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WHY DOES JAPAN RESIST FOREIGN MARKET-OPENING PRESSURE?

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Abstract

How should fair-trade claims be evaluated? When is outside intervention in the micro-details of a nation's economy justified, when is it not? What is the link between domestic market organization and the rules of international trade? This paper examines three Japanese business practices involving cooperative relationships among firms, each of which has generated accusations from the United States of unfair trade: collusion in public-construction bidding, subcontracting in manufacturing, and the regulation of large retail stores. All three involve exclusionary practices. But they are not as simple as they seem; they are far from being straightforward cases of protectionism. Two questions are asked of each case, one normative, the other positive. Was the change the United States demanded justified on economic-welfare grounds? Was it feasible, within the relevant time span, for Japan to make the demanded change? I conclude that the subcontracting case was unjustified and infeasible; the public-construction case was justified but infeasible; and the retail-stores case was both justified and feasible.

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Why Does Japan Resist Foreign Market-Opening Pressure?

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1. The Level Playing Field

Fairness is in the eye of the beholder. Whether or not the playing field looks level depends on the angle of the observer. Trade-policy partisans do not necessarily have an upright stance. The advent of fairness as a criterion has had the virtue of enlivening trade-policy debates with some unintended irony. An EC agriculture representative, rejecting US demands for a reduction in Common Agricultural Policy subsidies, said that acceding to the US demands would unduly favor US producers. European farmers, said the spokesperson plaintively, merely want a level playing field. This was said with apparent sincerity, even though anyone other than a French peasant would find it bizarre.[1]

Unintended irony arose also when the case against intervention in other countries' affairs, and for multilateral rather than bilateral trade-policy initiatives, was made by none other than the US trade representative, Mickey Kantor. In response to a 1993 Japanese government report accusing the

United States and the European Community of engaging in unfair trading practices--many of the practices named in the report are indeed distortionary, like the misuse of anti-dumping laws and discrimination in government procurement--Kantor said, apparently without a trace of recognition that his words could be turned back against himself, "We believe it would be better for Japan to take a leadership role in the Uruguay Round, instead of criticizing other countries' practices." [2]

When is criticism of other countries' trading practices justified? Economic analysis offers tools to help judge whether in any particular case foreign market-opening pressure is justified: techniques for measuring the costs and benefits of any given intervention. The implications for economic welfare of changing existing practices can be analyzed from the point of view of the plaintiff country, the target country, or the world as a whole.[3] Identifying the welfare effects of a market-opening initiative requires a different, more micro-level analysis than is usually done in empirical trade studies, because the benefits from a successful market opening typically include such gains as a reduction in domestic monopoly pricing, an increase in foreign firms' profits, and an improvement in the technical efficiency of the domestic industry.

When are outside interventions in the name of fair trade likely to succeed? Implicitly underlying fairness claims is the assumption that it is feasible for politicians or bureaucrats to carry out the requested changes: someone has the power to do what is demanded. I shall argue that, when the demanded changes go deeply into the country's domestic institutions, this assumption is often false. Lowering a country's tariffs can be done with the stroke of a pen. Changing a country's industrial structure is of a different

order. Any well-functioning economy has considerable inertia: the ability of politicians and bureaucrats to change an economy is limited.

Karel Van Wolferen's well-known critique of "the elusive Japanese state", of Japan as "a paralysed superpower", is both right and wrong.

> The frustration of many a foreign negotiator, meeting the umpteenth mediator sent his way, can be summed up in the single cry "Take me to your leader". Japan does not have one. It is pushed, or pulled, or kept afloat, but not actually led, by many power-holders in what I call the system. . .
>
> One could label the entire body politic, meaning all and everyone participating in some way in the power process, "the state". But this confuses, for the state would become something very nebulous indeed, and we would still have to postulate accountability, which in turn presupposes a centre. How, then, is one to label an entity which is not a state, but which does encompass the political life of a country? To me, the word"system" seems to invite the least confusion. It denotes little more than the existence of a set of relationships, with reasonably predictable effects, between those engaged in socio-political pursuits. . .
>
> It is impossible, from out of this huge system, to extricate anything that can really be called a state. The existence of a state is implied, of course, whenever Japan passes laws and adopts measures for foreign consumption--when, for instance, the bureacrats lower tariffs on imports. In practice, though, that means almost nothing. The workings of the System inevitably negate effects that would be normal anywhere else in the industrialised world. The System overrules the state at every turn.[4]

Allowing for some exaggeration, Van Wolferen in my view is essentially correct in describing Japan as a "system without a core". But he is wrong in claiming that this is a uniquely Japanese phenomenon: it applies, with appropriate modifications, to any complex modern society. Van Wolferen goes too far in arguing the state is powerless. But the economy, being a complicated and reasonably stable system, does impose limits on what the state can do.

I shall examine in what follows the effects of *the system*--the "set of relationships . . . between those engaged in socio-political pursuits," as Van Wolferen characterizes it. My emphasis, unlike Van Wolferen's, will be less on political interactions than on economic interactions. It would be absurd--and empirically false--to claim that foreign pressure for change can never be successful in Japan or anywhere else. But I shall argue that any such proposed change will always be met with resistance, generated by systemic interactions.

If implemented, the change would have a string of direct and indirect consequences, with the indirect consequences often being much larger than the direct consequences. Because the economy is a system, the indirect consequences of a change can be, and usually are, important. The indirect consequences are difficult to foresee and as a result are usually overlooked by the proponents of the foreign intervention. To the extent that these consequences, direct and indirect, impose losses on people, the change will be resisted. Sometimes this resistance will be weak and easily overcome; but often it will be powerful and will overrule the foreign pressure, regardless of what the country's trade negotiators may have promised.

Depending on your point of view, the leading perpetrator of unfair trading practices, or the main victim of unjustified complaints about unfair trade, has been Japan. For this reason I shall draw my examples from Japan. Japan does seem to be an extreme case: its institutions seem to be more resistant to change than those of other countries. (Former US Commerce Secretary Baldridge, in one of the stronger statements of this view, once told the Japanese: "You will have to change your culture."[5]) Japan's economic and political institutions are in many ways different from those of other countries. But I suggest that Japan's propensity to resist foreign pressure is

not fundamentally different from any other country's, and that what is learned from the study of Japan can be applied elsewhere.

To help clarify the general issues, I shall examine three Japanese business practices involving cooperative relationships among firms, each of which has generated accusations from the United States of unfair trade: collusion in public-construction bidding, subcontracting in manufacturing, and the regulation of large retail stores.[6] All three involve exclusionary practices. But they are not as simple as they seem; they far from being straightforward cases of protectionism. In each case the US pressure was met with resistance from within Japan. Two questions will be asked of each case, one normative, the other positive. Was the change the United States demanded justified on economic-welfare grounds? Was it feasible, within the relevant time span, for Japan to make the demanded change? I shall conclude that the subcontracting case was unjustified and infeasible; the public-construction case was justified but infeasible; and the retail-stores case was both justified and feasible.

Is Japan victim or villain? I come down firmly on both sides. It depends on the issue. In some cases, such as public construction, Japan's practices damage the global trading system (as well as Japan's own citizens) and foreign intervention is justified. In others, such as subcontracting, Japan has been unjustly maligned. The point is that any broad, uncontingent statement about the rightness or wrongness in general of foreign market-opening demands is likely to be an oversimplification. Whether a foreign intervention is justified can be answered only after empirically examining the details of the particular issue, estimating the size of the costs and benefits of the proposed changes and calculating whether their net effect is positive or negative.

I shall analyze the three cases of US pressure on Japan not for their own sake but to try to extract some general lessons. How should fair-trade claims be evaluated? When is outside intervention in the micro-details of a nation's economy justified, when is it not? What is the link between domestic market organization and the rules of international trade?

2. Winners and Losers from Market Opening

Restrictions on the entry of foreign competitors in many cases are designed not to exclude foreign firms in particular, but simply to exclude new entrants in general. Preventing foreign competition is often just part of a broader phenomenon of inhibiting competition overall for the sake of some favored firms. This is true, as will be seen, of Japan's restrictions in public construction and retail stores. Other cases of US market-opening initiatives against barriers to competition include Guatemala's law that goods being shipped to Guatemala be carried in Guatemalan ships (the first use by the United States of its Section 301 legislation); South Korea's restrictions on its insurance markets; and Brazil's regulation of its computer industry. In these cases, as in many others, it is government policies that generate the restrictions on entry and competition.

Regulatory restrictions exist, according to George Stigler's notion of capture, because the regulatory body that oversees the industry has been lured by the incumbent firms into being their advocate. Regulation, Stigler said, is "designed and operated primarily for [the industry's] benefit". As a result, regulation often harms consumers. In the United States, according to Alfred Kahn, a former regulator himself, regulation "has consisted largely in the imposition and administration of restrictions on entry and on what might

otherwise have been independent and competitive price and output decisions". In Japan, as Chalmers Johnson has eloquently documented, official policies in public construction, retailing, and elsewhere cause considerable harm to ordinary Japanese people, generating the phenomenon of "rich Japan, poor Japanese." [7]

Whether Stigler was right and regulation is anti-competitive, or whether it is pro-competitive, depends on the circumstances of the particular case, according to the deepest existing analysis of the logic of cartelization by regulation, the Laffont-Tirole (1993, Ch. 13) model. The regulator will tend to favor the incumbent firms at the expense of consumers and outside firms if (a) the incumbent firms are well organized and consumers and potential entrants are not; (b) information about the size of the potential gains from competition is not readily and widely available; and (c) supervision by politicians of the bureaucrats in the regulatory agency is weak. Given these circumstances, the political-economic equilibrium has regulators and industry comfortably cohabiting at the expense of the consumers and potential entrants.

Foreign intervention adds a new player to the political-economic game. If those domestic interests that benefit from the status quo are sufficiently well organized relative to the domestic interests that are harmed by it, the foreign intervention will be unsuccessful. If not, the foreign pressure could change the nature of the political-economic equilibrium so as to induce the regulatory body to permit entry and competition. A foreign attack on anticompetitive regulation, if successful, will actually help the target country, in that it will make domestic consumers better off through reducing monopoly pricing (as in the cases of Japan's public-construction market and large retail stores law). The Australian political scientist Aurelia George says:

"US pressure has become a powerful catalyst for change in the Japanese economy, polity, and society. . . . In many respects the United States is itself an actor in the Japanese policy process: as a surrogate opposition party presenting the only true set of alternative policies to the government's, as an interest group representing the voice of Japanese consumers, and as an alternative power base for Japanese prime ministers seeking to overcome both shortfalls in their factional strength and domestic resistance to change."[8]

A standard prescription in international economics says that free trade works as an effective antitrust device: allowing imports is an easy way to remove the market power of a domestic monopolist (Bhagwati, 1965). The use of antitrust policies to promote free-trade outcomes reverses this prescription: the entry restrictions that permit domestic monopoly are broken down for the sake of international trade.

A market-opening initiative against an entrenched monopoly position, if successful, creates both welfare gains and welfare losses. Consumers, powerless to affect the outcome in the absence of the foreign intervention, are made better off by the increased competition. The incumbent domestic firms are harmed, and foreign firms, and often some formerly excluded domestic firms, gain. Beyond these straightforward direct gains and losses is a range of indirect gains and losses, as the effects of the change work their way through the political-economic system. The increase in competition generated by a successful foreign intervention has not only direct benefits to the economy--such as lower prices and more choice for buyers--but also indirect benefits and, perhaps, costs.

In a large firm, with separated ownership and management, product-market competition generates discipline on managers. When competition is strong, a firm must be efficient to survive; whereas when competition is

weak, managers, and perhaps workers, are able to extract rents for themselves to the detriment of the efficient operation of the firm. ("The best of all monopoly profits is a quiet life," as Sir John Hicks said). As the firms respond to the extra competition that they now face, managers and workers will be given more high-powered incentives, making their pay and promotion prospects depend more sensitively on both short-run and long-run performance measures, according to the model of Gates, Milgrom, and Roberts (1993). As a consequence, a further welfare gain from eliminating monopoly comes in the form of increases in the firms' technical efficiency: production is organized less wastefully, so that more output is achieved from a given amount of inputs.

If the gains from market opening come in the form of increased competition, lower prices, and higher technical efficiency, then measuring those gains requires a different, more micro-level method of analysis than is usual in empirical trade studies. It is necessary to look at the industry or the firm. Examples of studies that quantify the gains from the removal of monopoly price distortions following an opening to foreign competition include the simulation by Harris and Cox (1983) of the effects of free trade on Canadian manufacturing industry, the study by Krause (1962) of the effects of import quotas on the US steel industry, and the analysis by Levinsohn (1991) of Turkey's trade liberalization. Studies that go to a still more micro level, looking at the consequences for firms' technical efficiency of market opening in the United States, the United Kingdom, Canada, South Korea, and Australia, are collected in Caves (1992). Partial-equilibrium modeling is not enough, however, for that assumes away any systemic interactions; the sectoral studies must be extended to incorporate some general-equilibrium effects (as in Harris and Cox (1983)).

The test to be applied to any given attempt to open a country's market in the name of fair trade, then, is: Would the net effect of the foreign intervention be to raise technical and/or allocative efficiency, in both the target country and the rest of the world?

In the following analysis of the effects of U.S. pressure on Japan for market opening in public construction, subcontracting, and retailing, I shall try to list the potential or actual gainers and losers, inside and outside Japan. I shall look for both direct and indirect effects. The systemic interactions, as will be seen, are such that the indirect effects often outweigh the direct effects, although they are harder to predict and as a result are often overlooked.

I shall try to identify the gainers and losers from two points of view, economic welfare and political power, corresponding to the two questions, normative and positive. Is the foreign intervention justified on economic-welfare grounds? Is it likely to be successful? What is attempted in what follows is a quantitative analysis, measuring the gains and losses. These effects can in principle be measured, but in many cases the numbers needed for such a computation are not yet available. I shall offer guesses or rough estimates of the relative magnitudes of the various effects. Although in most cases it is easy to guess at the relative sizes of the various effects, the analysis is incomplete: my purpose is to suggest a method of approach to an accounting of the gains and losses from the various market-opening initiatives, rather than to offer definitive answers.

To address the normative question of whether the foreign intervention is justified on economic-welfare grounds, it is enough to identify the gainers and losers and to measure the sizes of their gains and losses. To address the positive question of whether the intervention will be successful, it is necessary to go one step further and ask how the gains and

losses translate into political action. How effectively can the gainers and losers compete with each other in the political arena? As is illustrated by innumerable examples of bad policies, it is possible for a policy that generates a net loss to society to be enacted. A small number of agents with concentrated stakes in the outcome, according to the standard argument, can beat a large number with diffuse stakes. Thus it is necessary to ask how well organized the groups affected by the prospective market opening are, and how the political institutions, like the electoral system and the political-funding process, determine the relative effectiveness of the different groups.

One potential benefit of foreign intervention is information provision. People within the target country who are harmed by the restrictive practice, such as consumers, may be unaware of the size of their losses. The foreign intervention might be effective merely because it induces the domestic groups to start exerting pressure on politicians in their own interest.

3. *Dango*

Dango is a negotiation among bidders for a Japanese public-works contract in which it is decided which firm will get the job. The designated firm submits a high bid and its "rivals" bid still higher, maintaining the illusion of competition. Under *dango*, each firm knows it will eventually "win" a contract, without having to go to the trouble of competing; and *dango* spares the firms the discomfort of low prices.

Collusion in the public-construction market does not occur only in Japan: it is common in Europe and the United States. The Reagan administration's antitrust chief, Charles F. Rule, said of bid-rigging: "The cost of building roads in this country was increased by 10% or more as a result of

these crimes." The main difference between Japan and the United States is the strength of the antitrust laws and the assiduity with which they are enforced. While *dango* is illegal in Japan under the Antimonopoly Act, sanctions against bid-riggers are weak. The investigative capacity of the Japanese authorities is more limited than that of the US authorities: the Japanese Fair Trade Commission secretariat has a staff less than one-fourth the number working in the US Federal Trade Commission and the Justice Department's Antitrust Division. Administrative surcharges levied by the Fair Trade Commission against bid-riggers, before the US intervention, amounted to only 0.5% to 2% of the contract value--far less than the amounts that could be earned from colluding (up to one-third of the contract value, according to the simulations in McMillan (1991)). The average fine levied by the Japanese antitrust authorities between 1985 and 1988 was $38,000, one-sixth the $224,000 average fine in the United States over the same period. Criminal cases are filed at a rate of about 80 a year in the United States. Convictions in the United States regularly result in prison sentences: 20 between 1985 and 1988, compared with none in Japan in the same period, although prison terms are provided for in Japanese law.

Even if the legal authorities can be evaded, collusion is--in any industry, in any country--difficult to achieve. Any bidding conspiracy must somehow overcome its natural tendency to self-destruct. Japanese government policies, advertently or inadvertently, help to sustain *dango*. [9]

A decision must be made by the bidding firms before the bidding on how high to bid. The scope for potentially damaging disagreement among the conspirators is removed by the official practice of setting a ceiling price, and the unofficial practice of leaking this ceiling price to the bidders (often via former Ministry of Construction officials now employed by the bidding

firms). In many *dango* cases, according to a Japanese newspaper, "local government officials effectively have helped to hide the abuse by setting estimates that include generous profit margins for the contractors." Further aid to collusion comes from the policy of announcing all bids after the bids are opened, with the result that each bidding firm is aware that, if it deviates from its prespecified bid, the others learn of its deviation immediately.

Entry of new bidders, which if it were allowed to occur would undermine any collusion, is hindered by the designated-bidder policy, under which only selected firms are allowed to bid for any given contract. (This policy of selective tendering, incidentally, while rare in the United States, is common in many other OECD countries.) For a firm to be put on the list of qualified bidders, only work done in Japan is taken into account. This effectively prevents the entry into the market of foreign firms, for they do not have a history of work in Japan. The foreign firms are caught in a Catch-22: you cannot win a contract unless you bid; but you cannot bid unless you have won a contract.

The main victim of *dango* is the Japanese taxpayer. The Japanese government awards over $100 billion worth of construction contracts annually. The unduly high prices attributable to *dango* mean that many billions of dollars of taxpayers' money are wasted.

Why does *dango* persist, and why is the construction industry so hard to reform? Who benefits from *dango*? Reported profit data provide no evidence that the firms involved benefit greatly. Doubtless some of the profits from dango make their way into the pockets of the firms' owners and are hidden by creative accounting; but most do not. The firms are on a treadmill: they must try so hard to earn the monopoly profits that they end up with little net gain. Firms use up resources in competing for monopoly

profits; and the entry of new firms into this rent-seeking competition results in the resources expended rising to become equal to the monopoly profits themselves (Posner, 1975; Bhagwati, 1982). Entry into the construction industry is relatively easy: the Japanese industry contains over half a million firms, and the number increases steadily over time. Any excess profits that *dango*'s high prices generate are bid away in the competition for political favor.

Much of the dango profits end up in the hands of the politicians. The construction industry is the largest single source of political contributions in Japan. The political funding process is so murky that it cannot be known how large the construction industry's contributions are; but they probably come to some billions of dollars. According to a Japanese newspaper report, the large construction companies distribute money to politicians according to how influential the individual politician is in the awarding of public contracts: each politician is twice a year assigned a letter grade that determines how large a contribution he receives. This money is used to cover the large costs in Japan of being a politician and running a political party. When Tokyo prosecuters in March 1993 arrested Shin Kanemaru, the deputy Prime Minister and LDP power broker, on charges of income tax evasion, they found in his office safe over $50 million worth of cash, bonds, and gold bars: donations mainly from the construction industry (intended, according to Mr Kanemaru, not for his personal use but to realize his "cherished dream of political reform").

Construction Ministry bureacrats also benefit from *dango*. When top officials retire, they "descend from heaven" into well-paid jobs in construction firms. In return for hiring a former official, construction companies reportedly receive $88,000 worth of contracts.[10]

It is unlikely that the US pressure, by publicizing the costs of *dango*, changed public opinion. The general public seem to have been well-informed before the United States intervened: parts of the news media had been campaigning against *dango* for many years (in fact, colluders seemed to fear discovery and publicity by the media more than they feared official antitrust enforcement).

The US government demanded that Japan strengthen its antitrust enforcement and replace the designated-bidder policy (which US trade representative Carla Hills called "a hotbed of *dango* practices") with open competition. Japan was asked, in other words, to become more like the United States. The Japanese government response to the US pressure was to increase the Fair Trade Commission's investigative capacity by hiring more staff, and to revise the Anti-Monopoly Law, with stronger penalties for collusive behavior: the administrative surcharge levied on participants in a cartel was raised from 2% of the value of sales to 6%; the maximum fine was raised from 5 million yen to 100 million yen; and a program under which the Fair Trade Commission would assist private plaintiffs to recover damages was instituted (Matsushita, 1993). A cartel than could not raise prices by more than 6% would be a notably incompetent group of conspirators;[11] so the US compliants that the sanctions were still too low were probably correct. The Japanese government said that US firms must form joint ventures with Japanese partners "in order to understand the particular demands of the Japanese construction and design market." The designated-bidder rule remained in place. Foreign firms were given permission to bid on some specified contracts, but there was little real opening to foreign firms: in 1992, US firms received 0.02% of Japan's construction contracts.[12] Thus, as of mid-

1993, after seven years of negotiations, the market-opening pressure was ineffective.

What would have happened had there been some genuine response to the US pressure? The direct effects would include a harm to many, though not all, of the Japanese construction firms. Many of the firms currently operating, according to industry observers, survive only because the *dango* system guarantees them a share of the contracts. The introduction of genuine competition would be followed by a shakeout, with many firms, mainly small firms, going bankrupt. Construction workers would suffer from the unemployment that would follow reform. Some Japanese construction firms, however, would gain: the large, efficient firms would have a bigger market share once the inefficient firms were no longer being propped up. (By the early 1990s, some of the larger and more technologically advanced Japanese firms were in fact advocating an end to *dango*.) The technical efficiency of the Japanese industry would be improved, as the new competition generated extra discipline on the firms. Foreign firms would gain from access to the huge Japanese public-construction market. Japanese taxpayers would gain from the lower price of public-works projects: this gain is potentially huge, and doubtless outweighs any of the other considerations.

The indirect effects of removing *dango* would be on political funding: as noted, the political parties are dependent on construction-industry donations. This political side-effect is not inconsequential, and determined the Japanese stance in the negotiations with the United States. (As one of the Japanese trade negotiators said, public works expenditures "provide the necessary lubrication to the Japanese political process.")

It seems clear that the welfare effects of eliminating *dango* are large and positive, because of the overwhelming benefits to Japan's taxpayers, and

because *dango* is inconsistent with an open global trading system. But the systemic resistance--the effects on political funding, and the political influence of the very many small firms that would be harmed--is strong enough to overwhelm any influence from the potential gainers. What looks at first glance to be a simple issue, a clear-cut case of some corrupt firms conspiring to earn illicit profits at the expense of the economy as a whole, turns out to be deeply rooted in Japanese society.

4. *Keiretsu*

Keiretsu have had a bad press outside Japan. According to the Office of the United States Trade Representative, "Japan's *keiretsu* system involves close intercompany linkages which impede the importation of many U.S. products into the Japanese market." According to Laura Tyson and John Zysman, "even when the government reduces policy barriers to market access in Japan, foreign firms continue to confront barriers that stem from the long-term contractual relationships among Japanese firms." According to Ronald Dore, "Imports penetrate into markets, and where there *are* no markets, only a network of 'established relationships,' it is hard for them to make headway." [13]

Are keiretsu simply a device to exclude foreign firms? Or do they have something else going for them? Entry restrictions raise the costs of the procuring firm: since these entry barriers are imposed by the procuring firm itself, they are not consistent with the procuring firm's acting in its own interest unless they bring some additional benefits. The *keiretsu* form of organization is, according to many observers, a source of efficiency. According to the Ministry of International Trade and Industry (MITI),

"Japanese manufacturing industry owes its competitive advantage and strength to its subcontracting structure." A US automobile executive has estimated that about a quarter of the cost advantage of Japanese autombile firms is due to the superior efficiency of their supplier networks.[14]

Evidence of the efficiency-promoting effects of subcontracting relationships comes from a series of studies that ask statistically whether *keiretsu* have a measurable impact on Japan's trade volumes: Fung (1991), Lawrence (1991), and Noland (1991). These studies find that vertical keiretsu--those involving subcontracting relationships--tend to increase exports, suggesting that the vertical *keiretsu* is associated with low-cost and high-quality production. These studies also find that a different kind of *keiretsu*, horizontal *keiretsu*--groups of firms operating in separate markets, often with common financial links--tend to decrease imports, and therefore seem to have a protectionist effect. In what follows I shall focus on vertical *keiretsu*, for they raise interesting issues about the relationship between domestic institutions and global trade.

Japanese-style subcontracting, involving deals among separate firms, actually makes more use of the market mechanism that the more vertically integrated form of organization traditionally used by US firms. Subcontracting permits an efficient division of labor among firms. And decisions as to what gets produced and who produces it are guided not by internal accounting but by the price mechanism (although*keiretsu* involve a more subtle use of prices than that depicted in elementary economics textbooks).

Long-term relationships are essential to the workability of the Japanese subcontracting system, for several reasons. Buyer-seller interactions in general do not always work smoothly. As Williamson (1975) has pointed out,

the manufacture of an item requiring specific investment cannot be successfully contracted to another firm unless short-sighted profit seeking can be curtailed. A subcontracting firm often has to retool in order to be able to manufacture a particular item. Having made this specific investment, not usable for anything else, the subcontracting firm is in a weak bargaining position; it is susceptible to a demand from the procuring firm for a renegotiation of the contract. Unless there is some assurance that the procuring firm will live up to its promises, the subcontracting firm will be reluctant to undertake the specific investment. Willamson concluded that production requiring specific investment can be undertaken only within a vertically integrated firm. The theory of repeated games suggests another resolution. If firms deal with each other repeatedly, they have incentives to act cooperatively. In an ongoing situation, firms cooperate because it is in their interest to do so. Concern for the future can prevent a firm from squeezing the last cent of profit out of its trading partner. The maintenance of these ongoing relationships is facilitated by Japanese firms' propensity to deal directly with a relatively small number of subcontracting firms; fewer than a typical US firm.

As well as providing a way around the specific-capital problem, long-term relationships serve to generate incentives for the subcontractors. A subcontracting firm is motivated to do good work by the threat that, if it does not, when its contract expires it will not be renewed. Direct and immediate monitoring of a subcontractor's performance is often impossible; the procuring firm only accumulates information about performance slowly and imperfectly. In such circumstances contracts that base payment on current performance do not work well. The subcontracting firm is instead motivated by the promise that, should it do good work--producing high quality parts, or

finding cost-lowering innovations--it will receive favorable consideration at contract-renewal time (Laffont and Tirole, 1993, Ch.8).

Incentives also come from the hierarchical nature of the Japanese subcontracting system. Subcontractors are organized in multiple tiers, with the procuring firm dealing directly only with a few first-tier subcontractors, who in turn control second-tier subcontractors, and so on down to third-tier and sometimes fourth-tier subcontractors. The size and complexity of this system is exemplified by Toyota, which in 1980 had about 170 first-tier subcontractors, 4,700 second-tier subcontractors, and 31,600 third-tier subcontractors. The benefit of the multitier hierarchy of separate firms is that the buyer at the top of the hierarchy need know less of the details of low-tier production than would be necessary in a hierarchy that was completely inside one firm (McAfee and McMillan, 1993) The classical benefit of decentralized systems is that they economize on the costly activities of acquiring and processing information. A huge amount of diverse information about production technologies, sources and prices of input supplies, and so on is needed in any reasonably complex modern manufacturing process. In a centralized system, all of this information must be collected at the top. In a decentralized hierarchy, by contrast, less information need be collected and collated, for control rights are closer to the source of the information. The hierarchy is a crucial part of Japan's subcontracting, viewed as an incentive system. High-tier subcontractors are awarded larger and more technologically sophisticated, and therefore more profitable, contracts. Low-tier subcontractors are promised promotion to a higher tier, and consequently higher profits, should they perform well over a series of contracts. Promotion to a higher tier, analogous to a worker's promotion within a firm, is explicitly part of the reward system in Japanese subcontracting.

The exchange of technological information between subcontractor and purchasing firm is a feature of Japanese subcontracting. Long-term relationships are needed for this: a subcontractor would be reluctant to reveal its innovations if it believed that its contract would not be renewed and so one of its competitors would reap the benefits of its discovery.

Long-term relationships, therefore, are crucial to the working of the subcontracting hierarchy. The corollary of ongoing relationships is that incumbents are favored when contracts are renewed, and it is hard, though not impossible, for outsiders to win contracts. Practices that look exclusionary in fact increase efficiency and therefore are ultimately pro-competitive.

Although insiders are favored, the *keiretsu* system is not static: outsiders can, and do, win contracts. But entry is a much slower process than in a simple arms-length system in which the lowest bidder wins the contract. Relationships are built up slowly: a new firm typically is given small contracts, and only after proving itself is given larger and more technologically sophisticated work.

The US case against *keiretsu* is different in nature from the public-construction and retail-stores interventions, where the barriers to entry were government-imposed, and the United States wanted the Japanese government's involvement to be reduced. In the case of *keiretsu*, the barriers to entry are imposed by the firms themselves, and the US demand was that the Japanese government strengthen its powers of oversight; the United States wanted the Japanese government's involvement to be increased rather than decreased.

The US government's demand that Japan make its subcontracting practices more open--by limiting cross-shareholding, and requiring that managers publicly disclose the basis of their purchasing decisions--produced

few concessions from the Japanese. The US negotiators wanted to force "the Japanese firms to be more responsive to profit considerations" (Schoppa, 1993, p.13); though, if the above argument is correct, this position was based on a misunderstanding of the *keiretsu* system. The US proposals were attacked by Japanese business representatives, academics, and bureacrats. The Japanese negotiators insisted that the United States recognize "certain aspects of economic rationality of the *keiretsu* relationships." The Japanese argued that it was the United States that should change its system (which, as will be discussed, had in fact been happening spontaneously--without government guidance--for over a decade).

The Japanese government agreed in 1990 to increase its monitoring of *keiretsu*, to check whether *keiretsu* restricted competition; but the 1992 Fair Trade Commission report that resulted from this concluded that trade within *keiretsu* groups did not discriminate in favor of insiders. One of the US arguments was that the lack of transparency of Japanese firms' decision-making was a barrier to trade. In response to the US pressure, the Ministry of Justice in 1993 proposed changes in Japan's commercial code designed to make executives more accountable for their decisions: giving shareholders greater access to confidential corporate documents, and making it easier for shareholders to file lawsuits against management.[15]

The trade friction has had the effect of encouraging Japanese car makers to buy some US-made parts. Exports of US-made car parts to Japan rose through the second half of the 1980s, though by 1992 they still amounted to only 1% of the Japanese car-parts market. In January 1992, during President George Bush's much publicized trip to Japan, the Japanese car companies announced what they called a voluntary plan to double their 1990 purchases of American-made auto parts by 1994. MITI officials are reported to have told

the five major Japanese car makers in 1993 to increase their purchases from US parts makers by 90%. Actual purchases rose 30% from 1992 to 1993. Initially, simple mechanical parts and such items as carpets and aluminum were purchased, rather than more technologically complicated parts like electronic controls and engines. When the US trade negotiators complained about this, the Japanese car makers said that high-technology parts must be designed into the car by a collaboration between purchaser and supplier, and so the purchase of such parts could not begin immediately. By 1993, some US-made parts were starting to be incorporated into the designs of new car models, and more complex parts were beginning to be purchased. In the meantime, Japanese parts makers were complaining that they were suffering from the new competition. Changes did occur, therefore, though only very gradually.[16]

What would have happened had Japan suddenly made the changes the United States demanded? The direct effects are straightforward: some Japanese supplier firms would lose, and some foreign supplier firms would gain. Ironically, the size of the potential gain to US supplier-firms from opening the Japanese parts market is determined by the United States's own protectionist policies. US restrictions on car imports from Japan--euphemistically called voluntary export restraints--have the well-known effect, by creating a scarcity of Japanese cars in the United States, of generating extra profits for Japanese car manufacturers. A portion of these extra profits, according to the computations of Ries (1993), in turn go to some of the subcontractors within Japan, reflecting the fact that the larger subcontractors have some bargaining power in their dealings with the car manufacturers.[17] Thus a successful market opening, allowing US firms to sell to the Japanese

car manufacturers, might in turn transfer some of these profits, artificially created by US protectionism, back home to the United States.

The indirect costs of forcing Japanese manufacturers to procure components from foreign firms would be huge, if the preceding analysis of the value of the subcontracting system, in promoting efficient production, is correct. Japanese procuring firms would lose, through having to pay higher prices and accept lower-quality parts. Technological innovation would be reduced. The technical efficiency with which production is carried out would fall. Japanese and foreign consumers would lose, paying higher prices and getting lower quality products. These indirect effects would seem to be sufficient to explain Japan's reluctance to change its subcontracting system in the way the United States demanded.

The US pressure was intended to produce harmonization: to make Japanese practices more like US practices. Oddly, this pressure came at a time when there was already a well-established trend for harmonization. But this was spontaneous harmonization, and it was working in the opposite direction: US practices were becoming more like Japanese practices. There has been a kind of technology transfer from Japan to the United States, not of ordinary technology but of organizational technology. By their actions if not their words, US businesspeople reject the negative interpretations of the Japanese subcontracting system.

During the 1980s, many American firms began adopting *keiretsu*-like interfirm relationships. Increased use began to be made of subcontracting in place of vertically integrated production; subcontractors were given extra design and production responsibilities; and longer-term relationships between procuring firm and subcontractors were instituted. The US automobile manufacturers, for example, began reassessing their relationships

with their suppliers, shifting toward more work being subcontracted, longer-term relationships with suppliers, fewer suppliers, earlier involvement of suppliers in the design process, and more monitoring of suppliers' quality. The US machine-tool industry made increased use of subcontracting. American textile firms began reducing the number of their suppliers and offering longer-term contracts; in exchange for the greater security, the subcontractors were expected to time their deliveries to minimize the textile firms' inventory holdings. Xerox reduced its pool of suppliers from over 5000 companies to 400, trained the selected suppliers in quality control, and began involving them in the design of new products. Boeing began working with its suppliers to reduce their costs and improve their quality, and involving them earlier in the development processes.[18] The US firms began using these *keiretsu*-like methods of organization as part of a quest for increased efficiency prompted by import competition, often from Japanese firms. Imitation, as they say, is the sincerest form of flattery. This imitation by US firms of Japanese practices casts doubt on the basis for the US government's complaints about *keiretsu*.

5. Large Retail Stores

The case of the large retail stores is the easiest of the three to analyze, for we have the benefit of hindsight: the U.S. pressure was successful and the Japanese market was opened.

Japanese retailing in the 1970s and 1980s was, according to common belief, inefficient. The number of retail stores per capita was much higher than in the United States and Europe, and they were less efficient (by an OECD estimate, their value-added per employee was 28% lower than in the

United States).[19] Under the large-scale retail sales law a retailer wishing to open a store of more than 1,500 square meters had to notify MITI, after which MITI was supposed to consult the existing small retailers and others, including consumer groups, before making a recommendation. In practice MITI, as described by Upham (1992), "privatized" the law, delegating its implementation to the retailers themselves. The prospective large store had to negotiate and reach an agreement with the local merchants, which MITI would then routinely ratify. The negotiations took up to a decade to complete. Since consumer groups were excluded from the negotiations, and their supposed representative, the government, chose not to involve itself, the resulting agreements were not notably consumer-friendly. The large stores, once admitted, earned profits from their privileged position. The local merchants were able to extract a considerable part of these profits from the veto power MITI had granted them. The agreements typically included requirements that a new large store "include specified local merchants as subtenants on favorable terms; make large 'donations' to local merchant groups; and maintain prices or services at the same level as surrounding merchants" (Upham, 1992, p.16). Just as in Stigler's account of regulatory capture, MITI was administering a retailers' cartel.

The force of the restrictions on entry was demonstrated by the flood of entry that followed MITI's 1990 lowering of the barriers. "In the first six months following the measures, over nine hundred prospective new large stores were announced, more than double that of the previous year and more than nine times the rate of 1982-85. The American toy retailer Toys 'R' Us in December 1991 became the first foreign store to be allowed to open under the large-scale retail stores law, and announced that it planned one hundred new stores within ten years" (Upham, 1992, p.35).

The direct effects of relaxing the large-scale retail stores law are straightforward: a lowering in the profits of the incumbents, both the small stores and the large stores that were already in place and therefore benefiting from the entry restrictions; an improvement in the well-being of Japanese consumers as a result of the lower prices and increased choice following the increased competition in the retail market; a gain to U.S. and other foreign retailers and the manufacturers who supply them as a result of having access to a market they were formerly excluded from. Foreign manufacturers gained to the extent that the status quo had hindered imports. (The benefits to US manufacturers, however, turned out to be smaller than predicted: less than a fifth of the toys sold by Toys 'R' Us in Japan are made in the United States.[20])

There would seem to be few indirect effects within Japan. One, probably small, is a gain to Japanese manufacturers. (The *Keidanren*, Japan's big-business federation, in fact supported the change.) A manufacturer with market power loses out if the retail market is imperfectly competitive, in that some of the profits attributable to the manufacturer's monopoly position stay with the retailers. Making the retail market more competitive has the effect of transferring those profits back to the manufacturer. A broader indirect effect was the effect of this market opening on the global trading system: to the extent that the retailing restrictions served as a nontariff barrier to trade, their removal strengthened the global trading system. The net welfare gains from this particular market opening, therefore, were clearly positive.

Although the US demands were at first strongly opposed by MITI, the Ministry of Home Affairs, and the ruling Liberal Democratic Party (responding to pressure from the very numerous owners of small stores),[21] the pressure from the United States ultimately met quite easily with success. The change caused, apparently, few indirect effects, and so the opposition it

faced was weak. At the time of the U.S. intervention, forces had already been building up within Japan for a shift in policy: the Economic Planning Agency and the Fair Trade Commission were publicly in favor of change, and the news media were campaigning for reform. The American pressure helped move the opinion of the general public in favor of reform, according to Schoppa (1993, p.33). The internal political equilibrium seems to have been finely balanced, and some outside pressure was all that was needed to shift the equilibrium.

6. Restrictive Practices and Global Trade

Calls for harmonization of different countries' business practices often seem to presume that the term "market economy" defines a unique and well-defined entity. This is, however, an oversimplified view of how markets work. According to Albert Hirschman, "there is and always has been a large variety of 'really existing' market societies. This diversity helps to account for the shifting leadership of advanced industrial countries; it has also been a considerable, if somewhat hidden, element in the overall resilience of market societies" (Hirschman, 1992, p.vi). The market is not a unique organizational form; many different forms of organization are consistent with the label "market economy" and with efficient production and exchange. This obvious, even trite, point is often obscured in discussions of fair trade: the call for a level playing field is a call to eliminate organizational differences. I have argued that in some, but far from all, cases it is (a) justified and (b) feasible to ask a nation, in the interests of fair trade, to harmonize its industrial practices with international norms.

A market is a subtle and complex institution, which needs rules and customs in order to operate. Given the disparate goals of the market participants, and the uneven distribution of information among them, the rules of exchange must be craftily structured for a market to work smoothly. Market institutions facilitate the flow of information among market participants, and create appropriate incentives to shape their decisions. Moreover, market economies are systems; how exchange is organized in one part of the system affects how it is organized elsewhere. The markets-as-institutions view explains the empirical observation that quite different forms of market economy can coexist. Because markets are complex institutions, there is scope for institutional innovation, serving a similar purpose to technological innovation in the quest for improved methods of production. And because markets are systems, different choices about organizational structure in one area dictate different choices elsewhere, so market economies in their totality can look quite different from each other.

Japan's use of exclusionary practices cannot be explained as being the result of Japan's supposed cultural uniqueness. There is nothing inherently Japanese about attempts to shelter firms from competition. Each of the three forms of exclusionary practices discussed above has echoes elsewhere. European governments are as reluctant as the Japanese government to buy from foreign firms. Only 2% of European government contracts go to foreign firms; the European countries buy almost nothing abroad, even from their partners in the supposedly unified EC market. EC restrictions on American sales of electrical-power generation equipment and telecommunications equipment were the subject of a 1993 trade dispute. Excluding large retail stores for the sake of small stores happens elsewhere than in Japan. The French Prime Minister, Edouard Balladur, announced measures in 1993 to

make it harder for new supermarkets to open, and ordered a six-month freeze on the opening of new supermarkets. The small shopkeepers, an influential constituency of Balladur's RPR Gaullist Party, were also offered subsidized loans.[22] Organizing production by means of long-term buyer-supplier relationships among firms is far from being uniquely Japanese: practices that are in many ways similar can be found in Italy and Germany, for example, as well as, to a smaller but increasing extent, in the United States. "Harmonization" is inappropriate terminology: to eliminate Japan's restrictive practices would be move Japan away from what is commonly done in many other countries.

Are exclusionary practices consistent with mutually gainful trade among nations? It depends on the nature of the exclusionary practice. It is not the case, to borrow a phrase from Gifford (1993), that "exclusion is exclusion." The essential difference between vertical *keiretsu*, on the one hand, and large-retail-stores restrictions and *dango*, on the other, is in the effects on technical and allocative efficiency of the exclusionary practice. If, as with vertical *keiretsu*, a practice is efficiency-enhancing, and if there is nothing to stop firms in other countries from adopting the practice, then it is analogous to technological progress and is not inconsistent with liberal trade.

I have argued that international actions against a nation's restrictive practices are sometimes justified (as exemplified by the *dango* and large-stores cases). Such actions have up until now been unilateral, with one country, usually the United States, acting as prosecuting attorney, judge, and jury. Even when the unilateral action is justified, however, multilateral action, if feasible, can be expected in general to produce better results, for several reasons. First, unilateral action runs a greater risk than multilateral action of being applied with excessive force and leading to a contentious impasse, with

harm to the global trading system as a whole (see McMillan (1990a), Spier and Weinstein (1992)). Second, the response to US pressure might take the form of leaving the restrictions on entry in place and including a few US firms in the the set of priviliged incumbents, so that the selected US firms share in the monopoly profits. From a global point of view this would be no improvement, as third-country firms, as well as other US firms, would continue to be excluded. (European governments are for this reason wary of unilateral US market-opening actions directed at Japan.) Third, trade negotiators being much subject to Stigler-style capture as domestic regulatory bodies--they often act as though what is good for General Motors is good for the country--a multilateral, rules-based approach might serve better than unilateral actions to protect the interests of consumers against well-organized producer lobbies. The co-opting of trade negotiators is illustrated by the 1985 Section 301 action over the South Korean insurance market. Negotiators from both sides "approached the case with the perception that the main issue was the sharing of profits in Korea's insurance markets. In the negotiations, both governments, especially that of the United States, basically represented the interests of their insurance industries. The effect of what was being sought in the negotiations on other activites, and on the efficiency of the economy as a whole, was not a major consideration" (Cho, 1987, p.493).

Must actions against restrictive practices, because of the complexity of the issues, be unilateral? Or could the multilateral rules of international trade be extended to incorporate them? A precedent exists. GATT's stillborn predecessor, the International Trade Organization (ITO), explicitly addressed restrictive practices, as John H. Jackson points out: its 1948 charter obliged member countries to enact laws against restraint of trade, price-fixing, and so on. Ironically, given its subsequent concern about other countries'

competition policies, it was the United States itself that blocked this, when the Congress rejected the ITO charter on the gounds of national sovereignty. The GATT treaty that replaced it omitted the ITO's competition-policy measures. The GATT subsequently made some attempts to address the issue, which produced little more than procrastination. A GATT study group recommended in 1960 that there be consultations whenever a member country felt harmed by restrictive practices in other member countries. But the group concluded that competition policy should not be written into GATT rules, arguing that any action "would involve the grave risk of retaliatory measures . . . which would be taken on the basis of judgments which would have to be made without factual information about the restrictive practice in question, with consequent counterproductive effects on trade." I suggested above, however, that factual, quantitative information on the effects of restrictive practices is obtainable, and so this objection no longer applies. Can rules against restrictive practices be written into the GATT? Jackson says they can: "If the Uruguay Round concludes reasonably successfully, and its results include a new 'MTO--Multilateral Trade Organization' Charter, this could provide a very useful institutional umbrella for some new meaningful work connected with competition policy." [23]

Notes

1. Quoted on the BBC World Service, June 11, 1993. By an OECD estimate, EC farmers in 1992 received a total of $132 billion in direct and indirect subsidies; this is equivalent to more than $15,000 for every full-time farmer in the community, or to $950 for each hectare of farmland, nearly four times the OECD average (*Sunday Times* (London) June 27 1993, p.8).

2. *New York Times* May 12 1993, p. C2.

3. The measure of welfare that will be used in what follows is the sum of consumers' surplus and firms' profits. This is oversimple, but workable. Noneconomists might argue that the concept of economic welfare is limited and does not encompass all of the relevant costs and benefits. I do not deny this, but in what follows I confine attention to what can be measured. Any additional effects that are thought to be important can be added, according to taste, into the policy accounting that follows.

4. Van Wolferen (1989), pp.43, 47.

5. Quoted by Johnson (1993, p.26).

6. These are only some of the areas in which the United States has demanded changes of Japan. Others include land policy, rice pricing, satellite and computer procurement, cellular-phone services, financial-market deregulation, and macroeconomic and savings policies. Related analyses of US market-opening pressure on Japan include Ito (1993), Johnson (1990), Kahler (1993), Saxonhouse (1993), Schoppa (1993), Sheard (1991, 1992), and Upham (1992).

7. Stigler (1971, p.3); Kahn is quoted in Laffont and Tirole (1993, p.537); Johnson (1990).

8. Quoted by Johnson (1991, p.13). Schoppa makes the point that the effects of US market-opening pressure on Japan can be understood only by looking at how the foreign pressure

interacts with domestic politics: "the effectiveness of foreign pressure is not simply a function of the voracity of threats, it is also a function of how positively foreign demands resonate in the domestic politics of the target country" (Schoppa, 1993, p.41). Kahler says: "The principal preequisite for success [in harmonization negotiations] seems to be the presence of powerful domestic allies in the target state, both to ensure effective implementation of agreed policy changes and to guard against nationalist backlash" (Kahler, 1993, p.46).

9. For more on *dango*, and for the sources of the facts cited here, see McMillan (1991). On the incentives of colluding bidders, see McAfee and McMillan (1992).

10. The letter-grade practice is reported in *New York Times*, March 28 1993, p. A9; the story of Kanemaru comes from *Financial Times* July 23, 1993, p.4; and the hiring of former ministry officials is reported in *Far Eastern Economic Review*, April 15 1993, p.55. On the construction industry's political ties, see Coles (1989), Curtis (1988), and Hrebenar (1986).

11. Some Economics 101 arithmetic illustrates this. Suppose a cartel succeeds in raising the price from the perfectly competitive level (which is equal to c, the marginal cost, assumed to be constant and the same for all firms) to the monopolistic level (which, by the standard formula for marginal revenue, is equal to $c/[1-(1/\eta)]$, where η is the price elasticity of demand). Then the price rise is less than 6% only if the market demand elasticity η exceeds 17.67, an implausibly high number.

12. *Financial Times*, June 21 1993, p.4; *Economist*, May 22 1993, p.37.

13. These quotations were collected by Sheard (1991, pp.32, 40).

14. For more on Japan's subcontracting networks, and for the sources of the facts cited here, see McMillan (1990b; 1992, Ch.13).

15. Schoppa (1993, p.14); *Far Eastern Economic Review*, March 11 1993, p.47.

16. *Financial Times*, June 16 1993, p.18; *Economist* Jan. 11 1993, p.62; *New York Times* July 1 1993, p.C16.

17. Ries deduced this from looking at Tokyo stock-price data before and after the imposition of the voluntary export restrictions. He found that the VERs had a statistically

significant effect in raising the stock-market values not only of the car makers, but also of some of the parts suppliers--those suppliers that were large or produced specialized components.

18. Alexander (1993), Burt (1989), Cole and Yakushiji (1984), Dertouzos, Lester and Solow (1989), March (1989), McMillan (1990).

19. The facts cited in the section come from the fascinating analysis of Upham (1992). The common judgment about the inefficiency of Japanese retailing has been questioned by Ito (1992, Ch.13): according to Ito's estimates, the Japanese distribution system performs comparably to the American , as measured by value added, gross margin, and operating expenses.

20. *New York Times*, June 2 1993, p.C2.

21. Schoppa (1993).

22. *Financial Times*, June 29 1993, pp.1, 14.

23. The two quotations are from Jackson (1992, p.114).

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