authority of the Ministry of Finance, with 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 the evidence that it is attempting to preserve high 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. Certainly, its behavior has not run counter to this goal.

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, however, opened a back door to the entry of the U.S. companies into the domestic audit market. Faced with this ability of foreign firms to enter the market, the MOF has apparently relaxed its barriers to granting audit status to foreign firms. In order 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. Because demand for audit services will increase sharply due to new reporting requirements, incomes are unlikely to fall in the near term. However, in the longer run of five years or more, the breakdown in monopoly authority, brought about by the entry of foreign firms, could lead to a gradual fall in

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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.

Finally, we note that the authority vested in the JICPA does not match the power of the Japan Federation of Bar Associations to control entry into the legal profession. In comparison, accounting is relatively open. The JICPA shares (as a junior partner) authority with the MOF, whereas the bar association is the chief holder of authority over lawyers. Accordingly, U.S. accounting firms have made substantial inroads into the Japanese accounting industry. One could speculate that if corporate audit status had been granted to U.S. applicants in the early 1970s, and if the foreign CPA exam had continued to be given after 1976, U.S. companies would have dominated the audit firm sector of the industry. MOF's shepherding of the domestic industry prevented that outcome from occurring.
VI. DATA COMMUNICATIONS

DEFINITIONS AND CONTEXTS

Barriers to United States data communications business in Japan have been formidable, but have also 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, however, is undergoing rapid deregulation under the pressures of widespread local demands for decontrol and privatization, with U.S. interests constituting one of the many voices heard in the domestic Japanese debate. After describing the structure of the industry and its regulation, we shall discuss developments in three areas: Computer access; transborder data flows; and value-added networks.

Defining the Subject. In this case study, data communications includes both transborder data flows and data telecommunications within a country. We treat both subjects here for several reasons: They are closely related; there are large opportunities for a variety of U.S. businesses in international and Japanese domestic markets; and there have been significant Japanese barriers to entry in these areas. Because technology, regulation, and barriers in this sector are rapidly changing, we will not provide a single snapshot view of the moment, but rather describe the general structure of the industry, the evolving nature of regulatory constraints and barriers to U.S. trade, and the technological, economic, and bureaucratic forces that are at work.

Data communications enterprises can be divided into three groups: (1) Companies whose main product is information or information communications; these include data base services, private data network operators, and online computer service bureaus whose main product is teleprocessing; (2) companies providing services that critically depend on rapid data communications, such as airlines, banks, and credit card companies; and (3) organizations that use data communications but whose operations do not critically depend on such systems. In this study, we
are concerned primarily with the first group, but have also examined the problems faced by some companies in the second group.

**Worldwide Pattern of Reaction to Change.** The reactions of the Japanese Ministry of Posts and Telecommunications to the growth and proliferation of data communications networks and technological change in computing and telecommunications have not been different in kind from reactions of other such ministries throughout the industrialized world who have seen their long-held control of communications challenged by innovative providers of new services. Since the early days of telephone communications, public policy toward telephone systems has treated them as natural monopolies, largely because of the large initial investment and scale economies in local switching costs generated by the available technology. (Scale economies are probably weaker in long-distance transmission and in specialized services.) In recent years, several new factors have combined to change the technical-economic nature of telecommunications. The use of computers, digital techniques, and fast, cheap electronics technology have reduced the scale of operations needed to achieve lower costs. The second factor is related to the first. The connection of computers to the telephone system added an increasingly important set of users of message switching and transmission capacity. In the United States and other advanced countries, data communications is becoming an appreciable proportion of messages on voice circuits. Data communications can use conventional telephone circuits, but are also well suited to alternative systems such as satellite transmission, thus introducing an element of choice and competition into transmission market. The shift in the cost curves and the new technical capabilities for providing services to the new class of users have tended to reduce the economic arguments for treating telecommunications systems as natural monopolies, to be protected and regulated by the state. Moreover, the declining cost of specialized communications equipment has been accompanied by rapid increases in demand, such that a growing number of special services have become economically viable. Several companies, for example, began data communications and facsimile transmission networks in the 1960s and 1970s in both the U.S. and Japan.

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Most state-run post, telephone, and telegraph monopolies (PTTs), however, have been slow to develop the kinds of data communications network services demanded by potential users. To fill in this service gap, many PTTs have leased communications lines to private companies that have built their own private data networks. By paying flat monthly rates for the lines, and interconnecting them with private terminals and computers operating with privately developed software, the private networks have provided flexible, innovative, reliable, and efficient data communications.²

With the growth of these networks since the 1960s, PTTs became alarmed over several potential problems: loss of revenues as a result of traffic diversion; loss of control over multiple-user networks where private parties could engage in direct terminal-to-terminal communication or "message switching" in violation of the state's monopoly; and difficulties in equipment planning. To meet these problems, PTTs developed their own public data communications networks and online computer service bureaus to compete with actual or potential private ventures. The PTTs then charged for the services on a data-volume basis and ceased to offer the economies of flat-rate, leased line tariffs. In several instances, these moves increased data communications costs by several times.³ An AFIPS panel on transborder data flow has noted that, "the PTTs appear to be determined to force users of private networks onto the public data networks using economic means or restrictive regulations."⁴ Although these conclusions were based on European and other non-Japanese experience, as we shall show below, they are just as apt for Japan.

²This discussion is based on: American Federation of Information Processing Societies (AFIPS), Transborder Data Flows, Rein Turn (ed.), Vol. 1, 1979, pp. 15-36.
³Leased lines are only efficient when they can be used to capacity. They are therefore desired by large users or by network managers that can combine the requirements of many smaller users. For small users, usage-sensitive rates—from either private or public wholesalers—will tend to be cheaper than the alternative of leasing lines.
⁴Ibid., p. 27
Japanese Telecommunications. A government monopoly over public telecommunications in Japan was first established in 1885. In 1952, the present Ministry of Posts and Telecommunications (MPT) was established with regulatory authority over two operating companies: Nippon Telegraph and Telephone Corporation (NTT), responsible for and with a monopoly over domestic telecommunications operations; and the Overseas Telegraph and Telephone Company (Kokusai Denshin Denwa: KDD), with a similar role in the international area. In the 1950s and 1960s, NTT managed explosive growth in domestic Japanese telephone services. When it later appeared that voice telephone demand would eventually level off, NTT entered the online computer services market; today it operates the largest online computer service bureau in Japan. Because of its monopoly over the domestic basic carrier telecommunications services, its strength in computer services, and especially because of its close ties to the regulating ministry, NTT also held a de facto monopoly over so-called "value-added networks."

Value-added Networks. Value-added networks (VANs), in general, provide an interface between the equipment of telecommunications users (terminals, computers, displays, printers, etc.) 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 a variety of operations on data that are to be transmitted and received, such as altering transmission rates, detecting and correcting errors, changing character codes to make messages compatible between dissimilar equipment, providing temporary storage to accommodate different transmitting and computing speeds, 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 between users' equipment than could be obtained if users were to simply lease the communications and develop their own conversion and interface techniques.

The borderline and responsibilities between the basic carriers, VANs, computer service centers, and other users are indistinct. Generally speaking, basic carriers provide a standard communications
network available to all parties; VANs offer enhanced communications services to users of the channels of the basic carriers; and service bureaus and other data manipulators put their emphasis on computation, information retrieval, and other substantive operations on data. 5

Dispute Over Authority and Policy. A schematic of this structure in Figure 1 outlines the flow of data from a set of users, through the communications channels, to other users. Major issues center on barriers to both domestic and foreign firms in basic services, VANs, and the ability to efficiently conduct such user services as online

Data Communications Industry Structure

![Diagram of data communications industry structure]

Fig. 1 -- Schematic view of telecommunications industry and government supervisory roles.

computing and data base retrieval. There are several parties to the disputes over these issues. 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 a variety of telecommunications users such as manufacturers and trading companies for whom cheaper and more effective telecommunications and data processing mean a more competitive position in world markets. MITI does not view VAN services as telecommunications, but as data manipulation at either end of the circuit. MITI desires responsibility over VANs as integral parts of its traditional role of supervising the computer and electronic equipment 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 thorough deregulation of even the basic carrier networks. MPT is slowly moving toward greater deregulation, but not at the speed or completeness desired by MITI. (We shall return to this in greater detail below.)

Most Japanese and American companies that are present or potential actors in these markets side with the MITI point of view, primarily because of the business opportunities and improved operating efficiencies that they foresee. Some Japanese companies, however, are fearful of American dominance of the new markets because of the many years of experience already gained by the Americans in their domestic market.

FIRST MOVES TOWARD DEREGULATION AND REDUCTION OF BARRIERS

Computer Access. Many changes in regulations and barriers occurred in the 1970s, and substantial change is in the offing. Until the late 1960s, the Public Telecommunications 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

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*Edward Lincoln of the Brookings Institution, argues that MITI does not seek responsibility over VANs, which it recognizes as outside its rightful jurisdiction, but wants to influence decisions in favor of its constituents.
to establish a message switching system to transfer financial data among
a group of subscribing banks through lines that the computer division
"leased" from its parent corporation. Since the banks did not hold the
lease on the communications lines, their third-party use was prohibited
by strict interpretations of the law. However, NTT requested approval
to operate this service on a trial basis, using Japanese-built computing
equipment. This was permitted under a provision of the law that allowed
NTT to perform certain "unspecified" services. Clearly viewed as an
exception by the regulating agencies, this request was granted in 1968;
another similar service was also authorized for the Ministry of
Transportation in 1971—again, on a "trial basis." This development
aroused alarm among U.S. equipment suppliers and their customers who
feared that NTT would gain a monopoly over these new services and
prohibit both the use of foreign equipment and of leased circuits by
others in user networks.7 MITI feared that NTT monopolization of
computer services connected to its own telecommunication networks would
thwart the development of the computer industry.

MPT recognized that if these services were to be regularized, the
law would have to change. MITI sought liberalization of access to the
telephone and telex networks for other computer users, which until then
had never been allowed to be directly connected. Arguments focused on
to whom the benefits should be conferred—NTT or the general computer-
using industry—and on the mechanisms by which the benefits would be
transferred—regulated monopolies or free markets.

The Diet revised the telecommunications law in 1971 to permit NTT
and KDD to provide online computer services that they had previously
offered on an exceptions basis. It also granted freedom to other
parties to use both leased lines and "public" dial-up lines for shared
use and third-party use. There were restrictions, however, on use of
the circuits; in particular, "message switching" was prohibited as still
being in the exclusive domain of the regulated monopolies. Message
switching was defined as "use of a computer which relays information
without modifying its content."* Narrow interpretation of this

7This information is derived from an informative article by Mitsuru
Yokoi, "Agencies and Directions of Japanese Policy," Telecommunications
Policy, December 1982; and a sequel: "Second Liberalization in Japan,"
Telecommunications Policy, September 1983.

*Yokoi (1983), op. cit., p. 147.
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.

**Barriers to Transborder Data Flows.** Many of the larger computer data processing companies offering remote processing own or contract for computer services that are geographically distributed; they do this to obtain the benefits of off-peak prices in different time zones, for the reliability and back-up services that come from independent and dispersed computer centers, for privacy and security reasons, and for the special computing capabilities available in different facilities. The use of several centers often involves routing data from one computer center to another. For several years, Japanese government agencies and the monopoly telecommunications companies interpreted data transfer among computer centers as "message switching" and prohibited the practice, along with imposing other kinds of restrictions on data communications. Such barriers to transborder data flows are illustrated by the Control Data and Tymshare cases.³

In 1974, the Far East subsidiary of 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. The most significant restriction was to prohibit the transfer of data among Control Data's computer centers in the U.S., 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 U.S., and did not constitute message-switching under the rules of the U.S. Federal Communications Commission or the CCITT (Consultative Committee for International Telephone and Telegraph).⁴ Furthermore, the restriction was

³Much information on the Control Data and Tymshare cases was obtained from U.S. Congress, House Committee on Government Operations, *International Data Flow, Hearings, 96th Cong., 2d Sess.*, March-April, 1980.

⁴U.S. regulations and international recommendations permitted the transmission of unprocessed or partially processed data when it was integral to the provision of data services.
inconsistent with conventional international regulation of communication services in which national responsibility only extends to the midpoint of the international facilities. The second 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. These restrictions were considered by many observers to be moves to protect from competition 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 to its customers.

Similar problems were encountered by the remote-access computer service company Tymshare and its VAN affiliate Tymnet. After initial encouragement in 1976 by Japanese authorities for Tymshare to begin services in Japan, the company experienced delays of one and a half years in leasing international lines from KDD. A series of "exceedingly frustrating and unpleasant experiences, delays, intimidations, and constant obstructive ploys" followed before KDD even offered to provide leased lines under the same restrictions as offered to Control Data-- hookup in the U.S. to only one computer. However, the company was also informed that if Tymshare were to use the new KDD VENUS network on a usage-sensitive pricing basis, KDD would lift its prohibitions on the number of American computer centers that could be included in the Tymshare service. (KDD network costs were about ten times the leased line costs.) This offer suggests that the "message-switching" problem was only a means to accomplish other KDD goals.

After several years of government-to-government negotiations and private efforts to obtain relief, KDD agreed in 1980 to liberalize use of its lines and to continue to make available private line services concurrently with its new data network. Continued pressure from the

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11 Tymnet operates as a common carrier data communications network over leased lines. It transmits data not only for its sister company Tymshare, but also for any other user of remote computer processing.

12 Ibid., p. 63
U.S. government was acknowledged by the MPT. 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. He also suggested that KDD had been resisting ministry pressure, but declared, "I'm going to get a conclusion by the end of this year."\textsuperscript{13}

Despite an agreement in principle in late 1980 by MPT to liberalize use of its lines, discussions with individual companies were still being held throughout 1981 to fully clarify the new rules. In late 1981, for example, it was reported that a Tymshare joint venture (Kokusai Tymshare Ltd.) was requesting MPT to relax its strict interpretation of the regulations to enable Tymshare to extend its leased circuits to Dallas and Houston.\textsuperscript{14} It is significant that KDD did not agree to liberalization until it had its own international data communication system in place. KDD opened its ICAS (International Computer Access Services) in September 1980 as nodes to the U.S. Telenet and Tymnet networks. (ICAS later became part of the world-wide VENUS system in 1982.)

INCREASED MOMENTUM TO Deregulation Policy

\textbf{Moves to Liberalize Data Communications.} Around 1980, a noticeable change took place within the Ministry of Posts and Telecommunications. When the present ministerial structure was created in 1952, telecommunications rejoined the postal system from which it had been temporarily split in 1949. Since the ministry, which was focused on postal affairs, had few technical personnel with the expertise to administer the telecommunications sector, it transferred the required people from NTT. Subsequently, the Telecommunications Bureau became known in the industry as a "branch office of NTT." In 1980, a Bureau of Telecommunications Policy was established by MPT to provide a more independent view. Before this, the ministry, in reality, had little control over the operating companies: The MPT administrators were often former NTT employees; the Finance Ministry regulated the investment


budget; wages fell under the Public Corporation Labor Law; and the Diet approved other finances and tariffs. The creation of the new policy bureau was an attempt to break out of this web of control. At first the bureau's views were strongly influenced by KDD and NTT, but gradually it attained greater independence.

One of the first acts of the new Bureau of Telecommunications Policy was to convene an outside advisory committee—a Minister's private committee—that included participants not only from the operating companies, but also from suppliers, computer manufacturers, users, the press, academics, and others.¹⁵ Such advisory groups are standard parts of the policymaking landscape in Japan. Recognizing their importance in the early stages of policy formulation, the U.S. Commerce Department in 1984 sought U.S. representation on committees considering issues important to U.S. interests. Beginning their work in October 1980, the MPT committee spent the next year considering a variety of issues, including data communications, and the structure, ownership, and institutions of the national telecommunications system. At the same time that the consultative group was meeting, the government (under the Prime Minister's office) was sponsoring its own group—the Provisional Commission for Administrative Reform—that, among other things, was reviewing the telecommunications industry. Headed by a prominent and well-connected industrialist, Toshio Doko, this prestigious group was taking a broad look at government regulation of private and public sector corporations.

Amidst this ferment, in January 1981, a new president was chosen for NTT; Hirashi Shinto—a protege of Toshio Doko—came, not from the ranks of NTT, but from a shipbuilding company (Ishikawajima-Harima Heavy Industry) where he had earned a reputation for rationalizing and increasing the efficiency of a seriously overmanned firm with great excess production capacity. The clear implication of this unprecedented management selection was to lead NTT away from its highly regulated, monopoly, telephone orientation into a more competitive, efficient, and multiproduct future.

¹⁵Yokoi (1982), op. cit., p. 265.
In mid-1981, the government's Administrative Management Agency, which examines the structure and efficiency of operation of government bodies, strongly recommended that NTT's data communications operations be financially self-sustaining and streamlined. The MPT advisory group reported at the end of 1981; two of its principal conclusions were that policy should encourage: (1) Privatization, commercial incentives, and efficiency; and (2) quick action toward liberalization of the use of data communications circuits—particularly for shared use, third-party use, and interconnection—and a more precise definition of public telecommunications entities, with special regard to value-added network services. While similar recommendations had been heard earlier from academic circles and from MITI, this was the first time that an official MPT group had put forward such ideas. The Provisional Commission for Administrative Reform followed with its report in mid-1982. It called for broad deregulation, including permission for private corporations to enter into public telecommunications business by building, owning, and managing their own circuits.

Against the sweeping support for liberalization, conservative forces began to counterattack. Believing the view of "Japan, Inc.," opposing arguments—especially against privatization—arose within all the concerned organizations. NTT technical management saw that if profitability became the norm, limits would be imposed on their heretofore unrestrained investment budgets. They also expected the crumbling of their close relations with the NTT "family" of suppliers. MPT and NTT officials had customarily joined the management of their suppliers upon retiring from the civil service, and this would be threatened if procurement patterns changed in a new era of competition. Apprehensions were also rising among the NTT family of

17 Yokoii (1982), p. 266.
19 Former NTT officials comprised 8 percent (13 out of 234) of the executives of the 10 major NTT equipment suppliers, and 73 percent (56 out of 77) of the executives—including all the presidents—of the five top construction and installation companies. "Shakeup of NTT Family Reported," Nikkei Sangyo Shimbun, July 18, 1983.
suppliers. Large, diversified manufacturers were relatively well situated because they were not highly dependent on NTT; but smaller businesses, especially in facilities construction, were particularly fearful and were said to have been meeting weekly to head off liberalization moves.\textsuperscript{20} It was also reported that money was offered to NTT president Shinto to divert his course.\textsuperscript{21}

**Labor Support for Liberalization.** Acting in a surprising way for a labor union, the All-Japan Telecommunications Workers Union, in October 1981, publicly declared: "We are opposed to conversion of NTT to private enterprise, but in such areas as data communications, the basics for competition should be actively adopted."\textsuperscript{22} Privately, individual labor leaders seemed willing to go further than their public statements, even to the point of contemplating private management for NTT.\textsuperscript{23} One reason for this willingness to change was the view of the Tanaka faction in the LDP, which was said to have great influence on the union. Tanaka himself was suggesting a shift to private management. But other factors were also at work. Many observers, including LDP Diet-members as well as NTT President Shinto, thought that NTT was seriously overmanned. Estimates of something like 100,000 excess jobs were being circulated. In order 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. Even with a growth of telephone service of a few percent per year, expenses were growing faster than revenues, and an urgent review of costs was underway. The 1982 NTT budget called for the first decrease in employment since the founding of the company.

\textsuperscript{20}Sales to NTT of the construction and installation companies amounted to 92.5 percent of total sales, whereas the NTT share of the equipment companies' sales was only 14 percent. *Ibid.*


\textsuperscript{23}*Ibid.*
The greatest restriction on labor was that NTT had no independent power to set wages. Negotiations over NTT wage levels were tied up with the Japanese National Railways and the Tobacco and Salt monopoly under the Public Corporation Law, and these wage levels had become a political issue bound up in government administration reform. Although telecommunications was a high-technology, high-growth sector, its wage structure was constrained by the economics and politics of declining industries.

Enter the Politicians. The growth potential of telecommunications attracted the attention of the Liberal Democratic Party (LDP) in the early 1980s. LDP Diet members first took several steps to inform themselves on the questions and to take stands on behalf of the different actors in the policy debate. A 170-member League of Diet Representatives for Promotion of Information Industry had been formed several years earlier by interested LDP politicians. In early 1981, it established a Communications Data Processing Committee to examine deregulation of that sector.24 This committee, which was responding to liberalization moves that were already in train, was closely aligned with the Japan Federation of Economic Organizations (Keidanren)—a vocal proponent of complete decontrol.

As the movement toward telecommunications deregulation took shape, the Tanaka faction of the LDP, which had close ties to the MPT and to the telecommunications workers union, was drawn into the debate. Tanaka, himself, was said to be encouraging the shift of NTT to private management.25 The Miki and Suzuki factions were also solidly behind this policy.26 Political views on the subject, though, were far from unanimous. The "postal group" of the "posts and telecommunications lobby"—a loose assemblage of Diet representatives who were members of several influential committees—strongly supported the MPT's views; in the case of deregulation, this 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. These postmasters were important figures in local elections, whose support was highly valued by many Diet members.\textsuperscript{27} MPT supporters were found on many of the key telecommunications committees. The LDP Policy Research Council, for example, included a Telecommunications Division. A "study group" of this Division was firmly in the hands of pro-MPT members.\textsuperscript{28} Their arguments against deregulation and privatization were said to be identical to MPT reports.\textsuperscript{29} This pro-MPT study group had managed to take over the discussion of decontrol from a subcommittee that had earlier been formed to deal with the same issues.

There were indications, however, that the powerful "postal" lobby was becoming separated from those with telecommunications interests as deregulation continued and as the growth potential of new public media and diverse telecommunications systems gradually became apparent to the political leadership. The Telecommunications Division of the LDP's Policy Research Council, which previously had little status, by 1984 was among the most important subgroups of the Council.\textsuperscript{30} (The rise in importance of the Telecommunication Division paralleled that of its parent Policy Research Council, which had assumed greater involvement in formulating the government budget.) One indication of the leading role of telecommunications in LDP circles was that the most powerful LDP group, the Tanaka faction, had the greatest influence in the Telecommunications Division, which was being referred to in the press as the "Tanaka faction division."\textsuperscript{31} A political journalist, noting this

\textsuperscript{28}This subcommittee was called the "Telecommunications Basic Problems Study Group," headed by Tsunetaro Kato. "View of Ministry of Posts and Telecommunications," \textit{Sentaku}, May 1982.
\textsuperscript{29}\textit{Ibid.}
\textsuperscript{30}Hamamoto, \textit{op. cit.}
\textsuperscript{31}\textit{Ibid.} Of the 59 members, the Tanaka faction had 18, followed by the Suzuki faction with 11, and the remainder divided among three other factions and a small group of independents.
phenomenon, observed: "Kakuei Tanaka has, either for good or evil, excellent foresight on matters affecting interests and rights." The possibility of politically enticing "interests and rights" were seen to exist 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. Such possibilities, plus the sheer financial size of the telecommunications ventures that were being contemplated, were enough to attract forward-looking politicians. Thus when a group of Diet members formed an "Organization for LDP Members to Promote the New Media" in late 1983, all but six of the 25 members at the first meeting were from the Tanaka faction.

All this activity points to a heightened awareness and involvement of the Liberal Democratic Party in telecommunications as a political subject. As we shall show below, the LDP would also be involved in a governmental or decisionmaking role. The Party, therefore, is now a key player in this field.

**Negotiations Between MPT and MITI.** The call for data communications liberalization and review of the organizational structure of NTT came to a head in late 1981 and early 1982 as MPT and MITI entered arduous negotiations over the shape of the new laws and regulations. The Ministry of Posts and Telecommunications argued strongly against full deregulation despite the demands and recommendations from its own consultative committee, the government's committee on administrative reform, the Administrative Management Agency, the Fair Trade Commission, LDP Committees and the most powerful LDP factions, the Japan Federation of Economic Organization (Keidanren), MITI, and the U.S. government. The MPT had several motives for its conservative stance, in addition to the personal losses that were foreseen by some of its officials and client businesses. The most important substantive issues concerned the privacy and security of communications. MPT insisted on review and approval of network arrangements to ensure the adequacy of the organizational and technical capabilities of the parties to maintain privacy and security.

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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: (1) The ability to prohibit or regulate message-switching would be technically difficult or impossible; and (2) the opportunity for firms to lease circuits from NTT on a wholesale basis and then to retail communications services to users would force NTT to compete on the basis of price and performance. In particular, the ministry and NTT wanted to guard against "cream-skimming"—the diversion of the most profitable business to the private sector. This could occur because cross-subsidization within the existing NTT system resulted in prices of services in different areas not being related to their actual cost. That is, low-cost areas were being charged higher prices in order to subsidize high-cost users with prices that were below actual costs. This situation set the stage for other communications providers to enter the low-cost markets and draw customers away from NTT by offering lower, cost-based prices. This kind of competition could affect NTT's entire tariff structure, cross-subsidization policy, equipment replacement plans, and its whole approach to business.

Finally, and perhaps most importantly, MPT and MITI were negotiating over their spheres of political authority. MPT was trying to maintain its traditional control by preserving some regulatory power together with review and permission authority over new ventures. Reinforcing the MPT position was the historical public view of telecommunications as a public utility and the fact that NTT had demonstrated its competence as the highly successful provider of telephone service. MITI, through deregulation, was attempting to promote the growth of telecommunications in order to enhance the fortunes of its portfolio of client industries. Within this conflict can be seen two different ministerial philosophies. In telecommunications, MPT regulated and controlled the behavior of those acting under its authority. MITI, on the other hand, was the chief promoter and organizer of industrial and technological growth. It supervised expansion through coordination rather than through regulation. These opposing tendencies formed an underlying stratum of tension in the dealings between the two ministries.
With all these forces at work, negotiations between MPT and MITI proceeded with great difficulty. Despite the combined array of interests calling for deregulation, MPT held a powerful point in its favor: it was granted by law the responsibility over telecommunications and had built up over time a vested right and privilege—a shield that logic and economics could only pierce with difficulty. By mid-January 1982, although eight negotiating sessions had taken place, ministerial views were still wide apart. Since a bill would have to be submitted to the Diet by mid-March for passage in 1982, it appeared that a draft bill would be introduced that covered only those areas where both sides found agreement—thus delaying thorough-going deregulation.33 A month later, positions had been clarified, but had also hardened. MPT officials called a news conference to announce 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.34 Elements of the MPT draft law as of February 24, 1982 are shown in Table 12 and comparison with the existing law in Table 13. The main points of contention between MPT and MITI were over "joint use," "use by others," and "mutual connections." "Joint use" generally includes leased lines between parties with large volumes of regular communications. "Use by others" involves the retailing of circuit capacity by enterprises that lease in bulk from NTT. "Mutual connections" are networks that tie leased lines to "public" or "dial-up" lines that are normally available to any member of the public. "Use by others" was viewed as the focal point of private communications developments. MPT agreed to liberalize this for data-processing purposes, but not for message-switching, "because it is impossible to preserve communications secrecy through revising the law now in force."35 That is, the MPT called for an entire new law, which MITI opposed. MITI objected to the MPT draft on three points: (1) The proposed deregulation was inconsistent with the recommendations of the

Provisional Commission for Administrative Reform; (2) limitations on "use by others" would be disadvantageous to smaller firms, which were not large enough to afford the kind of "joint use" arrangements that large firms could establish; and (3) the "report" and "approval" system and the permission-granting authority reserved for MPT left too much of the planned liberalization unclear, unspecified, and open to later MPT interpretation.  

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 LDP Policy Board Chairman Rokusuke Tanaka, and agreed to accept his judgment.  

The main change agreed to from the earlier MPT draft addressed MITI's concerns over the relative disadvantages suffered by smaller firms. The "use by others" restrictions were modified to allow medium and small enterprises access to a broader range of services. In essence, this agreement permitted VAN services for the small and medium firms, but not for large firms.  

Other points of the agreement called on all parties to speedily formulate a conclusion on further liberalization.  

Under the agreed revised bill, joint use for data processing would be permitted for all enterprises with "continuing transactions" between them; moreover, message-switching was approved for parties with "close connections"—defined as the holding by one enterprise of more than 10 percent of the other's capital, or transactions between the two of 20 percent of total transactions, or the existence of "business tie-up relations." "Use by others" was expanded to cover data processing, and message-switching for medium and small enterprises with "close business connections."  

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36Ibid.  
37One newspaper's comments on the inability to reach agreement and the necessity of going to the Party for resolution were revealed by its headline, "Waiting for the 'Voice of God,'" Nihon Keizai Shimbun, March 15, 1982, p. 9.  
Table 12
MPT AND MITI PROPOSALS ON DATA COMMUNICATIONS LIBERALIZATION
(AS OF FEBRUARY 24, 1982)

<table>
<thead>
<tr>
<th>Element of Draft Law</th>
<th>MPT</th>
<th>MITI</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Joint use (by companies which have continuous business relations):</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No message-switching</td>
<td>Liberalization in principle</td>
<td>Liberalization in principle</td>
</tr>
<tr>
<td>Message-switching</td>
<td>Only between companies which have close business relations</td>
<td>Liberalization in principle</td>
</tr>
<tr>
<td>(2) Use by others:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No message-switching</td>
<td>Liberalization in principle</td>
<td>Liberalization in principle</td>
</tr>
<tr>
<td>Message-switching:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Between specific persons</td>
<td>Report system(a)</td>
<td>Liberalization in principle</td>
</tr>
<tr>
<td>Between nonspecific persons</td>
<td>Approval system(a)</td>
<td>Liberalization excluding message-switching which will impede services by NTT</td>
</tr>
<tr>
<td>(3) Mutual connection:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public circuits-specific circuits</td>
<td>Liberalization excluding message-switching</td>
<td>Liberalization in principle</td>
</tr>
<tr>
<td>Public-specific-public circuits</td>
<td>Separate approval</td>
<td>Liberalization in principle</td>
</tr>
</tbody>
</table>

(a) Not included in draft law at the time.
Table 13

COMPARISON OF MPT PROPOSED REVISION WITH EXISTING DATA COMMUNICATIONS LAW, MARCH 17, 1982

<table>
<thead>
<tr>
<th>Joint use</th>
<th>Existing Law</th>
<th>Revision Bill</th>
</tr>
</thead>
<tbody>
<tr>
<td>Approval shall be granted only to manufacturing industrials, wholesalers, and other enterprisers who have business connections.</td>
<td>Business restrictions shall be abolished, and (joint use) by enterprises, which have continuous transactions connections, shall be free.</td>
<td></td>
</tr>
<tr>
<td>Message exchange shall not be approved.</td>
<td>Message exchange between enterprises, which have certain fixed capital connections, shall also be free.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Use by others</th>
<th>Existing Law</th>
<th>Revision Bill</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business connections between customers are necessary.</td>
<td>Business restrictions shall be abolished.</td>
<td></td>
</tr>
<tr>
<td>Only for data processing between customers and information-processing companies.</td>
<td>Establishment of terminal communications between customers, which establishment will be accompanied by data processing, is possible.</td>
<td></td>
</tr>
<tr>
<td>Connection of information-processing companies to customers' computers is possible.</td>
<td>Connection to computers is possible.</td>
<td></td>
</tr>
<tr>
<td>Message exchange is impossible.</td>
<td>Message exchange is impossible (in the case of some medium and small enterprises, approval shall be granted under certain fixed conditions.)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Mutual connection (a)</th>
<th>Existing Law</th>
<th>Revision Bill</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public-specific connection shall be placed under separate approval system.</td>
<td>Public-specific connection shall be approved under certain fixed standards.</td>
<td></td>
</tr>
<tr>
<td>Public-specific-public connection shall be banned.</td>
<td>Public-specific-public connection shall be placed under separate approval system.</td>
<td></td>
</tr>
</tbody>
</table>


(a) "Public-specific" connections are those between the usual public, common-carrier dial-up lines that anyone can use without permission, and private or leased lines used by specific parties.
Following the "Tanaka judgment," MPT and MITI, together with representatives from the Administrative Management Agency, consulted with Chairman Hashimoto of the LDP Administrative and Financial Affairs Research Council to arbitrate the detailed points of the agreement. Hashimoto specified that MPT should "sufficiently accept the views of MITI and the Administrative Management Agency" in drawing up concrete regulations, and that a new law concerning "use by others" should be studied by a new council to be set up in the MPT. Furthermore, Hashimoto directed that all necessary approvals should be handled with the "minimum necessary procedures."

The agreed-upon bill was submitted to the Diet and became law in October 1982. Soon after this, the MPT announced a plan for realizing sweeping decontrol of data communications services, but did not expect such a review to be complete for another two years. MPT was therefore bowing before the considerable pressure of the world around it; but although it was now willing to consider radical decontrol, it was carefully moving to keep all private VAN services under its watchful jurisdictional authority. As a political actor in these affairs, it was hoping to develop a strategy that would gain public support for its continued supervisory role and its battles with MITI.

Impediments Under the New Law. The Ministry of Posts and Telecommunications was under orders from the LDP to continue its steps toward deregulation of data communications. However, despite announcements of studies for future liberalization, it proceeded slowly under the new law. Because of the strict conditions imposed by the MPT, the initiation of VAN services by the major information companies was slow to begin. After a first rush by four companies to register to offer VAN services immediately after passage of the deregulation bill in late October 1982, there was no further activity for the next eight months. A major impediment was a registration system instituted by the

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postal ministry in December 1982. The ministry required enterprises wishing to establish a VAN to list their facilities and data communications methods for review by an inspection authority in order to verify the network's permissibility. The rationale for this was that new networks "may not be necessarily dependable or good for the public interest" because linking different types of computers "is not always easy or compatible with the public interest if communications procedures differ among different computers." MITI's earlier suspicions about the possibly restrictive manner in which the MPT would use its report and approval authority were apparently well founded. One analyst noted that, "MPT's basic strategy is to maintain its jurisdiction over communications services by standing on its licensing and approval authority in the current of liberalization." Even as liberalization has proceeded, so has the MPT continued this strategy of attempting to retain its approval authority over new ventures. In the summer of 1983, however, the ministry began to apply the regulations flexibly, which encouraged several major companies to enter the market. By January 1984, 13 companies had registered to offer 17 different services. 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 via its own communications network (based on circuits leased from NTT). Since 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

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users and shop attendants if two competing services were allowed to coexist.\(^\text{47}\) MPT officials agreed to accept another IBM VAN service for small and medium companies, but said that the existing law would make it difficult to approve the credit card system. As justification for its stand against the IBM credit card system, it stated that the system would be a large-scale VAN—and therefore prohibited; also, since IBM Japan was a 100 percent foreign capital company, a communication system operated by it would violate "communications sovereignty." MITI rebutted these claims by noting that the credit card system was the same as existing online banking services: Since they were permitted, the IBM system should also be permitted. MITI also asserted that "communications sovereignty" only applies to trunk circuits.\(^\text{48}\) Even MITI's view, however, may have been too restrictive since other sources claimed that Japanese law at that time could not exclude foreign firms from telecommunications.\(^\text{49}\) However, the MPT was willing to contemplate a compromise. It would accept the IBM small-business VAN service and the credit card data processing system if IBM agreed to use the NTT VAN network. A month later, following discussions among IBM, MPT, MITI, and several credit card companies, an agreement was announced whereby the credit authorization business would be completely unregulated and the NTT VAN network would be used by IBM to transmit data to its credit card computer processing centers.\(^\text{50}\) 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.\(^\text{51}\)

\(^{47}\) The images of "chaos" and "confusion" arise repeatedly when regulated monopolies discuss a competitive future—not only in Japanese telecommunications, but world-wide. Examples can be cited from California wine grape growers to Japanese gasoline wholesalers.


\(^{49}\) Shimpei Hamamoto, "Fierce Competition Among Foreign, Domestic Firms for INS Market," Seikai Orai, September 1983, p. 27.

\(^{50}\) "NTT and IBM Systems Are Allowed to Coexist," Japan Economic Journal, September 6, 1983, p. 3.

\(^{51}\) Ibid.
In a seemingly unrelated move, IBM Japan announced two weeks later that it would not continue with its VAN plans for small and medium size companies. Although there were no explicit regulations blocking its entry, MPT and others had raised objections to a wholly foreign-owned company undertaking such services, claiming that the activity would touch on the issue of "national communications sovereignty."52 As part of a longer-run strategy, IBM Japan withdrew its application for fear that its entry would incite countermeasures when further deregulation bills were being considered in the Diet over the next several months.

**Continuing Efforts at Deregulation.** Prior to the IBM Japan announcement of its intention to operate a VAN service for medium and small companies, the MPT had formulated a bill to allow companies to operate VAN services, but only if they had less than 20 percent foreign equity. However, it withdrew the bill because of strong opposition from MITI.53 Continued delay in formulating an acceptable law created uncertainties for new entrants, especially foreign companies. One concern of MPT was that a few large-scale VAN suppliers would dominate the market and that U.S. firms like IBM or AT&T would beat out inexperienced Japanese competitors. Furthermore, MPT officials saw their responsibilities as overseeing "orderly market development."54 Free entry and exit, they said, could cause "problems and confusion" for users, and foreign-owned firms would less likely be responsive to MPT guidance.

Meanwhile, by late 1983, VAN services and data communications had become an issue in U.S.-Japan trade negotiations. The U.S. government was particularly concerned about the reported 20 percent foreign capital restrictions that had appeared earlier in the draft law; it was strongly urging the Japanese government to eliminate such barriers. The U.S. press reported that Japanese trade officials, in response to the U.S.

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position, had offered assurances that new bills would not be submitted without consultation with the U.S.\footnote{U.S. Says Japan Yielded on Some Issues in High-Technology Trade Discussions, "The Wall Street Journal", February 8, 1984.}

Reorganization of NTT accompanied the deregulation issue in Japanese government deliberations. The two items were seen to go together, with the outcome of one strongly affecting the other. In February 1984, MPT introduced the contents of two bills designed to deal with these issues. The bill to reorganize NTT was designed to turn the company into a quasi-governmental firm to be operated like Japan Air Lines, with all of the company’s stock to be held by the government for at least a five-year period.\footnote{Up to 49 percent of the shares could be sold to the public with Diet approval. Yasushi Yuge, "Japan's Telecommunications Market Faces Profound Transitional Changes," Japan Economic Journal, May 1, 1984.} It would be given management freedom in several areas in which it had formerly been constrained: NTT could invest in its present or related business, operate VAN services, and be free to manage its personnel independently of the public labor law that had governed its behavior. In fact, the corporation was ordered by the Diet to begin seeking ways to eliminate 100,000 excess jobs.\footnote{"Potentials of NTT Breakup Analyzed," Shukan Daiyamondo, November 5, 1983.} A recommendation by the Provisional Commission for Administrative Reform to split up NTT into regional units, however, was not carried out in the new law. The two communications bills did, though, open up the realm of basic communications to competition.

The telecommunications draft law classified the sector into two categories, both of which would be open to competition: (1) Basic services (Category 1), involving ownership and operation of communications circuits; and (2) secondary services (Category 2), such as VANs, that would use leased circuits from the basic services operators. VAN services were further broken down into large-scale, nationwide systems (Class 1), and networks limited to specific business groups or small companies (Class 2). Entry into basic services and large-scale VANs would require approval of MPT, while the other secondary services could operate merely upon notification of the
ministry.\textsuperscript{58} The ministry also reserved to itself the right to decide prices of basic services "when they are disputed."\textsuperscript{59}

As to the foreign capital requirements, MPT shifted its position shortly after first disclosing the contents of its draft. At first it had required at least two-thirds domestic capital for basic service operators, 50 percent for large-scale VANs, and no restrictions on the limited (Class 2) VAN providers. Within days after disclosure of the draft, MPT modified the 50 percent capital restriction on large-scale VANs by permitting reciprocity for companies from countries with less restrictive foreign capital limits. A short time later, this proposal was further amended when the MPT said it would consider large-scale VAN applications on a case-by-case basis, taking into consideration whether a venture would dominate the market. Since the postal ministry regarded large-scale VAN services as an all-inclusive telecommunications service, it felt that its regulation should be similar to that for basic services. Furthermore, if the large VANs were to be viewed as basic services, they would fall under MPT's traditional jurisdiction over telecommunications.\textsuperscript{60} In order to buttress this point, MPT changed its original policy, which had been intended to draw a clear line between common carrier services and VAN services; it announced that VAN companies would be able to provide such conventional communications services as telephone, telegraph, facsimile, and telex.\textsuperscript{61} However, U.S. government objections together with continuing arguments from MITI and other sources induced MPT to suggest a compromise over large-scale VANs that would reinstate reciprocity in foreign capital shares according to restrictions in the laws of a company's home country. This essentially allowed U.S.-based companies 100 percent ownership of large-scale VAN services.

\textsuperscript{61}\textit{Ibid.}
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. Internal political pressure for liberalization was raised a notch when Prime Minister Nakasone told a Diet session on March 13, 1984 that he believed free entry into VAN business should be assured in principle. The following day, the Fair Trade Commission made the same recommendation. Several weeks later, visiting U.S. Treasury Secretary Regan publicly criticized the lack of progress in several trade areas under negotiation. U.S. Ambassador Mansfield publicly reiterated his government's "strong dissatisfaction with the Japanese government's moves for legislation concerning telecommunications." The removal of the issue from the technical level to the political may have helped alleviate a problem for the MPT as it no longer had to answer to its constituents about the outcome of the argument.

Within a few days of these comments, senior LDP officials stepped in to mediate the intragovernmental dispute. The mediation plan called for a registration procedure for large-scale VANs, which was termed "a kind of stricter form of application" than would be applied to the limited VAN networks. MPT's control was somewhat reduced with this "virtual liberalization" of the VAN market. Controversy, however, 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

63 Ibid.
66 Ibid.
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 long as provisions concerning VANs were included in the law so it could claim control over the area.67 Following a strategy it had hinted at earlier, the MPT—only a few days after the negotiated settlement—said that it was considering allowing VAN companies to offer telephone services over leased lines along with the customary data communications services—but limited only to company users and not the general public.68 Of course, such business would be under stricter regulation than if confined solely to data communications. NTT raised objections to this proposal because the introduction of competition was estimated by some analysts as possibly resulting in telephone charge reductions of up to 95 percent on some long-distance services. NTT was thus drawn in as an opponent to VAN liberalization—at least over this specific point.

As soon as the initial VAN bill was disclosed in early 1984, several firms announced their intentions of applying to enter the business. By May 1984, more than a dozen companies and joint ventures had publicized their plans. More than half of these early entrants included the participation of American companies in both large-scale and limited VAN projects. Thus, the planned liberalization and deregulation of this market had an immediate effect on U.S. service trade, with a future revenue potential estimated to be in the billions of dollars.69

The 1983-84 controversy can be seen to have moved in familiar lines, repeating the concerns raised in the 1982 debate over deregulation. MPT wanted to protect privacy and security, secure a market for Japanese companies, and maintain its traditional jurisdiction. MITI sought influence in telecommunications policy; it

69Fujitsu estimated that within five years its large-scale VAN service would be generating revenues of 100-billion yen (about $430 million) per year. Yasushi Yuge, "Japan's Telecommunications Market Faces Profound Transitional Changes," *Japan Economic Journal*, May 1, 1984.
wanted complete deregulation written into the law in order to remove the possibility of later restrictions through the application of narrow interpretations and encumbering guidelines. MITI was also concerned about U.S. criticism leading to possible future trade problems for its client industries. MPT counted that small-scale VAN will be virtually deregulated, that basic services will be open to competition, and that the proposed bill is liberal by current international standards. These issues were brought before the political leadership of the LDP for resolution, following the earlier precedent. The problems are indeed political, involving the allocation of authority, the transfer of wealth, and the strongly expressed interests of a major friend and ally. However, the forces for change are powerful and widespread. The political outcome reflected these underlying forces. Passage of the law, however, was delayed when it was not given calendar time in the summer of 1984. (It was assured of passage by the end of the year.) It must still be implemented and the postal ministry will have the opportunity in countless minor actions to protect its interests. Moreover, 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.

LESSONS FROM THE Deregulation PROCESS

One of the reasons for going into the background of the 1982 and 1984 legislation is to understand the forces and parties involved in barriers to trade in data communications. Several points emerge from this narrative. First, opinion was not monolithic. Even within the concerned organizations, different viewpoints were often held. Furthermore, these changed over time with the flow of information and arguments. For example, NTT technical personnel first disliked deregulation because of the possible effects on their investment budgets. Then, as they came to understand the looming financial problems of the corporation, they viewed a change in the corporation's status as a hope for the future.
The second point is that the often-mentioned Japanese ability to develop a consensus over deeply disputed positions was not achieved by the opposed ministries. However, the equally Japanese tendency to accept recognized authority led them out of the impasse. The agreement in 1982 to abide by the "Tanaka judgment" helped to generate a partial solution. Nevertheless, a more complete solution was not achieved for several years, and required further political interventions. This process has not yet reached a final conclusion.

Third, the gradual accumulation of stress in the system, with only infrequent moves to relieve the pent-up forces, has required more change than the system could absorb at one time. In the United States, telecommunications deregulation had been proceeding on a piecemeal basis for 25 years. Parties were able to adjust gradually in an evolving, stress-relieving adaptation to change. In Japan, the power to resist change that lay in the authority of the regulatory agencies and the state-created monopolies eventually required adjustments of such magnitudes as to threaten several important actors in major ways. These adjustments therefore became political and required resolution at the highest political levels. Political resolution of the disputes has centered on arbitrating the proposals brought forward by the ministerial bureaucracies, rather than introducing new ideas or independent alternatives. At earlier stages, however, politicians may be involved in a variety of activities to advance their own clients and ideas.

The final point is that the high-level political authorities that were called upon to help reach a solution are also those most likely to be influenced by the U.S. government. These individuals have a balancing role to play among the contending forces and properly take a broad view of their responsibilities. They are therefore appropriate conduits for the expression of American interests. However, the data communications problem may not be typical of most service trade disputes, which usually would never come so high for resolution. Data communications involves strong and widespread forces for change and a central ministry that has steadfastly fought sweeping deregulation. For the more typical case, the involvement of the top leadership would not flow out of the natural course of events. Nevertheless, the government
and LDP leadership would still be a party with interest in a case if a national viewpoint were thought important enough to be introduced into a dispute. Therefore, it would be appropriate for U.S. actors—private as well as government—at least to make known their interests and to activate the political leadership to be an involved contributor to dispute resolution. Other conduits for expression of U.S. interests include the various LDP committees and other semi-official committees that influence administrative affairs. As seen in the data communications case, these groups had an important influence on structuring the nature of the problem and in generating advice on outcomes. Influence, here, would require a longer-term approach: continuity of attention rather than episodic political involvement at critical points. This then implies a depth of knowledge and understanding of areas of interest to the U.S. government and business. In the rapidly moving area of telecommunications, this mixed strategy of routine exchanges of information and views, combined with rarer political interventions, is designed to influence events in an undramatic but cumulative manner.

Despite the almost unanimous views of powerful parties against the positions of the MPT, the postal ministry was able to withstand the pressures for several years and to maintain a semblance of its traditional authority. However, change did come about; and external pressure did much to impel the system to adjust to forces that were internal in nature. Application of external pressures, however, cannot be expected to be as effective when the internal alignments are not as favorable to change.

Regulation of Japanese telecommunications has restricted access to new markets to both foreign and domestic companies. However, since U.S. companies had gained experience in the U.S. market in many of the services they were attempting to sell in Japan, there is a strong possibility that they could have made significant gains while Japanese companies were still developing their own experience. Once again, we observe that monopolization and cartelization have been the creatures of regulation and not an independent contribution to trade barriers.
VII. 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. The second to the tenth largest companies share 30 percent of Japan's market, with about three-quarters of the total shared among the largest 72 firms.\(^1\) In the U.S., for comparison, the top 72 companies collect about 60 percent of total billings. Although the largest U.S. firm, Young and Rubicam, is about the same absolute size as Dentsu, its share of U.S. advertising agency billings is only about 6 percent.\(^2\) The share of the top four U.S. agencies is about 20 percent, versus 41 percent in Japan.

Functionally, the industry can be divided into three parts: (1) the giants, including Dentsu and a half dozen other large agencies with about half the total market; (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; (3) 2,000 smaller companies serving local markets and clients sharing 45 to 50 percent of total billings—mainly in local newspapers and radio. The U.S. companies in the second group are now struggling to attract the accounts of the large domestic Japanese advertisers.

Reflecting a major difference in business approach between advertising agencies in Japan and the U.S., the large Japanese agencies work closely with the media, whereas the U.S. firms are close to the client. One implication of this difference is that 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

\(^1\) *Japan Economic Journal*, December 27, 1983, p. 27.

broadcast companies and newspapers. With this kind of market power, Dentsu can bargain for prime media space at a low price and offer the best time and space to its clients. However, when bought in bulk in advance, the commodity takes on the characteristics of any other good that has a fixed supply quantity; its price becomes purely a matter of demand. In other words, the price is what 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 in Japan that do business the American way (buying time directly for specific clients) may end up "getting the crumbs that are left over," as one interviewee put it. However, our interviewees also stated that this is a "business problem" of the type found in dozens of varieties around the world; they do not perceive it as a 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 top ten U.S. agencies have established joint ventures with Japanese agencies, including a joint venture between the largest in each country—Dentsu and Young and Rubicam. Similarly, eight of the ten largest Japanese agencies have joined with U.S. companies in the United States for the same reasons.

Although business contacts have been widely cited as a problem, 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. In contrast to U.S. custom, which retains the creative production work within the agency, Japanese practice is to farm out the work to scores of small, independent creators. Thus, a foreign firm can take advantage of this same system of buying local talent and sensitivities.

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3 In economic terms, this is equivalent to a vertical supply curve, where the price is determined by the level of demand.
4 See, for example, "Japan Shops Face Tumbling Billings," Advertising Age, September 15, 1980.
A natural question to ask at this point is why foreign agencies have been unable to capture more than about 3 percent of the market, given unconstrained competition and few cultural impediments to the creative aspects of advertising. Although we cannot offer a complete answer, a number of points can be pointed to. First, the natural market segment of the foreign agencies—the foreign companies operating in Japan—constitute only about 5 percent of total billings. The foreign companies, therefore, have about 60 percent of this corner of the market. Second, defining the market more broadly as the national market minus the Dentsu share yields a net market that is only about half as large as total national advertising sales. The handful of foreign advertising agencies do not have a disproportionately small share of this vigorously competed market. Thus McCann Erickson-Hakuhodo ranks eighth in radio advertising and sixth in television, and J. Walter Thompson is seventh in magazines. Three American companies (or joint ventures) were among the top twenty agencies. The third point is that it takes time to make progress—especially for a foreign company in Japan. (Dentsu and Hakuhodo—numbers one and two—have also been in existence the longest of the domestic companies, since the early days of Japanese capitalism over 80 years ago.) McCann Erickson-Hakuhodo is among the oldest foreign companies (starting in 1960) and is now the largest, standing in ninth place in total billings. Forty of its ninety regular clients are Japanese corporations, accounting for 20 percent of its earnings. J. Walter Thompson began operations in 1958 and has been in the top 20 for many years. Nevertheless, U.S. firms continue to face problems in building relationships with leading advertisers. A fiercely competitive marketplace does not make this task any easier, but there are indications that domestic advertisers are now more willing to question their long-term ties to their advertising agencies and are asking more than one agency to give creative presentations. Additionally, clients are hiring different agencies for different

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products. The virtues of patience and competition may thus eventually pay off for U.S. advertising agencies in Japan.