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## POLITICAL ECONOMY OF REFORM: THE CHARACTERISTICS OF JAPANESE INSTITUTIONS

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JAPAN IS IN A PROCESS OF TRANSITION. Some of its long-standing institutional characteristics are being questioned and face enormous pressure for change; at the same time, some of the most traditional institutional forces are carrying out some of the most important changes. This apparent contradiction actually illustrates the fact that Japanese institutions have always had a degree of internal capability for innovation and reform—a capability that enabled Japan to become the first non-Atlantic nation of the modern era to become a major economic power. Because these institutional characteristics are endogenous rather than universal, it may be difficult for outsiders to understand and anticipate the shape and speed of the reforms that Japan is trying to achieve. This paper will outline some of Japan's institutional characteristics, explain why they prevail, and discuss their impact on Japan's current political, economic, and social changes. The inequality with which the benefits of reform are shared among the different sectors of society means that reform is not easily achieved. Japan, for example, has been slow to move away from its much-admired role in the postwar reconstruction era, despite major changes in its external and internal circumstances. Gender and age biases in the decision-making group additionally favor the traditional approach to reform, such as construction-based reflation policies.

### **BUREAUCRACY-LED POSTWAR RECONSTRUCTION AND MODERNIZATION**

Japan achieved universal suffrage and full democratization under Allied occupation following the Second World War. After regaining independence in 1952, Japan worked hard to return to full-fledged membership of the international system. A prominent characteristic of this system was a strong statist orientation that charged the modern government with responsibility for leading its nation toward development based on the

core values of the postwar international system: economic growth, democracy, financial stability, free trade, and liberalization.

Japan, eager to recover its international status and credibility after the war, strove to adopt the core values advocated by the major victorious powers. The country's democracy was still in its formative stage, however, and struggling to achieve a stable distribution of power, was not strong enough to fulfill the expected goals of the state. Japan's imperative thus became building and maintaining strong technocratic institutions staffed by bureaucrats with the ability to assure that Japan quickly became a strong and responsible state. Two important institutional characteristics emerged from this experience.

First, the bureaucracy learned to play the role of mitigator as it sought to convey the values of the outside world to the Japanese people, for whom the traditional exogenous values remained strong. The inflexible imposition of an alien system of values would have caused politically intolerable social destabilization, and the bureaucrats were well aware of the enormous gap that existed between the universally manifested values and Japan's traditional social culture.

As time went by, Japanese civic culture and expectations gradually converged with the new value system, but the bureaucracy became caught in the archetypical bureaucratic malaise: inertia. To this day, it still tries to play the role of transmitter and gatekeeper of standards and values between the world and the Japanese people, clinging to the memory of the heroic function it played as buffer between international standards and domestic realities.

Japan's bureaucracy must now confront the challenge of how to become what it was initially meant to be—the agent of modernization needed to harmonize Japan with global values and standards. Recent history has shown that Japan is capable of maintaining its traditional integrity in an environment of globalization, and that cultural strength and integrity in fact can be more easily maintained from the position of economic and political power that is achievable only through participation in the global competitive network. Should it fail to come to terms with this reality, the enhancer of Japanese development could become instead the spoiler of Japan's readiness for reform.

A second major component of the legitimacy of the postwar bureaucracy was its reputation for reliability. To maintain this reputation, Japan's ministries and agencies have strictly defined spheres of jurisdiction that are both mutually exclusive and exhaustive. The extent of bureaucratic responsibility is pervasive, but the coordination of powers and joint problem-solving capabilities in areas involving newly emergent issues or the complex conjunction of issues is limited. This results in excessive transaction costs for domestic and overseas actors that undertake consultations or

negotiations with Japanese bureaucratic institutions, since the institutions' spheres of authority are segmented and their ability to engage in coordination is limited. Bureaucrats are also unaccustomed to any kind of intrusion into their spheres of power and responsibility, either in the form of interministerial coordination or through deregulation and liberalization.

One of the major points of emphasis of the initiatives for administrative reform advanced by recent governments was the enhancement of interministerial coordination and the flexibility of the Cabinet Secretariat. The goal of the initiatives was to achieve comprehensive coordination by overriding ministerial segmentation, inertia, and vested interests. The recommendations were contained in the final report of the Prime Minister's Committee on Administrative Reform and were enshrined last year in law. Japan will have a newly defined set of bureaucratic institutions and functional formulae in 2001.

#### PIECEMEAL ADAPTATION VERSUS CONCEPTUAL ARTICULATION

In addition to the bureaucratic characteristics that emerged from Japan's postwar experiences, some other important characteristics influence Japan's capabilities for reform.

Japan is often accused, incorrectly, of never changing in any significant way. In reality, Japan has frequently shown an ability and willingness to adapt to externally defined constraints and roles—few other countries can have gone through such tremendous social and economic changes as Japan has during the last half-century. The country's political and bureaucratic institutions have similarly shown an ability to adapt. What they have not done so well is provide comprehensive explanations and conceptual articulations of their intentions and commitments, and this has often led to confusion and misperceptions.

Japanese institutions are not known for their willingness to forcefully present principles and concepts, but in their defense, in the postwar era they were not in the position to do so. Japanese decisionmakers were obliged to behave more as decisiontakers in international affairs: it was more important for Japan at that time to be adaptive than talkative. The demands from the outside world were not always consistent or constant. Japan has an extraordinary capability to adapt to external forces, as seen in its industrial development, but its adaptation thus tended to be piecemeal and ad hoc rather than systematic. Articulation of these piecemeal changes was difficult.

Japan has failed to grasp how quickly its position has changed from the status of decisiontaker to that of decisionmaker. It does not fully comprehend the fact that the international community is waiting for Japan to make decisions on nonmilitary problems ranging from the East Asian economic

crisis and currency stabilization to remedies for poverty and protection of the environment. As Japan gradually assumes the roles of agenda-setter and consensus-former on issues of global governance it must improve its conceptual articulation, so that the world will better understand its intentions and commitments and feel more comfortable about partnership.

### LACK OF INCLUSIVITY IN DECISION-MAKING

Japan is not a homogenous country, but is often perceived as one because of strong homogeneity at the decision-making level. At all levels in the national government, local assemblies, private firms, banks, universities, and labor unions, middle-aged men with similar educational backgrounds are the mainstream decisionmakers. Young people and women are conspicuously absent, and this could also be considered a general characteristic of Japanese institutions.

Pronounced gender inequality and generational imbalance at the decision-making levels of most institutions may be the primary cause of Japan's inability to foster well-balanced development. Japan is a major economic power, but the Japanese citizen must contend with the daily hardships of long working hours, long-distance commuting, cramped housing, inadequate child-care services, excessive competition in education, and scarce help for the elderly. The greater involvement of women in the decision-making process could realistically have produced a greater diversity of economic reform and anti-recession policies, conceivably placing more emphasis on the household sector and on welfare services. The greater involvement of younger men and women in boardrooms and ministries might have seen more emphasis on venture capital, the software industry, and conservation projects, and less on the traditional construction project-based recovery plans. If Japanese institutions were to appoint more women to higher positions, it is likely that the Japanese economy would be more resilient, more flexible, and more creative—in fact, more reform-oriented.

### SUMMARY OF RECENT POLITICAL AND ECONOMIC REFORMS

Despite these constraints and constraining characteristics, Japan has shown an extraordinary commitment to invigorating its democracy and economy. Some examples of recent political and economic reforms follow:

#### Administrative Reform of the Central Government

The Headquarters for the Administrative Reform of the Central Government is overseeing the launch of a new set of government organizations,

scheduled for 2001. The reorganization will downsize some national government agencies in order to effect an improvement in efficiency: 84 government activities will be transformed into Independent Administrative Institutions (IAI), and the total number of secretariats and bureaus will be reduced from 128 to 96. The staff of the government will be reduced at least 10 percent within 10 years.

While most ministries and agencies will undergo mergers or downsizing under the reorganization, there are two noteworthy exceptions. First, the Environmental Agency will be upgraded to become an independent Ministry of the Environment, representing Japan's strong commitment to addressing national and global environmental problems. Second, a central office to plan, implement, and monitor gender equality issues will be established in the Prime Minister's Cabinet Secretariat. The office will be charged with promoting women's empowerment and with overcoming the traditional division of labor and prejudice against women.

#### Financial System Reform

Reforms are addressing the continually diversifying needs of investors by expanding the means of asset management, enhancing investment trusts, introducing over-the-counter securities, derivatives, and providing other means of investment. The government also proposes to liberalize security company services and fees, encourage new entries, and engage in other reforms designed to improve access to higher-quality services from financial institutions. The government will eliminate the obligation for member insurers of the rating organizations to use premium rates calculated by the rating organization for fire, automobile, and other insurance products, and will switch from the current licensing system to a system requiring registration only in order to encourage new entries into the securities industry. To promote cross-sectorial entry, the government will enable insurance companies and other financial institutions to participate through their subsidiaries in other business activities. The government will also allow securities companies in Japan to open and operate proprietary trading systems to enable investors to trade online.

While adhering to the principle of self-responsibility, the government will also enhance disclosure requirements and will formulate fair-trading rules. The law has been amended to require consolidated disclosures covering both parent and subsidiary companies when filing securities registration statements and annual reports. A new requirement will additionally be enacted to oblige depository institutions such as banks to make their financial statements, including the amount of bad loans, available on the public record. Measures are also being taken to create a new securities investor protection fund: The legal obligation to manage cus-

tomers assets separate from company assets will be introduced to protect investors in the event of a securities company failure.

### **Financial Regulatory System Reforms**

The mounting nonperforming loans problems of financial institutions and housing loan companies triggered reforms in the financial regulatory system, as enshrined by the 1997 Law Establishing the Financial Supervisory Agency and other related legislation. The Financial Supervisory Agency, established under the Prime Minister's Office, is invested with the authority to inspect and supervise private financial institutions. This is done with the understanding that separating financial-institution inspection and supervision functions from financial system planning and formulation functions will contribute to the conversion of financial administration to more transparent and fair administration. Institutions covered by the agency include commercial banks, insurance companies, securities companies, nonbank, and other private institutions dealing with financial transactions.

### **Amendment of the Foreign Exchange and Foreign Trade Control Law**

The goals of this amendment are to liberalize Japan's cross-border capital transactions in order to bring them into line with global standards, and to stimulate the Japanese market through complete liberalization of the foreign exchange business. Permission and prior notification requirements were abolished in principle, enabling individuals and companies to make free capital transactions and settlements with foreign individuals and companies. The authorized foreign exchange bank system, the designated securities firm system, and the money exchanger system were all abolished. In order to ensure a proper understanding of market trends and to prepare statistics on the balance of payments, it remains necessary to develop an effective ex-post facto reporting system on cross-border capital transactions.

### **CONCLUSIONS**

The methods and distortions that have dominated Japanese institutional decision-making mean that the pace and patterns of Japanese reform leave much to be desired. It has also been argued that other major factors, including the political-electoral system and the corporate system, restrain reform efforts. Under the current electoral system, for example, rural voters, who are typically conservative, have disproportionate influence, and are keeping medium-income urban dwellers out of the decision-making

process. In the corporate sphere, the business-labor partnership, characterized by the lifetime employment system and other related features, has tended to slow down reform because it tenaciously resists the option of unemployment.

The distortions deriving from the electoral system certainly contribute to the problem, but at the same time one cannot help but notice the irony of such a system. Rural conservative voters repeatedly elect experienced and powerful parliamentarians, but the tendencies of these politicians are in reality to focus on major societal reforms rather than on local projects that would serve their rural constituents. Again, while the employment practices of corporations are part of the problem, the recent dismemberment of the lifetime employment system was so clinical that few would now argue that it is a major factor inhibiting reform. The private sector has been more adaptive to the changes in the market environment than the public sector.