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October 2010

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The Tokyo Foundation is a public interest incorporated foundation established in accordance with the collective will of the Nippon Foundation and Japan's motorboat racing industry and whose activities are supported by grants provided from motorboat racing profits.

Publisher: Hideki Kato (President)
Editor-in-Chief: Akiko Imai (Director, Public Communications)
Senior Editors: Kaoru Matsushita, Mari Suzuki (Public Communications)
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CONTENTS

Yuzuriha's Crusade to Keep Handicrafts Alive <i>Tanaka, Yoko</i>	3
“The Second End of Laissez-Faire” (9) The Keynesian Postulate of Money: Wage Stickiness as the Stabilizer of the Capitalist Economy <i>Iwai, Katsuhito</i>	7
“The Second End of Laissez-Faire” (8) The Speculative Nature of Money Holding and the Fundamental Instability of Capitalism <i>Iwai, Katsuhito</i>	12
Craft, Community, and the Cost of Global Capitalism <i>Kato, Hideki</i>	15
The Upper House Vote and the Process of “Creative Destruction” <i>Curtis, Gerald L.</i>	17
The Changing Face of the Obama Administration at Home and Abroad <i>Kubo, Fumiaki</i>	23
Corporations in Evolving Diversity: Cognitions, Governance, and Institutions <i>Aoki, Masahiko</i>	37
Where the Market and Morality Intersect: A New Approach to World Poverty <i>Novogratz, Jacqueline</i>	42
The Urgent Task of Lowering Japan's Corporate Tax Rate <i>Morinobu, Shigeki</i>	48

The Long Road to Fiscal Stabilization <i>Kobayashi, Keiichiro</i>	57
The Japan-U.S. Alliance at Fifty: The Challenges Facing the New DPJ Government <i>Kato, Hideki</i>	60
Is Futenma Really the Litmus Test for Commitment to the Alliance? <i>Watanabe, Tsuneo</i>	69
Program Review: The First Step to Budgetary Reform <i>Tanaka, Hideaki</i>	72
Japan's Security: 10 Proposals for the Hatoyama Administration <i>The Tokyo Foundation</i>	79
Japan's Watershed Forests in the Cross Hairs <i>The Tokyo Foundation</i>	88
Priority Issues in Japan's Resource and Energy Diplomacy <i>Abiru, Taisuke and Hiranuma, Hikaru</i>	92
From Cash Handouts to Refundable Tax Credits <i>Morinobu, Shigeki</i>	99

September 17, 2010

Yuzuriha's Crusade to Keep Handicrafts Alive

By Tanaka, Yoko

Many of the handicrafts of northern Japan were born in response to the region's harsh climate and reflect a lifestyle in deep respect for and affinity with the natural environment. They also embody a rich, proud spirit that lies at the heart of Japanese culture, and efforts must be made to preserve them for generations to come.



The pristine forests of Towada are full of life and energy.

“All the good things in life have been made by hand since the prehistoric Jomon period, including food, utensils, homes, bridges, and Buddhist statues. . .” This is a comment I read somewhere that made a very deep impression on me. Our ancestors made everything they needed for their survival on their own, utilizing the plants and animals near at hand. Japan's traditional handicrafts, consequently, embody the ingenuity born of a lifestyle in deep affinity with nature and through close contact with their neighbors. This no doubt gave rise to the country's beautiful yet utilitarian handicrafts that have a universal appeal. Life today has become very convenient, but at the same time we have also lost touch with something very precious; this is something we are reminded of every time we run into a meticulously handcrafted item or are in the midst of family and friends.

Tanaka, Yoko *President, Craft Shop Yuzuriha.*

Yuzuriha Gallery and Shop on the shore of Lake Towada in Aomori Prefecture have been showcasing the handworks of northern Japan for 22 years. The items on display have been painstakingly chosen by visiting the artisans in person one by one. Through a process of trial and error, I worked with them to explore how craftworks can help enrich the modern lifestyle and endeavored to convey to customers the story behind each handmade product.



Decorative sashiko embroidery is hand-woven, stitch by stitch.

The long, forbidding winters make many parts of the Tohoku region of northern Japan nearly inaccessible, but they have also engendered a rich assortment of handicrafts. One example is Aomori's *sashiko* (embroidery) made by women, including during the months of heavy snowfall. It was originally a way of repairing torn daily garments and work clothes with patches in the shape of familiar flowers or animals, but this functional stitching technique is used today to produce highly decorative and beautifully refined quilts and embroidery. Tohoku's winters are too cold to grow much cotton, so even tattered, worn-out pieces of cotton fabric were precious. Stitching patches to hand-woven linen cloth provided greater warmth, enabling people to survive the frigid winters. Fabric was more than a daily necessity; it was as important for survival to the people of northern Japan as the food they ate, and women treated pieces of cloth with as much care and love as they showed for their families.



Mage-wappa boxes that men in mountain villages used to make from thinly sliced pieces of Akita cedar.

One item produced by men in mountain villages is the *mage-wappa* box made from thinly sliced pieces of Akita cedar. The slices of cedar wood are steamed, allowing them to be curved into shape, and spliced together with the bark of the cherry tree. *Mage-wappa* boxes are suited to storing lunch, as cedar keeps away bacteria and absorbs moisture, so food items remain fresh and delicious. The pattern formed by the cherry bark served as a “signature” of the person who made the box, so when they ran into an accident in the mountains, they could release the box into a nearby stream as a way of alerting villagers further downstream. The mountains were also sources of vines, taken from *akebi* and wild grape trees, which were woven into *kago* baskets that served an invaluable role in people’s daily lives. People expressed gratitude to the mountains for “sharing” the vines with them, despite the severe seasonal limitations on when such blessings could be gathered.

People of the past held the powers of nature in deep respect and adapted their lives to the harsh conditions, acquiring in the process a steadfast will to live, pride in their lifestyle, and humility. In this age of material affluence and the emphasis on mass production and cost effectiveness, we must not forget that the objects we require for daily life were originally all made by hand, and that the materials used were obtained from nature. All handicrafts, including those that are no longer produced today, recount a rich and engaging tale of people’s intimate ties with nature and with others. They also embody the spirit of the Japanese people, unchanging despite the changing times, that serves as the wellspring of Japanese culture.

The forests of Towada in Aomori Prefecture are resplendent in their natural beauty. With each winter, the leaves on the trees fall one by one until none are left, and while on the ground they serve as fertilizer until next spring under a blanket of pure white snow. Snow-covered forests are so beautiful, people say, because they clothe so much underneath. The same, perhaps, can be said of people, developing a natural richness and luster as we go through life's experiences. Preserving such richness for future generations is a mission toward which I feel we should all contribute what we can.



A young Japanese serow walks across a frozen lake in the severe Tohoku winter.

Photos: Takeshi Hosokawa (from Yoko Tanaka's *Yuzuriha no uta*)

October 12, 2010

The Second End of Laissez-Faire

9. The Keynesian Postulate of Money: Wage Stickiness as the Stabilizer of the Capitalist Economy

By Iwai, Katsuhito

About the Series "The Second End of Laissez-Faire"

This series features an academic paper prepared by Professor Katsuhito Iwai for the Interdisciplinary Workshop on Money at the Free University of Berlin, June 25-28, 2009. The original title of the paper was "The Second End of Laissez-Faire: The Bootstrapping Nature of Money and the Inherent Instability of Capitalism." The 14-chapter paper is being posted on the Tokyo Foundation website on a chapter-by-chapter basis.

The picture of the capitalist economy painted by Knut Wicksell, or rather, the picture Wicksell *would* have painted if he had pursued the implications of his theory to their logical conclusion, was a self-destructive laissez-faire capitalist economy. Any disequilibrium between aggregate demand and aggregate supply (or the natural rate and the market rate of interest) would set off a dynamic process that would move the general price level cumulatively away from equilibrium. Unless some outside authority intervened to restore equilibrium, its ultimate destination would be either hyper-inflation (if aggregate demand continued to exceed supply) or a major depression (if aggregate demand continued to fall short of supply).

But—and this is a critical “but”—the actual capitalist economy in which we live does not appear to be so violently self-destructive. Of course, booms and slumps have always been with us as different phases of the regular business cycle; but hyperinflations and

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depressions have been rare exceptions in history (although we may be on the brink of another great depression now). This observation must have been the starting point for John Maynard Keynes when he began work on his *General Theory*. He wrote:

It is an outstanding characteristic of the economic system in which we live that, whilst it is subject to severe fluctuations in respect of output and employment, it is not violently unstable. Indeed, it seems capable of remaining in a chronic condition of sub-normal activity for a considerable period without any marked tendency either towards recovery or towards complete collapse.... Fluctuations may start briskly but seem to wear themselves out before they have proceeded to great extremes, and an intermediate situation which is neither desperate nor satisfactory is our normal lot. (*General Theory*, pp. 249-259.)

We are thus led to pose a question that would have sounded paradoxical to those who used to live in the world of Adam Smith: “What saves the capitalist economy from its self-destructive tendency?”

Once the question has been posed in this manner, the answer presents itself immediately, although it appears as paradoxical as the question itself. For it is not hard to notice that the Wicksellian theory of disequilibrium as a cumulative process makes one critical assumption: namely, that the price of every commodity, including labor, will respond flexibly to any disequilibrium between demand and supply. After all, Wicksell was too pure a neoclassical economist to introduce any imperfections into his theory.

As I have already pointed out, Keynes was a Wicksellian when he wrote his *Treatise on Money*¹ and remained so, at least in part, even in *The General Theory*, as exemplified in the following passages:

If ... money wages were to fall without limit whenever there was a tendency for less than full employment ... there would be no resting place below full employment until either the rate of interest was incapable of falling further or wages were zero. (pp.

¹ For instance, Keynes wrote in *A Treatise on Money* that: “[I]f the volume of saving becomes unequal to the cost of new investment [i.e., if aggregate demand becomes unequal to aggregate supply], or if the public disposition towards securities take a turn, even for good reasons, in the bullish or in the bearish direction [i.e., if the natural rate rises above or falls below the market rate of interest], then the fundamental price levels can depart from their equilibrium values without any change having occurred in the quantity of money or in the velocities of circulation.” *A Treatise on Money, Vol. 1: The Pure Theory of Money*, p. 132.)

303-304.)²

Keynes then argued that:

In fact, we must have some factor, the value of which in terms of money is, if not fixed, at least sticky, to give us any stability of values in a monetary system. (p. 304.)

What Keynes pointed to as a factor whose monetary value is, if not fixed, at least sticky, was of course “labour”. In normal wage bargaining, he wrote, “labour stipulates (within limits) for a money-wage rather than a real wage,” for “[w]hilst workers will usually resist a reduction of money-wages, it is not their practice to withdraw their labour whenever there is a rise in the price of wage-goods.” Such behavior is of course “illogical” from the standpoint of neoclassical economics, for it appears to imply that workers suffer from a money illusion and do not care about the purchasing power of their money wages. (p. 9.)³ Keynes, however, argued that “this might not be so illogical at it appears at first,” and then added an enigmatic sentence: “and, . . . fortunately so.” (p. 9.)

In the first place, once we accept that workers are not isolated individuals whose aim is merely to seek their own well-being, but social beings (*zoon politicon*, à la Aristotle) whose main concern is how they stand *vis-à-vis* others in the same social network, it is no longer illogical for workers to resist a reduction of money-wages but not to resist an increase in the price level. One object of workers in wage bargaining is not to determine their real wage but “to protect their *relative* real wage.” Indeed, insofar as there is imperfect mobility of workers across jobs, regions, employers, etc., “any individual or group of individuals, who consent to a reduction of money-wages relatively to others, will suffer a relative reduction in real wages,” whereas “every reduction of real wages, due to a change in the purchasing-power of money ... affects all workers alike,” keeping their relative position more or less intact. (p. 14.)

More fundamentally, we are now able to make sense of Keynes’ enigmatic statement: “and, . . . fortunately so.” It is indeed “fortunate” for the capitalist economy that workers

² Similarly, on p. 269, he wrote: “[I]f labour were to respond to conditions of gradually diminishing employment by offering its services at a gradually diminishing money-wage, this would not, as a rule, have the effect of reducing real wages and might even have the effect of increasing them, through its adverse influence on the volume of output. The chief result of this policy would be to cause a great instability of prices, so violent perhaps as to make business calculations futile in an economic society functioning after the manner of that in which we live.”

³ See George Akerlof and Robert Shiller, *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism*, Princeton University Press: Princeton, 2009; pp. 42-50, for a history of thought on the money illusion.

resist a reduction of money wages but not an increase in the general price level, in line with their self-identity as social beings who care about the fairness of their treatment within a social network. The real paradox is that this seemingly illogical behavior of workers—their money illusion—and the consequent stickiness of the value of wages in terms of money that has given us a degree of stability in our capitalist economy. In other words, it is the presence of “impurities” in the labor market that saves the capitalist economy from its self-destructive tendency! As Keynes himself put it:

To suppose that a flexible wage policy is a right and proper adjunct of a system which on the whole is one of laissez-faire, is the opposite of the truth. (p. 269.)

However, it should be emphasized that this suppression of the cumulative process in no way implies the disappearance of disequilibria from the capitalist economy. On the contrary, the downward stickiness of money wages will merely replace one form of macroeconomic disequilibrium with another. Indeed, under the downward stickiness of money wages, the laissez-faire capitalist economy is subject to severe but not violently unstable fluctuations in output and employment, through the multiplier process of incomes and the acceleration principle of investments. When aggregate demand falls below aggregate supply, the majority of producers who are unable to force a reduction of money wages must reduce the number of workers they employ in order to scale down their output supply. Consumers are forced to curtail consumption in reaction to lower incomes, and producers in turn are forced to cut back on their investment in plant and equipment in reaction to lower profits. Aggregate demand will decline further and set off a second-round reduction of output, employment, and investment, which will then induce a third-round reduction, followed by a fourth, and so on. In the end, the induced fall in aggregate demand will be many times larger than the original fall. Under the downward stickiness of money wages, therefore, laissez-faire capitalism tends to suffer a large amount of inefficiency in the form of chronic underemployment and recurring underutilization of productive capacities.

It was for this reason that Keynes devoted the entirety of *The General Theory* to the study of “the forces which determine changes in the scale of output and employment as a whole” (p. vii). The macroeconomic inefficiencies of underemployment of labor and underutilization of capital are the price we have to pay to tame the inherent instability of general price movements under capitalism.⁴ This is the second form taken by the

⁴ Note that because of governments’ commitment to full employment after the (short-lived) success of Keynesian economics after WWII there emerged an inflationary bias in most advanced

fundamental trade-off between efficiency and stability under capitalism, where everybody has to deal with the object of the purest speculation—money—in their daily economic activities.

capitalist countries and that inflation, rather than unemployment, was the price we had to pay until 1980s.

September 13, 2010

8. The Speculative Nature of Money Holding and the Fundamental Instability of Capitalism

By Iwai, Katsuhito

This is still not the whole story. A cumulative rise or fall in prices may in turn alter the relationship between aggregate demand and aggregate supply, thereby creating new macroeconomic conditions for further developments. Note that a rise in the general price level, or inflation, is equivalent to a depreciation of the value of money, while a fall in the general price level, or deflation, is equivalent to an appreciation of the value of money. It is from this point on that the purely speculative nature of money-holding begins to play a decisive role.

When aggregate demand is set and maintained above aggregate supply, the general price level starts to rise. As long as this is regarded as temporary, there is little change in people's attitudes to their money holding. As inflation persists, however, some people may begin to expect inflation to continue. Once a majority of people come to expect that many others do, the spell is broken. People start to lose confidence in the value of money and try to reduce their money holdings by buying commodities. This tends to stimulate aggregate demand and speeds up the pace of inflation. Fearing a further acceleration of inflation, people stampede to unload their money holdings by snatching up any commodity available. Inflation accelerates even more, confirming consumers' fears. The economy now enters into the hyperinflation phase, triggering a full-scale flight from money. Eventually, nobody is willing to accept money as money anymore, and it is reduced to an insignificant sheet of paper or a useless disc of metal, and the economy collapses, reverting to the most primitive system of barter exchanges. What we have seen

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is a bust of money as money.¹

Conversely, when aggregate demand is maintained below aggregate supply, the general price level start to fall, and once a significant number of people start to anticipate that other people expect deflation to continue, they may come to desire money, itself no more than a medium of exchange for commodities, more than the commodities themselves. This tends to dampen aggregate demand and causes further deflation, meaning that the value of money rises still more relative to commodities in general. This in turn makes people even more inclined to hold on to their money. In the end, the economy falls into a depression, in which nobody wants to buy anything. This is a bubble of money as money.

Of course, as long as a certain form of outside money (mostly bills and coins issued by central banks and governments) is being used for economic payments, cumulative inflation will have the effect of reducing its real value and may work to narrow the gap between aggregate demand and aggregate supply, either by discouraging directly the demand for consumption goods (the so-called Pigou effect) or indirectly the demand for investment goods through the tightening of financial markets (the so-called Keynes effect). However, we now know that the effects of rising prices on the private debt/credit structure in financial markets have far stronger opposite effects. So long as they are not anticipated in advance, rising prices have the effect of transferring real purchasing power from the holders of private financial debts to their issuers, by relieving the real indebtedness of the latter. Since debtors are likely to have a higher propensity to spend out of their wealth than creditors, this redistributive effect of private debts is sufficient to exert a destabilizing effect. Moreover, the relief of the indebtedness of private debtors effected by rising prices may encourage them to deepen their indebtedness further by issuing more debt or by replacing their short-term debts in maturity with long-term debts. This injects new liquidity into financial markets and encourages both consumption and investment spending still more. This may be called “the debt-inflation process.”

The same argument applies equally well (indeed, more strongly) to the case of a cumulative fall in prices. Indeed, Irving Fisher, having lost both his academic reputation

¹ Wicksell was well aware of this possibility. He wrote: “We may go further. The upward movement of prices will in some measure ‘create its own draught’. When prices have been rising steadily for some time, entrepreneurs will begin to reckon on the basis not merely of the prices already attained, but of a further rise in prices. The effect on supply and demand is clearly the same as that of a corresponding easing of credit.” (*Ibid.*, p. 96.)

and financial wealth in the Great Depression whose occurrence he had denied publicly and speculated against privately, came to the view that the process of debt deflation (the reverse of debt inflation), was the chief cause of the Great Depression. His post-Depression view was elaborated further by Hyman P. Minsky.² Besides, in what Wicksell called the “pure credit economy,” where all payments are effected by means of bookkeeping transfers through the private banking system, there is no room for a stabilizer to work.³

Wicksell’s theory was an emancipation from the spell of the “invisible hand”—or at least, a first step away from it. In contrast to an equilibrium between the demand and supply of an individual commodity, an equilibrium between aggregate demand and aggregate supply has no self-regulating tendency in itself; any deviation from it will trigger a disequilibrium process that drives the general price level cumulatively away from a state of equilibrium. What is more, the purely speculative nature of money-holding makes matters worse by widening the disequilibrium between aggregate demand and aggregate supply and throwing the economy into hyperinflation or depression. Not only is the “invisible hand” not working—it is causing the instability of the capitalist economy. The world of Adam Smith has been turned upside down.

We human beings stumbled upon money in the dim and distant past. It was the cause of the original move toward greater efficiency in economic activity, removing the inconvenience of barter trade and freeing economic exchanges from restrictions of time, space, and individuals. Without money, the grand economic structure of global capitalism could not stand. But at the same time, it is money that makes it possible for depressions and hyperinflation to occur. This is the fundamental trade-off between efficiency and stability under a capitalist system.

² Irving Fisher, *Booms and Depressions: Some First Principles*, Adelphi, 1932; -----, “The Debt-deflation Theory of Great Depressions,” *Econometrica*, 1(3), 1933, pp. 337-57; Hyman P. Minsky, *Can “It” Happen Again? – Essays on Instability and Finance*, M. E. Sharpe: New York, 1982; -----, *Stabilizing an Unstable Economy*, New Haven: Yale University Press, 1984, reprinted by McGraw Hill: New York, 2008.

³ *Interest and Prices*; pp.70-71.

August 9, 2010

Craft, Community, and the Cost of Global Capitalism

By Kato, Hideki

At a time when baskets mass-produced in China can be had for a few hundred yen, who would pay a hundred times that for a similar basket—an everyday item, after all—laboriously hand-woven in conformance with traditional Japanese techniques? That consumer selection would weed out such items and doom them to extinction on the marketplace seems inevitable. “It’s too bad,” we say, “but that’s life.”

But before we dismiss handwork as a quaint relic of the past, we need to understand just what it is we are dismissing. The creation of a single hand-made object entails a multitude of processes, beginning with the gathering of materials. Hand-woven textiles, for example, require not just weavers but also people to spin the thread, dye it, and so forth. Those occupations shape the lifestyles of the people engaged in them, and those lifestyles differ from one another as a result. In the past, the need for all these different people to collaborate, interact, and deal with one another led to the development of complex social customs, rules, and mores. In time this interaction evolved into a network of social relationships—a community, in other words—in which people came together for festivals, celebrations, and solemnities. In this way whole cultures evolved.

Urbanization, economic globalization, and the triumph of money as the be-all and end-all of our economy and society have driven the hand-made object from our midst and in the process destroyed the foundation of communities and cultures that evolved over the centuries. Needless to say, this phenomenon is not limited to Japan. Leaving aside certain luxury goods produced for the wealthy—Kashmiri rugs, English furniture, Italian leather—cheap, mass-produced goods have taken the place of hand-made objects

Kato, Hideki *President of the Tokyo Foundation. Joined the Ministry of Finance in 1973. Served in several positions, including in the Securities Bureau, the Tax Bureau, the International Finance Bureau, and the Institute of Fiscal and Monetary Policy; resigned in September 1996. Founded Japan Initiative, a not-for-profit, independent think tank, in April 1997, serving as its president since then. Served as professor of policy management at Keio University, 1997-2008. Assumed the chairmanship of the Tokyo Foundation in April 2006. In October 2009 became secretary general of Japan’s Council on Administrative Reform within the Cabinet Office, and in April 2010 became president of the Tokyo Foundation when it became a public interest incorporated foundation.*

in the daily lives of consumers around the world, and as a result, the communities that grew up around handicraft economies are now either extinct or endangered.

We need look no further than Tokyo to get a sense of where this trend leads. With money, one can do or get almost anything in Tokyo. But without money, one can do almost nothing, because the ties that once bound people to one another have all but dissolved. The harsh truth of this was driven home late in 2008, when thousands of temporary workers who had lost their jobs and homes in the wake of the October financial crisis converged on Hibiya Park seeking food and shelter to tide them over to the new year.

When a mass-produced basket replaces a hand-woven basket, little or nothing is sacrificed in terms of the basket's function. But something else is lost. In a series of articles, using a mundane basket as our starting point, a fast-disappearing way of life will be explored in an effort to better understand what it is we are losing and whether it is something we can really afford to lose.



Hand-woven baskets like these, most often made from bamboo, were ubiquitous in rural villages, where farmers, fishers, peddlers, and others used them to carry goods of all kinds on their backs. (Courtesy of Shikoku-mura)

* * *

About the Series “Craft, Community, and the Cost of Global Capitalism”

In a world awash in mass-produced goods, hand-crafted articles seem destined to vanish from our lives, except perhaps as luxuries, curiosities, or hobbies. As handicraft industries succumb to urbanization and globalization, communities succumb as well. This series examines a vanishing way of life from a variety of angles; explores the implications of its disappearance for society, culture, and the environment; and raises serious questions about the costs of global capitalism.

August 4, 2010

The Upper House Vote and the Process of “Creative Destruction”

By Curtis, Gerald L.

The Democratic Party of Japan’s setback in the July 11 House of Councillors election has produced “a political gridlock worse than anything Japan has experienced in half a century,” notes Gerald Curtis, a Tokyo Foundation senior fellow and the Burgess professor of political science at Columbia University. This is part of a process of “creative destruction,” though, that Japan must pass through to create an effective and responsive government.

QUESTION: How do you analyze the results of the July 11 House of Councillors election?

GERALD CURTIS: The election results have produced a gridlock worse than anything Japan has experienced in half a century. It’s much worse than the situation the Liberal Democratic Party faced before it lost power to the DPJ, when it had a two-thirds majority in the House of Representatives. The Democratic Party of Japan doesn’t have that now, so it will be unable to override a House of Councillors rejection to pass key pieces of legislation.

The DPJ will have to find other parties that will agree with it on specific pieces of legislation. The possibility of this happening, though, is very small. Much likelier is that the LDP, Minna no To (Your Party), and Komeito will resist making policy agreements with the DPJ because they will feel that if they vote with Prime Minister Naoto Kan, they’ll be helping him out. So they’ll take an uncompromising position, demanding that he swallow their position whole. Rather than make policy agreements, they are likely to put a lot of pressure on Kan to dissolve the Diet. This Diet is not likely to last for three more years. This political standoff will prevent the country from dealing with many

Curtis, Gerald L. Senior Fellow of the Tokyo Foundation. Burgess Professor of Political Science, Columbia University. After earning a social science degree from the University of New Mexico in 1962, attended Columbia University, where he got his MA (1964) and PhD (1969) in political science. Went on to serve as assistant professor and associate professor at Columbia, where he was also director of the Weatherhead East Asian Institute from 1974 to 1990. Became a full professor in 1976. From 2000 to 2006 was a visiting professor at the National Graduate Institute for Policy Studies. In 2004 was awarded the Order of the Rising Sun, Gold and Silver Star, one of the highest imperial honors.

important issues, regarding both domestic and foreign policy.

What we're observing now in the Japanese government is part of a process of "creative destruction." Eventually a new political party system and new decision making mechanisms will emerge to replace the system that existed under nearly a half century of LDP rule, but to create something new means destroying things that currently exist. Right now it is easier to see the destruction than the creation but clearly Japanese politics is in a phase of major change and evolution. This may be good news for Japan in the long run, but the short term consequences are mostly negative. There's a very good chance that the next lower house election will result in an even more confused political situation. It is conceivable that there will be a major party realignment. This is likely to produce weak and ineffective governments for some time to come.

It would have been much better if the DPJ had won a majority in the upper house election. Then its responsibility for the government's performance would be clear and the voters would be able to hold it accountable in the next lower house election. Under this gridlock situation, each party will be blaming the other for the government's failure to deal with the nation's problems and the public will find it hard to choose among them.

Public unhappiness with the choices given them was evident in this election. The LDP won more seats, but the DPJ won more votes nationwide. Public opinion polls show declining support for the DPJ but no increase in support for the LDP. They're disappointed with the DPJ, but they're not attracted by the LDP either. The voters want to be led, they want a party that can persuade them about what needs to be done, but they're not getting it in any of the choices presented to them. The public is looking for politicians who have a compelling vision about where the country should be heading and how to get there.

QUESTION: What are the prospects of running into such a leader?

CURTIS: You never know who that leader is until he shows up. No one expected Junichiro Koizumi to be so popular. He wound up staying in office almost longer than anyone else in the postwar period. He was enormously popular but he was not a populist. He didn't tell the public what he thought they wanted to hear; he told them that the country needed to take risks, to do things differently in order to prosper. And the public believed in him and therefore supported his policies. Some people thought Kan might show a Koizumi-like determination and rally public support, but the way he raised and then

waffled on the issue of increasing the consumption tax badly damaged his image.

QUESTION: Perhaps the lack of visionary political leader is a problem with the electoral system, with the campaign period being so short, so candidates aren't really tested before they enter office.

CURTIS: There no doubt are structural factors that contribute to the paucity of political leadership in Japan. The rapid turnover of prime ministers cannot be simply a coincidence. The mostly single-member district system is inappropriate for Japan. This is a society without deep social cleavages along the lines of religion, ethnicity, race, class, and so on, so that with a two-party system, the two major parties invariably wind up being very similar. That's why there have been these wide swings in voter support since the single-member districts were created.

In Britain or the United States, where you still have strong cleavages based on region, religion, and race, there's a core base of support for each party, and there's fundamental stability. But here, neither party has an anchor in society. Japan would be much better off going back to a modified system of multiple-seat districts or adopting a fully proportional representation system.

The election law's excessive restrictions on campaign practices keeps politicians campaigning as they did decades ago even though the society has changed enormously; Politicians are still going around with loudspeakers on their trucks blaring out their names and saying please vote for me. This is because most campaign practices that are usual in other countries are prohibited here: no door-to-door calls, limits on the written materials you can distribute, no freedom to use the Internet during the campaign period, and so on.

In recent years the LDP and the DPJ have adopted a policy where if the party president resigns the person chosen to replace him has to serve out the term of his predecessor and then stand for election again. So instead of Kan being elected to a regular two year term as DPJ president when Prime Minister Hatoyama resigned, he is serving out Hatoyama's term and has to face an election in September.

QUESTION: What can Kan do to stabilize the political situation?

CURTIS: There're only two things he can do. One is to appeal to other parties to support particular policy initiatives and compromise with other parties on key issues. There has

to be a willingness on the part of Kan and the DPJ to make the Diet the central site for actual policy formulation and to find new ways to cooperate across party lines.

In Japan, the practice has been for the bureaucracy to draft policy and for the cabinet to submit it to the Diet, and the Diet either passes it or doesn't pass it. But the idea of actually writing legislation in Diet committees—or even revising them—doesn't happen here, or very rarely, so this is an opportunity to make the Diet an important site for actual policy formulation.

The second thing he has to do is find ways to appeal to the public for support. The key to effective political leadership in a democracy is the power to persuade. For American politicians this is common sense. President Barack Obama was tireless in trying to convince the public to support his health care reform and to use public support to pressure Congress to go along. But few Japanese politicians operate from this assumption. Koizumi did, but he was the exception. The question is whether Prime Minister Kan will be able to communicate to the public, build support for his policies, pressure the opposition parties to compromise and forge policy agreements across party lines. I am not very optimistic, and if he does not succeed, the political system will be immobilized.

QUESTION: Advances were made by women legislators in the most recent election, with Renho being one of top vote garnerers. Do you think this indicates a trend?

CURTIS: There are a couple of trends going on. One is that there are more professional women in Japan who are interested in careers in politics, such as Yukari Sato and Satsuki Katayama, both of whom were defeated in the last lower house election and came back and won in the upper house election. These are serious women who have had serious careers before entering politics. But the sample is still small because women have had few opportunities for advancement. The disadvantages of being a woman in Japan are still greater than in other countries.

The other trend is for parties to run women simply because they're pretty or because they have name recognition. This is demeaning to women. There are a lot of women in politics who are there because the LDP and the DPJ thought they could win for reasons that have nothing to do with politics. So, ironically, I think the larger number of the women reflects a kind of chauvinistic mentality.

Renho was a TV announcer, but she's also a serious politician. The motivation for

running so many women, though, reflects values in this society that partly explain why women are disadvantaged in professional life.

QUESTION: What are the foreign policy implications of the DPJ administration? How will the alliance with the United States be affected?

CURTIS: The United States wants to have a good relationship with Japan and that means having a close and positive relationship with the Japanese prime minister. But ever since Koizumi left office, there hasn't been a prime minister who has survived more than a year in office. So while the desire to have a strong relationship is there, there is a natural reluctance to invest a lot of time and energy in developing personal relations with a government leadership unless you can be fairly confident that they're still going to around for awhile. The combination of political instability in Japan and the controversy that emerged over the issue of relocating the Marine Air Station at Futenma has made it difficult for the United States and Japan to engage with each other as fully as they should on larger issues, like the environment, energy, nontraditional security threats, and how to cooperate in ensuring stability in East Asia.

QUESTION: Talk of hiking the consumption tax probably cost the DPJ the election, but the fiscal situation is something that must be addressed. How should the public debt be dealt with?

CURTIS: Unlike the situation when Ryutaro Hashimoto or Noboru Takeshita was prime minister, the majority of Japanese seem to feel that an increase in the consumption tax is unavoidable. Unfortunately, because of the way Kan raised this issue, he actually set back the timing of introducing an increase.

Increasing the consumption tax without having some kind of strategy to increase growth, though, will only depress the economy. So this has to be part of a broader tax and spending reform package. One thing Japan could do to increase government revenue without a tax increase is to introduce a taxpayer identification system. If every taxpayer had the equivalent of the social security number used in the United States there would be far less tax evasion.

Coming back to the election results and the long-term positive effects of "creative destruction," last year's lower house election produced the biggest turnover of the members of parliament since the purge under the Allied Occupation. The LDP will no doubt increase its seats in the next lower house election and that too will bring in new

people into the Diet, so over a period of five years or so, there's going to be hundreds of new Diet members. There are seventy to eighty DPJ politicians serving as cabinet ministers, senior vice ministers, parliamentary secretaries and the like. They are gaining experience in how to run a government and over time some of them will emerge as impressive political leaders. New blood in the Diet will result in changes in the relationship between politicians and bureaucrats, and the Diet will play a more central role in policymaking. In the long term, these are positive, creative developments, as the system will become more transparent and politicians will come to understand that you really have to persuade the public.

August 2, 2010

The Changing Face of the Obama Administration at Home and Abroad

By Kubo, Fumiaki

Domestic Policy

The Passing of the Health Insurance Reform Bill and Its Significance for Democrats in Congress

With public opinion largely opposed to the health insurance reform bill immediately before voting in Congress began, views were divided on whether it was better for the Democrats to pass the bill or allow it to fail. In particular, there was considerable debate on the impact the bill might have on the midterm elections later this year. Two things need to be looked at in this context: the significance of the bill for Democrats in Congress, and its significance for the president.

For congressional Democrats, the situation is complex. Indeed, in a strict sense the calculus differs for each member of Congress. For members elected from districts with strong Democratic support, the passing of a bill with such historic significance was a major positive. But the situation is different for many members from conservative districts where Republicans enjoy strong support: for these members, their prospects in November's midterm elections might have been better if they had voted against the bill.

Of Democrats elected to the House of Representatives in the 2008 elections, 49 are from electoral districts in which John McCain polled ahead of Barack Obama (see "Analysis of Voting Patterns on Major Bills During the First Session of the 111th Congress," available in Japanese only). With Obama beating McCain by an average of 7 percentage points nationally (53% versus 46%), districts where McCain received a greater share of the vote tended to be traditionally conservative areas. These are districts that might normally be expected to elect a Republican to Congress.

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With the winds of public opinion blowing strongly in their favor, the Democrats made substantial gains in the House elections of 2006 and 2008, winning seats far beyond their traditional areas of support, including conservative districts that had traditionally voted Republican, or where there had previously been close competition between the two parties. In a sense, these elections swelled the Democratic presence in the House of Representatives beyond its natural levels.

Would the Obama administration be better placed with these districts under Democratic or Republican control? The question is not black and white. Given the essentially conservative nature of these districts, it can hardly be expected that a Democrat representative will vote in support of all the party's basic policies. This is one of the biggest differences between a parliamentary cabinet system and the American presidential system.

But given the current ideological antagonism between the two parties, there is also little to no chance that a Republican will vote in favor of any Democratic proposals, and certainly no chance that such support will come from a member representing one of these conservative districts. At the very least, the administration can hope for some degree of support on some measures from a Democrat. The difference may seem small, but in a close vote it can make all the difference.

The midterm elections in November 2010 will be extremely tough for many congressional Democrats. Democrats who voted against the bill risk losing votes from faithful Democratic supporters, with little prospect of a corresponding increase in popularity among Republican voters. Meanwhile, Democrats who voted in favor of the plan can expect votes from committed supporters of the Democratic Party and President Obama, but will come in for stronger opposition than ever from conservative factions led by the Tea Party movement.

The Passing of the Health Insurance Reform Bill and Its Significance for President Obama

For President Obama, on the other hand, the passing of the health insurance reform bill was a vitally important victory. Many people warned that Obama risked becoming "another Jimmy Carter" if it failed, unable to get any legislation through Congress at all. Indeed, the bill seemed doomed to failure after the Democrats lost in January's special election in Massachusetts, thereby forfeiting its special majority in the Senate. But Obama was determined to block the opposition's attempted filibuster and push the bill through, demonstrating considerable confidence and strength. This is an important

image for the US president to project. Having passed legislation that will aim to provide health insurance to all US citizens a full century after the idea was first put forward by President Theodore Roosevelt, Obama can lay claim to a historic achievement.

These successes may have little bearing on the midterm elections, but they will surely be important factors when the presidential elections come around again in 2012. “The cynics said it couldn’t be done, but by working together the American people achieved a miracle”—we heard phrases like this many times in 2008, and we are likely to hear them again. We can also expect to hear similar remarks alluding to the agreement with Russia on nuclear arms reductions.

But it cannot be denied that getting the bill passed came at a high price. President Obama and his team of advisors and analysts worked hard to learn from the experience of the Bill Clinton administration, which failed at passing similar reforms in 1993–94. It was imagined that if a plan were drawn up in the White House first and then put before Congress, not even Democratic members could be relied on for support (this is in fact what happened in 1994). Instead, the president’s team decided to leave much of the bill-writing process to Democrats in Congress.

Timing also played a part, particularly the high levels of support enjoyed by Obama early on in his presidency and the sense of crisis enveloping US society. The Obama administration hoped to tap into this feeling. The sense of crisis that followed the financial crisis gave the president and his team confidence that they could pass bills that would normally stand little chance of getting through. (The massive financial stimulus package approved in February 2009 was one example of this.)

Another consideration that seems likely to have played a part in the decision to entrust the process to congressional Democrats was a reluctance to avoid wasting large amounts of time cobbling together a White House plan, as the Clinton administration did. And President Obama had to conclude that neither he nor his staff had what it would take to draw up a proposal swiftly on their own.

It is now widely acknowledged that these judgments were substantially mistaken, and that as a result of the proposal the administration continued to hemorrhage support throughout the summer of 2009.

At a Tokyo Foundation seminar held on December 4, 2009, Simon Rosenberg, president of Washington-based think tank NDN, pointed to a middle way between the approaches

taken by the Clinton and Obama administrations. Instead of putting together a plan behind closed doors in the White House, the administration could instead outline a number of basic principles and then leave the congressional Democrats to formulate a bill based on these. This is the approach being taken with financial reform, and Rosenberg suggested that this would be a more effective strategy.

Instead, Obama handed over the decision-making process to congressional Democrats and left them to formulate whatever plan they could agree on. It was a close-run thing, but the Democrats in Congress did eventually hammer out a bill, which passed. But this came at an extremely high cost in terms of public support. One reason was that the various proposals put forward by Democratic members of Congress—radical ones in particular—were attacked by Republicans as part of the “Obama plan.” Another factor was the disconnect that existed between the government’s determination to push ahead with healthcare reform and the desire of the electorate for a response to concerns about the economy and employment.

The Administration Strikes Back

Starting in January 2009, the Obama administration tried to gain a degree of support from Republicans for its health insurance plans, but to no avail. Eventually, the bill squeezed through with Democratic support alone. Republicans griped that even President Lyndon Johnson had managed to achieve significant support from Republicans for his healthcare reforms. But it is essential to remember that the Republican Party in the 1960s still contained liberal elements, and was quite different from the party it has become today.

At this stage, there was an interesting development. In April 2009, Obama abandoned an election pledge and spoke in favor of drilling for oil in offshore areas. This represented a major concession to the Republicans, aimed at providing much-needed momentum to the energy and environment bill then languishing in Congress. Conservatives complained that the president’s concessions were still not enough. But although the health insurance reform bill was eventually forced through with Democratic support alone, it would not be surprising if the administration had decided after this that similar tactics were unlikely to succeed again in the future. It is likely that the difficulties the administration experienced in getting the health insurance bill passed will bring about a dramatic change of tack.

Offshore drilling was a source of direct confrontation between Obama and McCain

during the 2008 presidential election, when chants of “Drill, Baby, Drill” were heard at the Republican National Convention and at other venues throughout the election campaign.

The Obama administration’s recent shift in direction has been reported in some quarters as part of a compromise designed to win Republican support for its energy and environmental bill. Conservatives insist scornfully that the concessions remain insufficient. Democrat-friendly environmental groups, on the other hand, have been shocked and outraged by the move.

It is doubtful whether these compromises will achieve the hoped-for results. At the moment, it looks as though the bill will struggle to get through Congress. It is also possible that the oil spill that hit the Gulf of Mexico in April will harden public opinion against offshore drilling. Nevertheless, the administration’s recent changes of strategy provide significant hints of the kinds of measures it may resort to in the future when circumstances require it.

Diplomacy

Breaking with the Previous Administration

In pushing forward its domestic agenda, the Obama administration has regularly encountered stiff opposition from the Republican Party, with only a handful of Republicans in the Senate supporting the administration’s massive financial stimulus package.

Although the context is different, a similar tendency can be seen in foreign policy. In its early days, the administration’s basic approach was to emphasize the differences and discontinuities between the new government and the “arrogant” and “unilateral” foreign policy of the George W. Bush administration. The Obama administration was eager to show readiness to engage in dialogue and negotiation. Rather than showing the way or simply giving orders, the United States would listen carefully to what other countries had to say. This attitude was at the forefront of the administration’s early efforts to engage with the world.

At a paper presented at this year’s Brussels Forum, this attitude was characterized as reflective of a firm sense of faith in a “rational” world. One might call it a diplomacy of reason (see Constanze Stelzenmüller, “End of a Honeymoon: Obama and Europe, One

Year Later,” <http://www.gmfus.org/brusselsforum/2010/docs/BF2010-Paper-Stelzenmuller.pdf>).

This more open attitude in foreign policy was a major priority for the Obama administration at the time of its inauguration. Apart from anything else, the strategy was worthwhile from the point of view of a simple calculation of interests. As president, Barack Obama knew that there were gains to be made by emphasizing to the world and his fellow Americans (with the exception of Republican hawks) that another, different America existed. And he hoped that with luck, the goodwill toward Obama’s America could be translated into soft power and might produce concrete benefits.

More concretely, Obama offered the possibility of direct negotiations with Iran and North Korea, reached out to the Islamic world with a speech in Cairo, and threw himself into peace mediations in the Middle East. In Asia, the new president showed an attitude of respect and dialogue toward both Japan and China. Symbolic of this approach were the visit by Hillary Clinton as secretary of state to the inner area of the Meiji Shrine in Tokyo and President Obama’s respectful bow to the Japanese emperor.

It would be difficult to deny that there was an aspect of naiveté to these initiatives. But probably there is more to it than that. The approach is genuinely different from what it might have been if the administration had adopted a tough stance from the outset, and can reasonably be expected to produce different results. Firstly, there is the impact within the United States. The bedrock of Obama’s support is on the left wing of the Democratic Party. These supporters are likely to be more amenable to tough policies once they see that a more flexible approach has been tried and has not produced results.

The approach may have a similar effect internationally. Widespread backlash against the United States would have been likely from a number of countries and powers had the Obama administration used sanctions or the threat of them from the outset. People would have objected that the new government’s policies were no different from those under Bush. But if the tough approach comes at the end of a steady process, there is a good chance that at least some of these countries will accept the stronger measures.

But the approach is not without its own difficulties and dangers. If things do not go according to plan, when will the administration be able to change tack? The longer the delay, the more likely it becomes that the administration’s initial approach will be dismissed as having failed. What about Obama’s diplomacy?

A Shift in Approach

Obama's foreign policy is undergoing significant change at present. The administration has been taking a noticeably tougher stance—relatively quickly in the case of North Korea, and since the second half of 2009, toward Iran and China too.

This change is at least partly due to differences between Hillary Clinton and Barack Obama, and between the Department of State and the White House. The Department of State has supported tough conventional policies, while the White House has been in favor of trying a more innovative and flexible approach. During the battle to secure the Democratic nomination for the presidency, Obama claimed that he would be prepared to meet the leader of any country without conditions, while Clinton pointed out the naiveté of this approach and the risks inherent in it. Today, Obama is drawing closer to Clinton's position.

From the start, Obama had no intention of depending on a softly-softly approach alone, as shown by his hints to Israel of a deadline for progress in Iran by the end of 2009. But what are the reasons beyond the recent shift in tone of Obama's foreign diplomacy?

The chief reason is that his initial approach produced almost no results. This can be seen even in dealings with members of the North Atlantic Treaty Organization, America's most trusted and reliable allies. In spring 2009, President Obama made a round of visits to various European countries, calling for a massive economic stimulus package and increased contributions in Afghanistan. The results were disappointing (see Fumiaki Kubo, "Three Months of Obama Diplomacy and US Relations with Japan and Europe," <http://www.tkfd.or.jp/topics/detail.php?id=136>, available in Japanese only).

In her paper at the 2010 Brussels Forum, Stelzenmüller pointed out that even among allies of the United States (including Turkey and Japan), there is a lack of respect for Obama and the country he represents.

Some countries, of course, did not respond positively to the flexible approach at all. North Korea responded by launching missiles and carrying out nuclear tests. In Iran, opposition supporters were openly suppressed during the violence that followed the presidential elections, and there was no sign of progress in terms of Iran's nuclear weapons program. Although domestic considerations may have been the biggest reason, it is undeniably true that developments in these countries did not go the way the United States would have wanted.

China has proved a particularly difficult partner to deal with. The administration's approach was to play down the points of contention between the two countries, preferring to prioritize the need for cooperation and negotiation. Obama has looked for cooperation from China on a wide variety of issues. The most important of these issues was help on economic stimulus policies, but they also included currency, trade, North Korea, Iran, and the environment. The results of this modest approach, however, were negligible. China pushed through the large-scale economic stimulus policy it needed itself, but Obama's dialogue with citizens during his visit to China was edited before it was broadcast. In summer 2009, Obama decided not to meet the Dalai Lama. Despite this, China was distinctly chilly in its attitude to the United States in Copenhagen at the end of the year.

Meanwhile, the Obama administration began to adjust its approach to China. Trade frictions had already come to the surface during 2009, and at the end of the year the United States decided to sell weapons to Taiwan. In the New Year, after this decision had been made, the Google problem hit. Google announced that it was no longer prepared to cooperate with Chinese government censorship, and made clear that it would withdraw from the Chinese market if this policy was not accepted. There were also reports that the government had been monitoring the e-mail correspondence of human rights activists and was involved in attempted intellectual property infringements affecting at least 34 US companies (see "Google China Cyberattack Part of Vast Espionage Campaign, Experts Say,") <http://www.washingtonpost.com/wp-dyn/content/article/2010/01/13/AR2010011300359.html>).

These issues involved human rights, intellectual property infringements, and even—in the case of cyber security—national security. In other words, aspects of these issues impinged directly on the national interest in a number of ways. In a telephone interview from Washington in February, Chris Nelson of Samuels International Associates, Inc. suggested that the friction could even result in a loss of support for China among pro-China factions in the US business world. Even allowing for exaggeration, there can be little doubt that the tensions must have reminded a number of companies of the risks they were taking by doing business in China.

There were good reasons for the Obama administration to take the problems seriously. Under Hillary Clinton, the Department of State was moving to use the Internet as a promotional and public diplomacy tool. This would make it possible to communicate directly with ordinary people around the world. Invited to speak at the Tokyo

Foundation in December 2009, President Simon Rosenberg of NDN talked about the protest movement in Iran and how it had been able to communicate what was happening there to the outside world via the Internet. Rosenberg argued persuasively that the Internet would be of primary importance to American human rights diplomacy efforts in the years to come.

Secretary of State Hillary Clinton has appointed Alec Ross as senior advisor for innovation. Ross's particular priority is to optimize the use of the Internet in foreign relations.

This was the context behind a January 21, 2010 speech by Clinton on the subject of Internet freedom, in which she criticized China and other countries for Internet censorship, using terms such as "Iron Curtain" and "Berlin Wall." Under the Obama administration, the Department of State is treating the Google issue as a serious and important matter.

Ross and NDN's Rosenberg have been collaborators for some time. NDN recently invited Ross to give a talk (Japan's ambassador to the United States Ichiro Fujisaki also spoke at the same venue on April 7). Venues such as this provide insight into the Democratic Party's core networks (<http://ndn.org/blog/2010/03/freedom-21st-century-alec-ross-speak-internet-freedom>).

There was further tension with China in 2010 over appreciation of the renminbi, with the Chinese currency again pegged to the dollar since the financial crisis. Even more importantly the Obama administration, worried by dwindling levels of support, switched its domestic priorities from health insurance reform to job creation. In the United States, there were calls from both the executive branch and Congress for a revaluation of the renminbi.

Relations with China began to improve around the time of the nuclear security summit in April. The Obama administration agreed to postpone a decision on whether to cite China for currency manipulation, while the Chinese president agreed to attend the summit. China also moved closer to America on the subject of sanctions against Iran.

However, the United States has still not definitely decided not to cite China for currency manipulation, and Chinese cooperation on sanctions against Iran is lacking in substance. There is every chance the current thaw will be nothing more than a temporary improvement in relations.

Of course, the administration's stance toward China has not necessarily toughened because of a lack of results with previous methods. It is likely that the sale of weapons to Taiwan was part of a strategy decided in advance. However, Obama's meeting with the Dalai Lama in 2010 after refusing to meet him in 2009 can only have come about as the result of a deliberate change of policy.

The biggest dilemma facing President Obama is Iran. To date, Iran has not responded positively either to America's flexible overtures or to its more hawkish pronouncements. At present the United States is looking at imposing sanctions through the Department of the Treasury, and is planning to impose further sanctions through the UN Security Council. For this to happen, the United States would need the cooperation of China and Russia—and at the moment it is far from certain whether the kind of effective sanctions the Obama administration hopes for will ever become a reality.

Obama has already approved two separate increases in troop numbers in Afghanistan, and has demonstrated a determination to continue the fight. Even when accepting the Nobel Peace Prize, Obama continued to emphasize the importance of being prepared to fight. This is another issue that may have an important bearing on his chances of reelection.

Foreign Policy Achievements

Probably the biggest achievement of the Obama administration in nearly a year and a half since its inauguration has been the agreement with Russia on strategic nuclear arms limitations.

A quite different approach to relations with Russia was possible when the new government came into office in January 2009. The United States might well have decided on a policy of containment against Russia, owing to factors such as the head-on collision over America's plans to deploy an antimissile defense system, Russia's ongoing drift away from democratization, and its invasion of Georgia—one of a number of acts designed to reassert Russian influence over the country's previous zone of control. It is likely that many of McCain's advisors, at least the neoconservative faction among them, thought in this way.

The contending view was that reducing the number of nuclear warheads and the burden they imposed on the budget would bring benefits to both sides, and that with the right persuasion Russia might be a potential partner in dealing with Iran and its nuclear

program. The Obama administration chose the latter option, announcing as it opened talks on strategic nuclear arms limitations that it was “resetting” the relationship between the two countries. Although the passage was rougher than expected, in the end the two sides did manage to reach an agreement.

Of course, it is still unclear whether the treaty will be ratified in the Senate. Some critics have hinted that the actual reductions will not be as substantial as the text of the pact suggests. And the United States and Russia have yet to reach any fundamental and substantial agreement on the deployment of missile defense systems in the future.

And yet if the new treaty is ratified, it is likely to become one of the Obama administration’s major achievements, along with health insurance reform. In fact, it can be described as the administration’s only real foreign success so far. It is likely that US–Russian relations would become more stable overall with the agreement in place than without it.

These achievements will probably play a very little role in terms of helping Democratic members of Congress in the midterm elections this November. Come the presidential elections in 2012, however, it is likely that President Obama will point to the administration’s three biggest achievements so far—the massive financial stimulus package passed in February 2009, the national health insurance reform bill, and the strategic nuclear arms reduction treaty with Russia—as evidence that he deserves another term. Obama will probably try to sell himself to voters as a “can-do” president capable of getting things done.

In pushing through these latter two measures, Obama is seen in many quarters as having demonstrated strength. When the Democrats lost the Massachusetts special Senate election in January this year, many predicted that the health insurance reform bill would not pass. Overtures to the Republican Party failed to yield results. But President Obama persevered assertively with the work of persuading Democrats in Congress, and eventually succeeded in getting the bill passed, albeit by a narrow margin. People grumbled that negotiations with Russia were more difficult than expected, but here too Obama was eventually able to steer negotiations toward an agreement without being blown off course by the controversy surrounding US plans to deploy a missile defense system.

In the early days of his presidency, Obama was sometimes seen as “weak”—a gifted orator but a leader whose conciliatory attitude made him prone to surrender and

compromise. The president has succeeded in changing this image to some extent.

Evaluating Obama's Diplomacy

Obama's foreign policy cannot be easily summed up in a few words, particularly as the administration's approach to diplomacy is currently undergoing substantial change.

In the early days of his presidential campaign, Obama made opposition to the Iraq war a central pillar of his foreign policy, relying on the left wing or antiwar faction of the Democratic Party for the bedrock of his support. It was the antiwar aspect of his approach that stood out first. His claim during the election campaign that he would be prepared to meet the leaders of Iran and North Korea without conditions was part of this same approach.

At the same time, however, the president regularly emphasized the need to continue fighting decisively in Afghanistan. From the beginning, in other words, Obama was never a straightforward dove. Some claim that the president was forced to take this approach in order to defeat first Hillary Clinton and then John McCain, regardless of his own view. But the Nobel Peace Prize acceptance speech makes it more likely that the president believes in the idea of a just war.

It has become clear by now that Obama is in some respects a realist, or that there is a pragmatic tendency to his strategy. In fact, these tendencies were noted from the very beginning of his administration. Obama was quick after his inauguration to contact people such as Colin Powell and Brent Scowcroft. Powell is well known for having officially endorsed Obama during the final stages of the election campaign. Obama reappointed Robert Gates, a famous pragmatist, as secretary of defense, and chose James Jones to be his national security advisor.

In an article published in the *New York Times* on April 14, 2010, Peter Baker argued that Obama's foreign policy represented a shift to *realpolitik* from the human-rights-focused diplomacy of Democratic predecessors such as Jimmy Carter and Bill Clinton (Peter Baker, "Obama Puts His Own Mark on Foreign Policy Issues," April 14, 2010, *New York Times*).

In the article, Obama comes in for praise for his diplomacy at the nuclear security summit involving 47 countries in April this year, where it was widely believed that Obama proactively provided positive leadership rather than simply underlining the

differences between himself and George W. Bush. A former diplomat was quoted as saying that Obama's "legacy in domestic policy is likely to be health care. But his legacy in foreign policy is likely to be this nonproliferation agenda."

Probably Obama has come to understand the limits of what can be achieved by persuasion. Obama himself has acknowledged that he underestimated how difficult it would be to bring about an agreement between Israel and Palestine, and that his policy of engagement has failed to inspire any cooperation from Iran, where he remains stuck in the same impasse as his predecessor.

According to the Baker article cited above, one major difference between Obama and his predecessors is the weight he gives to relations between the traditional great powers. His predecessors tended to make controversial points like human rights and democracy a priority. Obama's Chief of Staff Rahm Emanuel has said that Obama will probably be seen as a realist in the mold of the 41st president, George H.W. Bush.

A former official in the Bush administration says Obama's pursuit of a "great powers" strategy is remarkable for a president with his origins in the liberal wing of the Democratic Party: "It's almost Kissingerian. It's not very sentimental. Issues of human rights do not loom large in his foreign policy, and issues of democracy promotion, he's been almost dismissive of."

The current tendency is to emphasize the realist aspects of Obama and his foreign policy. However, Obama met the Dalai Lama this year, and Secretary of State Hillary Clinton gave a highly critical speech on the subject of Internet freedom. Thus, there remain some aspects of his foreign policy that are less than wholly pragmatic. In Afghanistan, for example, he seems to assign a significance to the war that goes beyond narrow national interest.

It is safe to say that the biggest point of conflict in foreign policy for the foreseeable future will be Iran. Persuading China and Russia to cooperate will be a crucial test for the Obama administration's "realist" approach to foreign policy. But even if Obama does achieve a degree of support from Russia and China, putting an end to Iran's nuclear program will not be easy. For this to happen, the administration may have to resort to harsher measures than those normally implied by the word "realist," or else may be forced into the more difficult and radical option of having to contain (and at the same time coexist with) an Iran that holds nuclear weapons.

One thing is certain: Both at home and abroad, President Obama faces more difficult challenges than he can have expected when his administration took office. (*This is a near literal translation of an essay originally written in Japanese for a Japanese readership.*)

July 14, 2010

Corporations in Evolving Diversity: Cognitions, Governance, and Institutions

By Aoki, Masahiko

Topics of pressing interest since the financial crisis of 2008 have been a reconsideration of the role of financial markets and the reestablishment of the fundamental relationship between financial and nonfinancial companies. The Tokyo Foundation's Virtual Center for Advanced Studies in Institution (VCASI) has been conducting research into corporations to address this issue, one recent product of the project being Corporations in Evolving Diversity, published by Oxford University Press. The following are excerpts from the book's Introduction.

Corporations are undoubtedly one of the most important societal devices that human beings have ever invented. Although the legal concept of corporations has been said to have originated in the Roman era, it was in medieval Europe that the corporation was initiated for various social functions and started to flourish in a variety of domains: religion, learning, politics, philanthropy, trade, and crafts.

Access to the corporate form was limited at this time to the elite, but this decentralized institutional innovation prepared "doorstep conditions" for Europe, allowing it to get one step ahead of other regions and to make an earlier transit to the modern democratic state and corporate economy.

As a reference point, a minimalist conceptualization of corporations can be verbalized as follows: Corporations are voluntary, permanent associations of natural persons engaged in some purposeful associative activities, having unique identity, and embodied in rule-based, self-governing organizations.

A corporation is a permanent entity that can do what individuals with limited biological

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longevity cannot do. The corporate ability to own property, backed up by the institution of share ownership and share transferability, makes the permanence of business corporations secure.

Actions, physical and cognitive, are also relevant, as corporations can organize associative activities among its members and can cognize and store what a mere collection of individuals cannot. The first prominent types of corporations that emerged in the early medieval period, such as universities and the Roman Catholic Church, were those founded for the encouragement and support of religion and learning. The primary functions of these types of corporations were to understand or interpret the world, accumulate, theorize, and bestow knowledge for future uses and advancement, and sustain culture as common knowledge.

The primary purpose of modern business corporations is to make money, not to learn. But even for them, the reasons why incorporation is vital for religious and learning activities are not entirely irrelevant. As knowledge use and creation (that is, innovation) become more important for the competitiveness of business corporations, this point cannot be overlooked.

Orthodox economic theory of contracts is premised on the idea that cognition can take place only within the mind of individuals, which lies at the heart of micro economics that theoretically supported the shareholder-oriented view of corporations in past decades. However, the recent development of experimental economics, cognitive neuroscience, and related areas increasingly provides evidence and theories that human cognition also takes place in more interactive ways at the group level. The way in which business corporations are organized as systems of associational cognition deserves no less attention than the financial aspects of the corporation.

The orthodox contract theory of the firm considers the human aspects of the business corporation only in terms of authority relationships between the management and the workers. This treats workers merely as “hands.” But in his classical treatise, *Concept of the Corporation*, Peter Drucker posited the idea of “knowledge workers” who can supply brains, not merely hands.

In a business corporation, cognitive activities, such as information collections, processing, uses, and storage are systematically distributed and interrelated between the management and the workers, as well as among the workers, while the investors supply cognitive tools to them. Such cognitive relations inside the corporate organization can

be referred to as associational cognition.

If the potential importance of associational cognition is recognized, the questions that follow are: How are cognitions to be distributed and related among the members? How are they related to the system of tools of cognition, such as computers, the Internet, robotics, machines, digital files, and so on? Are the workers simply the bodily extension of the manager's brain? Focusing on this aspect of corporate architecture appears to be particularly important in the era of information technology.

The question of what represents "purposeful activities" for a contemporary business corporation constitutes the crux of the matter we are concerned with: "What do corporations do?" Does it operate "exclusively for profit" as the shareholder-oriented view dictates or for something broader, as the stakeholder-oriented view claims. The proper answer theoretically depends on ways in which a system of associational cognition is architected in corporate organizations.

The shareholder-oriented model is one viable model under certain conditions, but there can also be another model that does not fall into the simplistic classifications of "management-oriented" (traditional American), "labor-oriented" (traditional German), or "state-oriented" (traditional French and Japanese). This model involves rather novel three-way relationships between management, workers, and investors, whose presence may grow with the rising importance of human cognitive assets in business.

It is telling that pre-business corporations, such as the Roman Catholic Church and municipalities, were not the immediate creations of the modern national state. They were voluntarily created, even though some of them needed the explicit or implicit approval of the rulers. As members of voluntary organizations, corporate participants must basically have consented to obey its own rather than any external authority.

This has implications for the inquiry into the nature of business corporations. We may inquire what kind of general rules for governance can be agreeable to and consented to by the constituent members of the corporation. Then we may ask whether those endogenous rules can be consistent with general rules prevailing in society. Without the first property, people would not participate in corporations voluntarily, while without the second property, corporations would not be sustainable in society. They are interrelated.

Social interactions are all games, regardless of whether payoffs are exclusively

self-regarding, material-oriented, hedonistic, or otherwise. Those games recursively played in society can be called societal games, although there are different kinds of domains of play. Viewing the societal order as stable patterns of game playing has been expounded by many authors. I follow this tradition but try to go beyond a mere analogy by differentiating the discrete domains of societal games that embed corporate organizations—commons, economic, social, and polity—by discerning mutually distinct game forms and examining the interrelationship between those games and the organization games played internally within business corporations by their members, including workers.

One great advantage of the application of game theory is its ability to analyze mutual relationships between embedding society rules and corporate self-governing rules as stable outcomes of play, that is, as equilibrium phenomena, of the societal and organization games as linked.

“Equilibrium” refers to the stable and mutually reinforcing aspects of the societal order and its impacts on the structure of business corporations. However, nothing in the societal order is static in a strict sense. Business corporations adapt their associative activities in response to evolving market and society environments, while evolving corporate behavior impacts on the latter. The recent contributions of epistemic game theory suggest that in order for a stable societal order to evolve, something more may be needed, say, common backgrounds in information and inference, as well as various social cognitive categories, such as social symbols carrying some meanings, public propositions, such as laws and regulations acting as focal points for cognition, culture as common priors, and so on. In order to understand the basic nature of institutional evolution, the ironclad methodological individualism needs to be laid to rest.

Japan’s “Lost Decade” triggered by the 1992 burst of the financial bubble is a meaningful reference to the societal cognitive crisis than just the economic consequences of macropolicy and banking failures: That is, the state in which traditional rules could not be taken for granted any more. No consensus has yet emerged as regards what the new rules could be. Behind the crisis, the Japanese corporate landscape underwent a tremendous change, and it can no longer be characterized by a single “Japanese model” stereotype. This diversifying phenomenon is not necessary an isolated event limited to Japan, but there is a suggestion of similar phenomena evolving globally, albeit each one in a path-dependent, unique manner.

Evolving corporate diversity is not so much due to national characteristics but a

ubiquitous phenomenon across economies exhibiting to differing degrees. It can thus be considered a product of global economic integration.

In order to derive the potential gains from the global process of a “convergence to diversities,” the global financial markets need to co-evolve as an infrastructure that will accommodate this evolutionary path, rather than exercise sovereign control over nonfinancial business corporations. The 2008 credit crisis revealed that relationships between financial intermediaries and nonfinancial business corporations are still uneasy. The painful process of a corporate recovery is to become a process of a search for a mutual fit between the two.

May 24, 2010

Where the Market and Morality Intersect: A New Approach to World Poverty

By Novogratz, Jacqueline

In April the Tokyo Foundation presented Acumen Fund CEO Jacqueline Novogratz as guest speaker at the 32nd Forum. Sharing Ms. Novogratz's commitment to leadership development, the Foundation has partnered with the Acumen Fund since 2008, working in Japan to publicize the Acumen Fund Fellows Program and encourage potential applicants. At the Forum, Ms. Novogratz discussed her work and the practical and moral imperatives that drive it in her presentation, excerpted below.

When I was ten years old, my Uncle Ed gave me a blue sweater that I adored. It had a design of mountains right across the chest, and I wore it up into my freshman year in high school. By then, my adolescent contours were interacting with the design of the sweater in a way that one day inspired my high school nemesis to yell across the hall that the boys need not travel to the mountains to ski any more; they could just ski across the mountains on my chest. I think every teenage girl experiences a moment of intense humiliation that she never forgets, and this was mine. I ran home to my mother, who ceremoniously dumped the sweater in the Goodwill bin, and I assumed I would never have to lay eyes on it again.

About 10 years later and 5,000 miles away, I had abandoned a career on Wall Street and was working with a small group of Rwandan women to launch their country's first microfinance bank. One day I was jogging through the streets of Kigali, when I saw a boy about 10 meters in front of me, wearing a sweater that looked exactly like the one I had thrown away. I ran up to the child, grabbed the collar, turned it over, and sure enough—there was my name, written on the collar of his sweater. It was a kind of revelation for me, and ever since then, I have cherished this story as a metaphor for human interconnectedness, a vivid example of how our daily actions—or inaction—can impact people we may never meet, all around the world.

From Rwanda to Acumen

Novogratz, Jacqueline *Founder and CEO of the Acumen Fund.*

In this and other ways, I trace my journey to Rwanda. Living and working there was an extraordinary experience that taught me what a small group of people can do if they put their minds to it. We built the country's first microcredit bank, and today, 21 years later, it is still the largest such institution in the country. It was not always a heartening experience; returning to Rwanda after the genocide, I found that the women with whom I worked had been both victims and perpetrators. But in the end, I came away with three vital lessons that have informed all my efforts since then, particularly my work with Acumen Fund.

The first lesson is that markets, left to their own devices, will not solve the problem of poverty. The market is efficient, and it can function as an excellent listening device, but it is not by nature a force for equality or inclusiveness; to the contrary, left unhindered, it tends to exacerbate the gap between rich and poor, a tendency we have seen not only in the United States but all around the world in recent years. The second lesson is that the traditional top-down approach of charity or grant aid cannot solve the problem, either. Too often it fosters dependence and undermines human dignity. And if I have learned anything over the past 25 years, it is that dignity is more important to the human spirit than material wealth. That was the third lesson.

I founded Acumen Fund in 2001 in the belief that the key to breaking the cycle of poverty was to treat people with respect, as human beings and agents of change eager and willing to improve their lives through their own efforts. I felt there had to be a better way than *laissez-faire* capitalism on the one hand and top-down charity on the other.

The idea behind Acumen was to enlist the market and its tools to achieve long-term social change. For this, we would need "moral imagination," and we would also need what we call "patient capital." Patient capital is in it for the long haul, and it takes risks that traditional capital would shun. Patient capital makes it possible to adopt and build on promising innovations and best practices even if they offer no prospect for short-term profits. Our plan was to raise patient capital and use it for philanthropic investments in the form of equity or debt, to support promising enterprises committed to building solutions for their poorest customers. We were convinced there was a niche for such investment because of the billions of dollars that go toward philanthropy each year—\$250 billion in the United States alone. Instead of just donating money, Acumen Fund proposed to invest it. We would be honest with our investors, sharing our failures as well as our successes, and we would measure success both in monetary

terms—because we would need financial returns in order to reinvest—and in terms of social impact.

To date, Acumen Fund has invested approximately \$40 million in projects oriented to basic services—water, healthcare, housing, alternative energy, and agricultural inputs—primarily in Pakistan, India, Kenya, and Tanzania. Locally, these investments have created about 25,000 jobs and delivered services to tens of millions of people. Moreover, we have seen more than \$1.2 million come back to Acumen Fund this year alone, and we expect that to rise to \$2.1 million by the end of the year. This is money that we can reinvest in the future.

Case Studies in Change

Of the 40 projects in which Acumen Fund has invested to date, I would like to present two that I regard as particularly instructive. One of our most successful investments has been carried out in partnership with a major Japanese corporation, Sumitomo Chemical. The company had developed a mosquito bednet impregnated with a long-lasting insecticide that could protect people from malaria for five years. Initially, the product was manufactured in Vietnam and China, but then Sumitomo had the idea of transferring the technology to African entrepreneurs, so that they could address Africa's problems themselves. The company linked up with Acumen, as well as with UNICEF, Exxon, and the Global Fund. We located an African entrepreneur in Arusha, Tanzania, who was willing and able to undertake a long-term project with significant risks—a venture of the type that traditional banks are generally unwilling to finance.

Using our patient capital, we extended a loan of \$350,000 in 2002. At the time, my hope was that the investment would lead to the creation of 105 jobs and the manufacture of 150,000 nets per year. As of now, the company has created some 7,000 jobs, making it one of Tanzania's largest employers, and it manufactures 20 million bednets that protect 40 million Africans every year. This is a huge success story for Africa and an inspiring example of how entrepreneurship can bring about positive change.

Another business that is improving people's lives in East Africa is Ecotact, based in Nairobi, Kenya. In Kenya 50 percent of the population lacks access to sanitation facilities, and the problem is particularly serious in crowded, low-income urban areas. The government invested in public facilities in such areas back in the 1970s, but these low-quality facilities had become filthy, dangerous places.

A few years ago, a Kenyan entrepreneur named David Kuria came to Acumen Fund with a nonprofit model for building a high-quality public toilet system. Although we saw the rationale for a nonprofit venture, we decided to work with him to develop it into a public-private partnership that could work with the government while also gaining access to private capital. The plan materialized, and today Kenya has about 26 of these high-quality public facilities, which together serve 16,000 to 18,000 people per day.

Kuria's undertaking is particularly significant because, in addition to an important health issue, it addresses the issue of human dignity. It operates on the assumption that people of all income levels want a safe, clean, pleasant environment and are willing to pay a reasonable fee for it. The toilets cost five cents per use, but they are kept scrupulously clean and even provided with piped-in music. Ecotact plans to build some 200 of these public facilities over the next five years, and the governments of Tanzania and Uganda are studying the possibility of adopting the same model.

Fostering Leadership

The project above illustrates an important lesson we have learned over the last nine years, namely, that capital alone is not sufficient; we also need to build human capacity to make new systems work and change society over the long term. With this in mind, we launched our Acumen Fund Fellows Program about five years back in an effort to identify and develop leadership around the world.

As we see it, leadership requires not only business management skills but also “moral imagination”—being able and willing to envision the consequences of one's actions from a moral standpoint—because that, after all, is what this work is really about. We need leaders with the patience and insight to listen, to understand the needs of low-income people, and to build solutions for and with them. The Tokyo Foundation shares our belief in the importance of leadership development, and it has become a valued partner in this undertaking.

Each year we choose 10 people out of some 600–700 applicants. We introduce them to some of the best and brightest leaders around the world, and we take them through a curriculum that includes not only business management but also philosophy and ethics—great thinkers, from Plato and Confucius to Nelson Mandela and Martin Luther King, who stressed our duty to our fellow human being and the struggle for social justice as part and parcel of this human journey of ours. Acumen Fund fellows come from about 65 different countries and bring with them important skills and outlooks of their

own. This past year, we were pleased to welcome Satoko Okamoto, who joined the Acumen Fund Fellows Program with the support of the Tokyo Foundation and contributed her own unique and valuable perspective.

Training such leaders is one of the most difficult things we do, but I believe it is also one of the most important. This is why we take our Fellows Program so seriously, and this is why it has been so gratifying to see the graduates of our program being recognized as promising leaders by major companies around the world.

Vision and Action

My immediate purpose in establishing Acumen Fund was simple enough—to address the problem of poverty. But defining poverty is not as easy as one might think.

Economists tend to define poverty in clear-cut monetary terms. But people in different societies may feel equally trapped and excluded from the mainstream economy even with widely disparate incomes. A person making \$10,000 a year in rural South Carolina with no social supports and no prospects may be more desperate than someone in Bangladesh living on \$3 a day but with a social network and a sense that things are going to get better. This is why I have come to view poverty fundamentally as a lack of choice. It may be about education. It may be about healthcare. It may be about having a voice.

Of course, when we see people struggling with basic issues of physical survival, our natural and correct response is that we need to find ways to solve those problems. But it seems to me that true moral imagination derives from an awareness that we are all interconnected—the lesson of the blue sweater, if you will. This is why, over the years, I have stopped thinking of the world in terms of developed versus developing, or “my nation” versus “your nation.” I feel we have reached a point in history where it is incumbent on us to think in terms of a single, interconnected world.

My ultimate goal for Acumen Fund is to overthrow the prevailing model of development—which veers between pure charity on the one hand and an unfettered free market on the other—and treat the poor as full-fledged human beings, looking at the situation from their perspective. We have a lot of work to do before we reach this seemingly simple goal. But the last 25 years has taught me how much we really can accomplish once we commit ourselves.

In Japan I was told that many young people admire that sort of optimism, but most are

realists and reluctant to tackle risky ventures, especially in these economically uncertain times. My answer to that is that every action we take entails risk, but inaction has its risks as well. It seems to me that, particularly when one is young, the risks of not following one's dreams are much greater than the risks of trying and possibly failing.

My own generation is largely to blame for this reluctance, I think. We have defined success in financial terms and equated happiness with security. Perhaps it is time to rethink these assumptions. As I see it, the secret of happiness is a sense of meaning and purpose, and that comes from committing oneself to something bigger than oneself. You can see the difference this makes in people, especially as they get older. Those who are living lives of meaning and purpose sparkle with energy and optimism, even if they happen to be going through difficult times. They have built something inside themselves that no one can take away.

For those who feel overwhelmed by the challenges, who despair of making a difference, I would stress the importance of taking one step at a time. I have spoken with young people who seem to think that they need to become CEOs overnight in order to make a difference in the world—when all they really need to start is to add one tool to their toolkit. Remember, “A journey of a thousand miles starts with a single step.” I would urge young people everywhere to take that first step, because the world has never needed you more than it does right now.

As they say, if not us, who? If not now, when?

May 21, 2010

The Urgent Task of Lowering Japan's Corporate Tax Rate

By Morinobu, Shigeki

Japan must consider lowering its corporate tax rate, which is among the highest in the world, to protect jobs and address the needs of a graying population. EU member states have actually seen tax revenues rise by lowering corporate taxes and expanding the tax base, and this offers valuable hints on how Japan can proceed with its own tax reform.

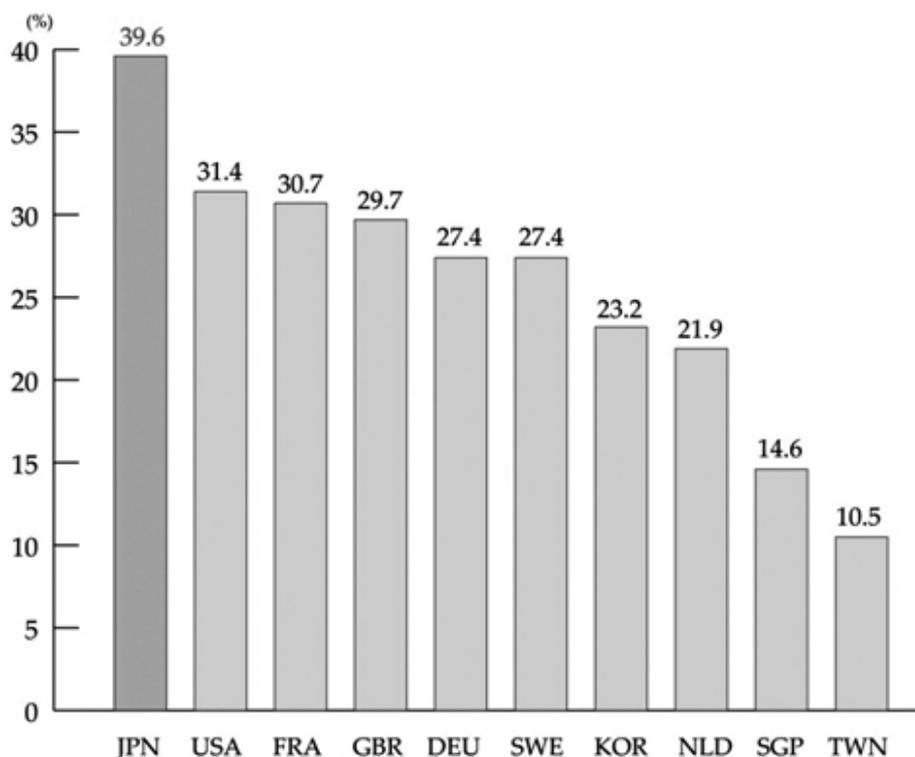
The Need for Reform

Remarking in the Diet on March 12 that corporate tax rates “should rightly be guided lower,” Prime Minister Yukio Hatoyama hinted that he would launch discussions on reducing the rates. His Democratic Party of Japan had been criticized for lacking a growth strategy, so many welcomed the remark as the first bright news in a long time.

An international comparison of nominal and effective corporate tax rates reveals that the statutory rate in Japan and the United States are around 40%, some 10 percentage points higher than other industrial countries (Figure 1). This, as will be described below, is the result of repeated efforts by countries other than Japan and the United States to lower their rates and attract foreign businesses.

Morinobu, Shigeki Senior Fellow of the Tokyo Foundation. President, Japan Tax Institute; professor of law, Chuo University. After earning a law degree from Kyoto University in 1973, joined the Ministry of Finance. Served as advisor to the Minister of Finance of Japan in London (head of the London Representative Office, Japan Center for International Finance); head of the Research Office, Coordination Division, Securities Bureau; director of the Coordination Division, Tax Bureau. Has been a professor at the School of Law of Osaka University and director general of Tokyo Customs, and has taught at Princeton University. Has also been president of the Policy Research Institute, MOF (2005–6), visiting professor at the University of Tokyo, and visiting scholar at Columbia Law School. Retired from MOF in 2006. Is a doctor of law.

Figure 2. International Comparison of the Tax Burden(Effective Tax Rates),
Fiscal 2004–06



Notes: (1) Average for fiscal 2004-06, consolidated basis. (2) Tax burden = corporate tax (after application of accounting for income taxes) ÷ pretax earnings. (3) Companies covered here are those included in the Nikkei 225, S&P 500, Europe 350, and S&P Asia Pacific 100 indices and whose financial data were available.

Source: Calculated using S&P's Compustat corporate financial database.

An increasingly popular method of transferring income is to establish an intangible property company (IPCO) in a low-tax country to collect and manage royalties from the licensed use of intellectual property rights, which are a major source of income for many businesses. Multinational pharmaceutical and beverage companies receive huge sums for the use of registered patents and trademarks, and many of them now retain such profits in low-tax countries.

Even among Japanese companies, there is a growing trend to view taxes as costs, particularly with the rise in the share of foreign shareholders and such deregulatory moves as amendments to Japan's Companies Act. Some are transferring or retaining their income in low-tax countries, leading to the drain of the country's added value and the loss of employment and tax revenues. Under the tax system revisions of fiscal 2009,

income that had been retained by an overseas subsidiary can now be transferred back to Japan tax-free, but this has the possibility of actually encouraging more companies to retain their earnings at their foreign subsidiaries.

This is not difficult to foresee when one looks at the partner countries of Japan's foreign direct investment and inward direct investment (Figure 3). The country with the largest balance of direct investment in Japan was the United States, as of the end of 2006. In second place was the Netherlands, with the Cayman Islands coming in fourth and Singapore seventh. As for Japan's direct investment in other countries, the list was topped by the United States, followed, similarly, by the Netherlands in second place, the Cayman Islands in fifth place, and Singapore in seventh place. Both the Netherlands and Singapore offer preferential tax rates as a way of attracting foreign capital, and many companies in the industrial world are evidently conducting their investments via these countries. The Cayman Islands are famous as a tax haven. This shows that direct investment to and from Japan is already being conducted via low-tax countries and also that the tax system is a major factor in investment decisions today.

Figure 3. Direct Investment to and from Japan

From Japan					To Japan				
(¥ hundred million)					(¥ hundred million)				
	Country, territory	Balance of foreign direct investment (end of 2006)	Direct investment (flow)			Country, territory	Balance of foreign direct investment (end of 2006)	Direct investment (flow)	
			2005	2006				2005	2006
1	United States	186,004	13,599	10,834	1	United States	49,933	85	140
2	Netherlands	54,012	3,620	9,940	2	Netherlands	14,478	2,663	-8,612
3	Britain	37,595	3,221	8,424	3	France	13,734	-88	322
4	China	36,052	7,262	7,172	4	Cayman Islands	9,989	1,218	-51
5	Cayman Islands	25,469	4,260	3,347	5	Britain	5,929	155	2,093
6	Thailand	17,647	2,355	2,307	6	Germany	5,449	259	-622
7	Singapore	16,969	634	444	7	Singapore	5,001	679	1,265
8	France	15,536	607	978	8	Switzerland	3,139	-908	369
9	Australia	14,486	693	547	9	Canada	2,716	-1,098	-3,209
10	South Korea	12,688	1,966	1,768	10	Hong Kong	2,293	1,129	-2,467
11	Belgium	11,452	-224	163	11	Belgium	2,260	-1,407	1,024
12	Brazil	9,310	1,069	1,654	12	Luxembourg	1,945	396	-18
13	Hong Kong	9,247	1,963	1,755	13	Taiwan	1,754	-34	128
14	Malaysia	9,232	590	3,455	14	Sweden	882	-72	778
15	Indonesia	8,868	1,341	864	15	Italy	588	7	56
16	Germany	8,818	304	1,312	16	Australia	577	-125	41
17	Canada	8,108	1,189	1,028	17	South Korea	503	32	126
18	Taiwan	7,525	914	571	18	Spain	232	48	47
19	Philippines	5,058	470	427	19	China	119	13	14
20	India	2,753	298	597	20	Russia	54	-	-

Note: Negative figures for the flow of investment indicate that the amount collected exceeded the amount invested in that year.

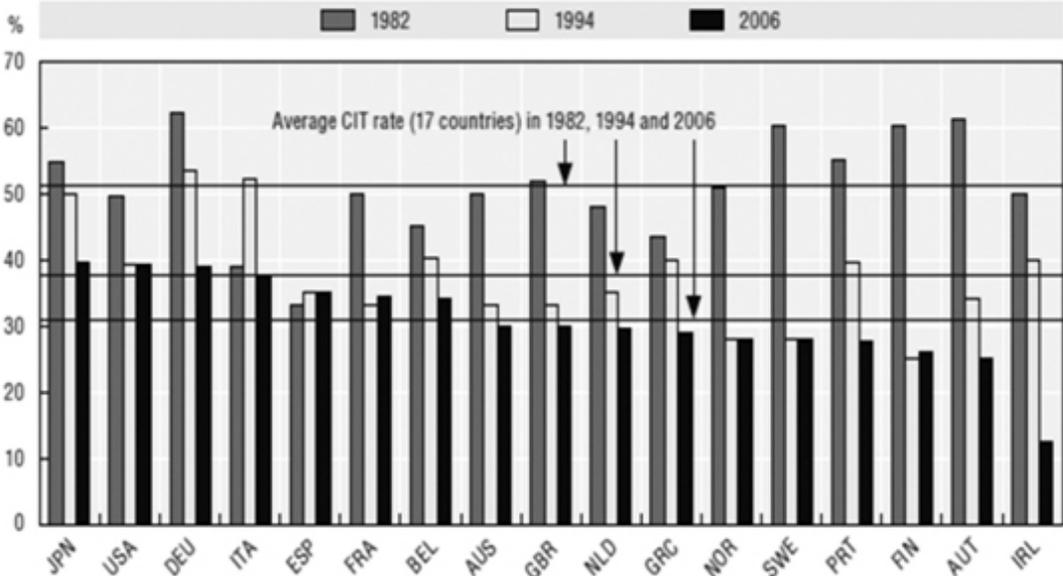
Source: Balance of payments statistics aggregated by the Bank of Japan.

To protect jobs in the face of international competition and to finance the necessary costs of an aging population despite a falling birthrate, Japan must not only prevent domestic companies from moving abroad but also attract greater foreign direct investment from other countries. This state of affairs is the chief reason and offers ample justification for lowering the corporate tax rate. Most arguments for a lower tax burden to date have focused on the impact it would have in encouraging capital investment and economic activity. The international competitiveness argument is more compelling; Germany, for instance, has been implementing corporate tax reform to enhance the competitiveness of operating in the country and to reclaim the tax revenue that had been flowing to the Netherlands and Ireland.

Essence of the Tax Reduction Race

The Organization for Economic Cooperation and Development has published the results of an interesting study on the correlation between tax competitiveness and tax revenues.

Figure 4. Statutory Corporate Income Tax Rate, 1982–2006



1. Data for 1982 was only available for 17 OECD countries (Japan, the US, Germany, Italy, Spain, France, Belgium, Australia, the UK, the Netherlands, Greece, Norway, Sweden, Portugal, Finland, Austria and Ireland). In the case of Ireland, there was a reduced corporate tax rate of 10 per cent for the manufacturing sector in 1982 and 1994.

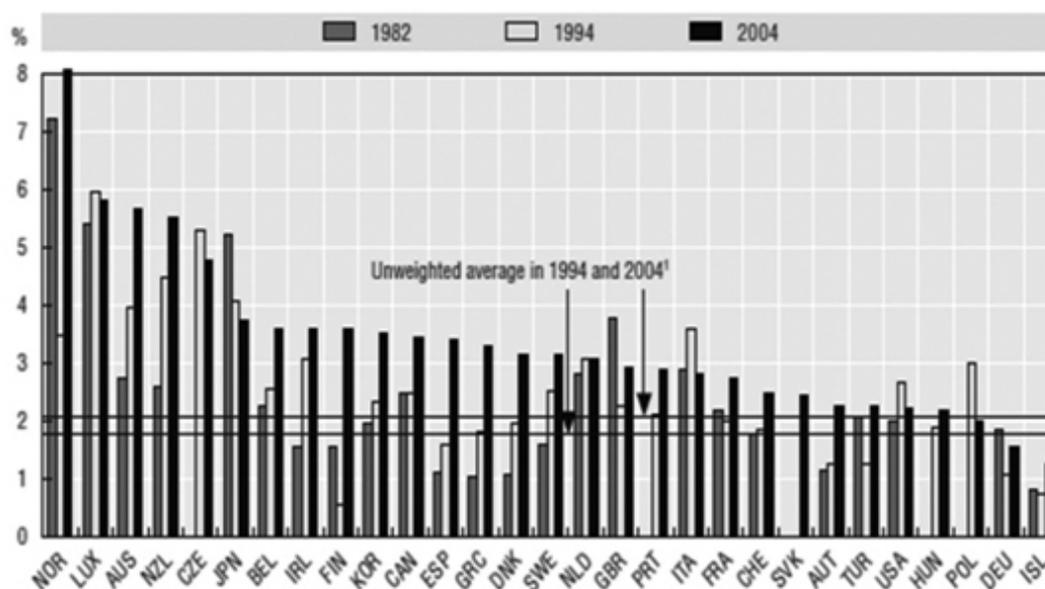
Source: Institute for Fiscal Studies (IFS) and OECD Tax Database.

The closer integration of the European Union has engendered an extremely fierce race for lower corporate taxes among the member states over the past decade, with the tax rate declining by several points, as mentioned above. East European states lowered their

rates in an attempt to attract German and French businesses and expand employment. This incited a “race to the bottom,” as the West European states reacted with lower rates of their own to keep domestic companies at home and to attract foreign ones. Figure 4 shows how the rates have declined over this period.

The OECD study shows, though, that while the EU member states have been cutting their corporate tax rates, corporate tax revenue as a percentage of gross domestic product has actually been rising. This seemingly paradoxical relationship between corporate tax rates and tax revenues has elicited great surprise and interest among the member states.

Figure 5. Taxes on Corporate Income as a Percentage of GDP

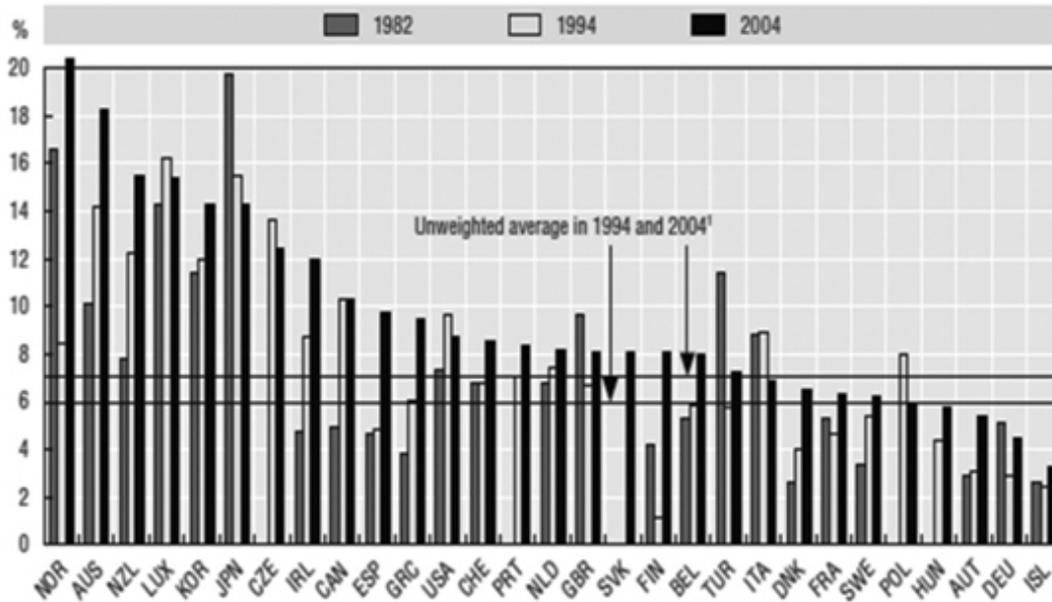


1. Missing data in 1982 for the Czech Republic, Portugal, Slovak Republic, Hungary, Poland and Mexico; in 1994: the Slovak Republic and Mexico; in 2004: Mexico. The unweighted average does not include Norway.

Source: Revenue Statistics 1965-2005.

Figure 5 shows taxes on corporate income as a percentage of GDP. indicating that the percentage rose from 1994 to 2004. Corporate tax revenue as a share of total tax revenues (Figure 6) has also risen between 1994 and 2004.

Figure 6. Taxes on Corporate Income as a Percentage of Total Tax Revenue



1. Missing data in 1982 for the Czech Republic, Portugal, Slovak Republic, Hungary, Poland and Mexico; in 1994: the Slovak Republic and Mexico; in 2004: Mexico. The unweighted average does not include Norway. For Portugal: 2003 instead of 2004 information.

Source: Revenue Statistics 1965-2005.

Why have lower tax rates resulted in higher revenues? The OECD report and researchers in the EU point to the following factors. They have analyzed trends in all member states by identifying three components of the tax-revenue-to-GDP ratio.

The first component is what is called the effective tax rate, which has remained relatively steady in most countries. It is this component that has been most affected by the lowering of corporate tax rates and the accompanying expansion of the tax base.

The second component is the corporate share of all added value in the economy. This percentage has been rising gradually in many countries, which is believed to have been caused by a shift from the personal sector to the corporate sector owing to the lower tax rates of the latter.

$$\frac{\text{Corporate tax revenue}}{\text{GDP}} = \frac{\text{Corporate tax revenue}}{\text{Corporate operating profit (first component)}} \times \frac{\text{Corporate operating profit}}{\text{Operating profit of entire economy (second component)}} \times \frac{\text{Operating profit of entire economy}}{\text{GDP (third component)}}$$

The third component is corporate profits as a share of GDP, which rose in many countries during the first decade of the millennium. This has been explained as a reflection of the many new companies that individuals established stirred by the spirit of entrepreneurship.

This analysis has produced two major conclusions. The first is that in many countries, corporate taxes were lowered together with an expansion of the tax base, such as through a reexamination of special tax measures and depreciation methods. This approach is typified by the taxation reforms carried out in Germany and Britain.

The second conclusion is that the tax-cutting race seen during the past decade resulted in an increase in business start-ups. The lower tax rates gave people incentive to start their own business, offering empirical proof of vitalized economic activity.

Steps to Follow

Debate on reforming the tax system is likely to begin in Japan as well. The links between corporate tax rates and business behavior is quite complex, though, with the statutory rate believed to affect the overseas transfer of profits and the effective rate influencing investment decisions. The Hatoyama administration has announced it is freezing the consumption tax rate for at least four years, so the prospects of a lower effective tax rate within the framework of reforms for the tax system as a whole remains rather opaque.

Given such murky prospects, it may be a good idea to first reform the corporate tax system and lower the tax rate, combined with an expansion of the tax base. Because such reforms would be tax neutral and result in lower rates, there should be little resistance from the general public. They may have the added benefit of encouraging entrepreneurship—invigorating economic activity and leading to higher tax revenues, as was seen in the EU—and of dampening corporate plans to shift operations to low-tax countries.

Ways of expanding the tax base include reexamining the special tax treatment now available in some cases; shifting the method of tax depreciation from one based on fixed rates to that on fixed sums; placing limits on deductions for interest payments, and abolishing preferential rates for stock transactions.

The next step would be to lower the effective corporate tax rate as part of comprehensive reforms that would also include the consumption tax. There would be a

need to cover any revenue shortfalls resulting from a lower effective corporate tax burden, so any adjustments would have to be considered in conjunction with discussions of a consumption tax hike.

The reluctance to reforming corporate taxes comes from the perceived individual-corporate dichotomy. It should be remembered, though, that businesses and individuals are on the same boat and in a state of mutual dependence. In their capacity as employees, creditors, and shareholders, individuals are provided with the added value generated by businesses in the form of wages, interest, dividends, and capital gains. Thus, corporate tax reform in Japan would not be aimed at helping Japanese business firms but at enhancing the competitiveness of basing corporate operations in Japan and of generating the necessary revenue to address the graying of the population. An early start to the tax reform debate would be most welcome.

May 20, 2010

The Long Road to Fiscal Stabilization

By Kobayashi, Keiichiro

Japan's fiscal 2010 budget is the largest ever, and there are growing concerns that long-term government bond prices could crash, sending long-term interest rates soaring. Are such fears about Japan's public finance warranted?

The chances of a fiscal collapse or a crash in the bond market are probably quite low over the next few years—and no doubt over the next decade as well unless there is a fundamental breakdown in Japan's industrial structure. But there will surely come a time four or five decades hence when instability in the bond market will impact quite negatively on the Japanese economy.

There are bond-related concerns over the short, medium, and long term. I will deal with each of them in turn.

As for the short term, the likelihood of a crash in the bond market is closely linked with trends in the foreign exchange rate. Should investors lose confidence in Japanese bonds, faith in the yen will also falter. As the yen grows progressively weaker, investors may opt out of yen-backed bonds in favor of more profitable foreign assets. Should such a situation continue, the bond market could very well nosedive.

Cyclical Mechanism

The yen, though, is unlikely to remain weak for long. A slight depreciation will make Japanese exports cheaper, leading to a bigger trade surplus. This will cause the yen to appreciate and subsequently make yen-denominated assets more attractive again. Investors will be more inclined to purchase Japanese government bonds (JGBs), pushing

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up their prices. It is thanks to such a cyclical mechanism that the JGB market should remain stable for at least the next several years.

This assumes that Japan's export industry will remain competitive. Should it begin to totter in the future, prompting both domestic and foreign investors to project perennial trade deficits for the country, the market will come to assume that the yen will depreciate and stay weak. This will make foreign assets more attractive than yen-denominated ones, and investors will begin dumping JGBs. This will cause bond prices to tumble and significantly diminish the value of the yen.

This assumes, of course, a structural weakening of Japan's export industry, as indicated, for instance, by several consecutive years of negative economic growth. Such a turn of events could trigger a collapse of the bond market.

It is inconceivable that the economy would become that feeble, though. Even if growth slows down, there would surely be at least some growth, so a financial collapse and a bond market crash are probably not very likely.

This is not to say, however, that there is no need for concern. Even if the economy continues to grow, the bond market would remain precarious. The government is so heavily in debt today that raising taxes would do little to reduce such debts right away, as interest payments would continue to snowball. Achieving fiscal stability will take around two to three generations.

A condition where expenditures equal revenues is called primary balance. An estimate made a few years ago by Keio University Professor Takero Doi at the Research Institute of Economy, Trade, and Industry shows that even if fiscal discipline was implemented so that revenues exceeded spending by a significant margin for over 40 years, it would still take about 100 years for government bonds to stabilize.

This is because the primary balance does not include expenditures for the amortization of bonds. Even after the achievement of primary balance, therefore, huge interest payments would still have to be made, so revenue shortfalls would continue, and government debt would keep accumulating for several more decades. Even if the government cuts back its programs and starts living within its means, it already has so much accumulated debt that it will keep running up deficits.

In this scenario, the government's net liabilities—calculated by subtracting total assets

from outstanding debt—will continue to grow through the first half of this century, ballooning to three times the country's gross domestic product around 2060 before beginning to contract. It will be about 2100 when total government debt will finally diminish to an equivalent of the country's GDP.

Burdening Future Generations

The total financial assets held by Japanese people in bank deposits and other instruments are only around three times GDP. This means that should the government's net liabilities exceed this level, then it will become impossible for the Japanese people alone to finance the debt; foreign investors will inevitably come to make up a substantial share of JGB holders.

One reason that Japan's stock market is so sensitive to trends in US stock exchanges today is because foreign investors account for a big share of the transactions on Japanese bourses. Should foreign ownership of Japanese government bonds rise, trends in the bond market will likewise come to rely heavily on the decisions of foreign investors.

What this suggests is that a minor rumor could have a major impact on market psychology, and the dumping of government bonds would become commonplace. Bond values would fluctuate wildly, resulting in the destabilization of both long-term interest rates and inflation and impacting negatively on both the corporate and household sectors. It may even lead to a vicious circle that could enfeeble the Japanese economy. Such economic and fiscal precariousness would expose the next generation of Japanese—and the one after that—to the kind of economic crises that afflicted Argentina and is now threatening Greece.

It is important to take heed of our responsibilities toward future generations and chart a long-term course toward fiscal rehabilitation.

February 5, 2010

The Japan-U.S. Alliance at Fifty: The Challenges Facing the New DPJ Government

By Kato, Hideki

The Tokyo Foundation hosted a public seminar entitled “The Challenges Facing the New DPJ Government” in Washington, DC, in mid-January in conjunction with the 16th Annual Japan-US Security Seminar, held to commemorate the fiftieth anniversary of the Japan-US alliance. The event attracted great interest, being attended by over 170 government officials, other experts, and media personnel. The annual security seminar was sponsored by the Embassy of Japan, the Japan Institute of International Affairs (JIIA) and Pacific Forum CSIS. The following is the text of the keynote speech delivered by Tokyo Foundation Chairman (now President) Hideki Kato.

Good morning, and thank you for attending the Tokyo Foundation Seminar. It is a great honor for me to be given the opportunity to speak to you today about the current political situation in Japan.

My address is motivated by the fact that the Japanese system of governance is not well understood by those outside Japan.

Today, I would like to focus on two things. The first is governance and the political system in Japan. And the second is the Hatoyama administration: what it's trying to do, what is happening at the moment, and future prospects.

Governance and the Political System in Japan

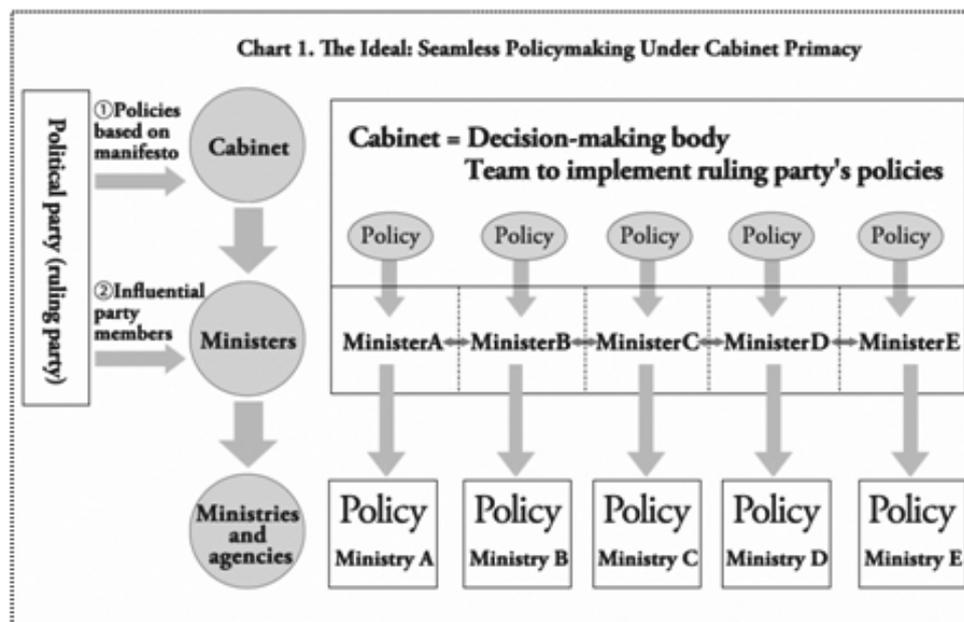
A parliamentary cabinet system is generally understood to consist of a process whereby

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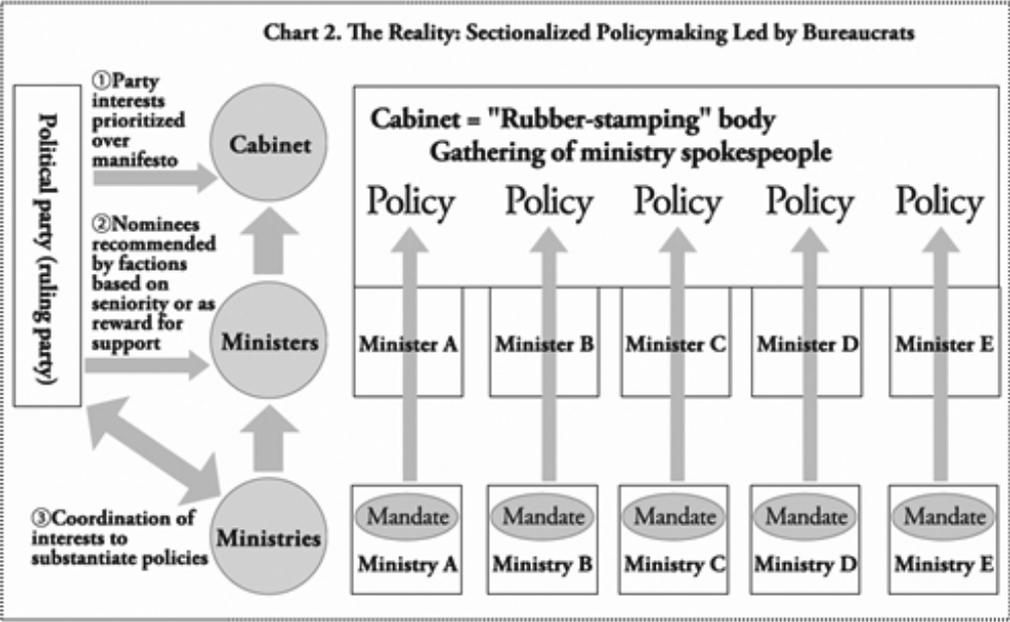
political parties publish manifestos—or policy platforms—the party or coalition of parties that wins an election and has a majority in the parliament assembles a cabinet, and ministers appointed to take charge of the policies advocated in the ruling party’s manifesto implement those policies, using bureaucrats as staff. This is the true meaning of “political leadership.” But in Japan, both parties and voters have tended to pay little heed to manifestos, even though they are essential to the first step of the process, and little effort has been put into producing them. The subsequent steps in the process of “political leadership” have not been established.

The factors behind this situation include the multimember constituency system that Japan employed until the 1990s and the fact that for many years the public did not need to make major political choices. At the root, however, are problems arising from the manner in which the parliamentary cabinet system has been employed in Japan.

As shown in Chart 1, in an ideal parliamentary cabinet system, the ruling party formulates policies based on its manifesto, and a cabinet comprising influential members of the ruling party is formed to implement those policies. Based on cabinet discussions of basic principles for managing state affairs, cabinet ministers implement the policies utilizing the bureaucrats in their respective ministries. As the cabinet considers policies from the perspective of the overall management of state affairs, this mechanism holds the interests of individual ministries in check and enables bureaucratic sectionalism and regulatory redundancy to be eliminated.



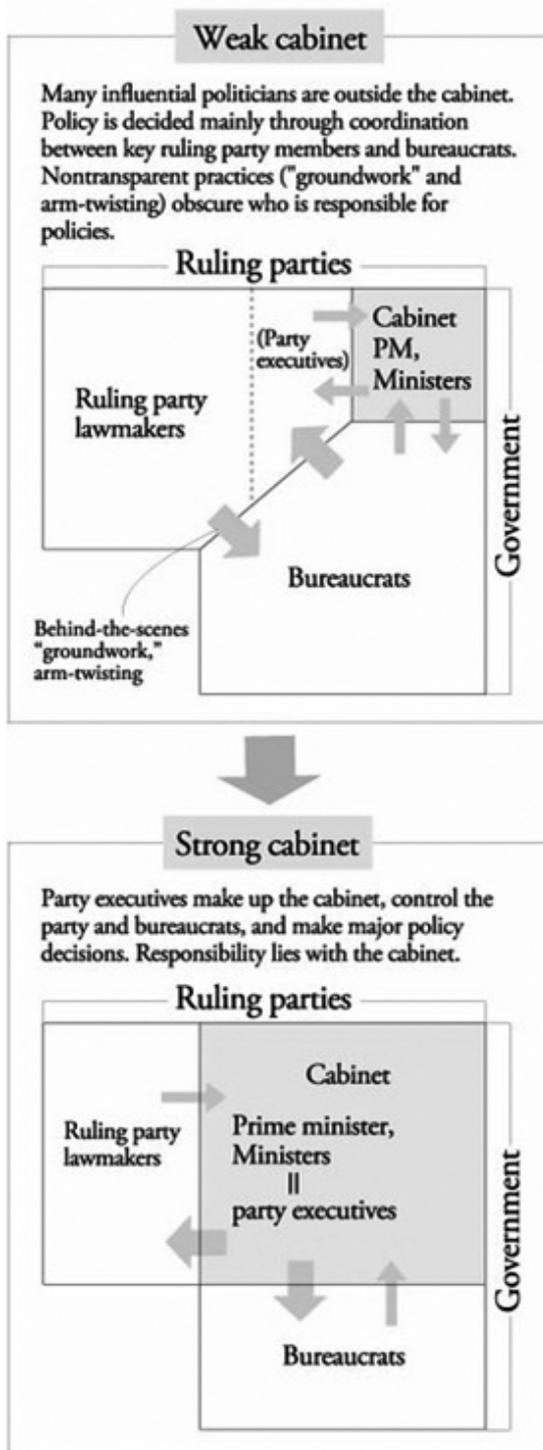
The reality of the system as it has been practiced so far in Japan, however, greatly differs from the ideal, as shown in Chart 2. In this setup, the ministries come first, and bureaucrats take charge of everything from policy formulation to implementation in areas that are within the mandates of their respective ministries. Ministers are effectively figureheads who simply “sit” on top of that structure, as shown by the fact that, at their inaugural press conferences, the vast majority of ministers read out texts prepared by bureaucrats. Most ministers, moreover, have taken to promoting the existing policies of their ministries and speaking for the ministries’ interests and positions as soon as they are appointed, no matter what views they may have espoused earlier. As a result, the ministerial coordination and cabinet leadership expected in a true parliamentary cabinet system take a backseat. The priority given to precedent and bureaucratic sectionalism makes it difficult for the government to effect drastic policy shifts or to respond swiftly to changing social conditions.



Under the new administration led by the Democratic Party of Japan, the so-called council of three political-level appointees comprising the minister, senior vice-minister, and parliamentary secretary has been established within each ministry. This is intended to enable politicians to take the lead in determining government policy, rather than bureaucrats. Newly appointed cabinet ministers of previous Liberal Democratic Party administrations were first given a briefing by the bureaucrats. Soon after the senior vice-ministers and parliamentary secretaries were appointed by Prime Minister Yukio Hatoyama, by contrast, meetings of the political-level council were held—on the very

day of the appointment at the Ministry of Education, Culture, Sports, Science, and Technology; the following day at the Ministry of Health, Labor, and Welfare; and within several days at the Ministry of Finance and the Ministry of Land, Infrastructure, Transport, and Tourism. As a rule, the new administration also banned press

Chart 3. Power Structure Between Ruling Party and Cabinet



conferences by administrative vice-ministers—the highest-ranking bureaucrats—so as to revamp the decision-making mechanism that had hitherto been led by the bureaucracy.

Dual Power Structure

Another factor that weakens the power of the cabinet and prevents the parliamentary cabinet system from functioning properly in Japan is the dual power structure consisting of the ruling party and cabinet.

In an ideal parliamentary cabinet system, the cabinet is a team that executes the policies of the ruling party, like the “strong cabinet” in Chart 3. Power within the ruling party is concentrated in the cabinet because those who become ministers are the party’s prime movers, and ruling party lawmakers who are not in the cabinet ordinarily do not defy the cabinet’s policy decisions, much less revoke them.

Under the LDP administrations of the past few decades, however, it became the norm for ruling party members outside the cabinet to wield more power than the cabinet, as shown by the “weak cabinet” in the Chart. As a result, many policy decisions were effectively made through

repeated contact, behind-the-scenes “groundwork,” negotiations, and arm-twisting between top ruling party politicians—including “tribal” lawmakers with close ties to specific lobbies—and bureaucrats, in total disregard of the cabinet. This deviates greatly from the principles of the parliamentary cabinet system and obscures who is responsible for making government policy.

The decision-making process within the dual power structure, which has become almost institutionalized over the decades, can be summarized as follows. In the case of the LDP, the party has its own policy coordination section called the Policy Research Council, which checks the bills and other policy proposals put forward by the cabinet. Government bills cleared by the Policy Research Council are then approved by the party’s General Council before being submitted to the Diet. This is called “prior screening” by the ruling party, a practice that is virtually unheard of in other major countries. It is not unusual for government bills to be drastically modified or even rejected in this process. The rejection by politicians outside the cabinet of policy proposals that representatives of the same party drafted in order to implement the party’s manifesto, in effect, amounts to a rejection of the parliamentary cabinet system itself. At the same time, in the sense that it reinforced the impression that any proposal approved by the ruling party would be approved by the Diet, it was also one of the factors that reduced the Diet to a rubberstamping role.

While all political parties have a broadly similar structure, in the LDP’s case the chairman of the General Council, the chairman of the Policy Research Council, and the secretary-general constitute a troika of top party officials who wield tremendous power over party affairs. Under LDP administrations, this troika had more power and a louder voice in many respects than the cabinet ministers, who were the policy chiefs of the government. The three executives controlled policy decisions despite having no legal rights or responsibilities regarding government policymaking. As a result, when a government policy proposal conflicted with the ruling party’s position, instead of the minister rallying the party around the proposal by the government or a government committee, the party’s wishes were often given precedence.

In this regard, the DPJ has brought about many changes. However, the party’s secretary general, Ichiro Ozawa, is still in a position to control political funding and the selection of candidates. Although Ozawa is outside the cabinet, he is still at the center of power. Having control over funding and candidates essentially means being able to control policies.

This results in a weak cabinet, enabling politicians to become a minister even if incompetent. They are not able to grow and develop even after become minister, leading to an increasing number of hereditary politicians. A certain member of Parliament of the UK came to Japan and he said, jokingly, that the House of Representatives in Japan is more like the House of Lords.

The weak cabinet, bureaucracy-led politics, sectionalism, and non-transparent decision making are all deviations from the ideal parliamentary cabinet system.

These are not fundamental, institutional issues, so improvements can be made without overhauling existing political institutions. There is, rather, a need to deal with conflicting interests within political parties. The LDP did not have the capacity to do that. Whether or not the DPJ can do so is something that will be tested going forward.

In a nutshell, this is an issue of party governance. The DPJ is aware of this and has done several things. One, Ozawa has said that he will focus his energies on the management of party affairs as secretary general, not involving himself in policy matters. Another change has been the creation of the “political-level council” comprising the minister, senior vice-minister, and parliamentary secretary to make policy decisions.

Challenges for Hatoyama

Now I would like to refer to what is actually happening now and the future prospects for the Hatoyama cabinet.

Firstly, with regard to reforming the system of political governance, this is something that the DPJ called for in its manifesto and is very important. The issue here is the expectations of the general public and the challenges that are involved.

Reference was made earlier to the mood of the Japanese public. The DPJ’s landslide victory in last year’s general election and the high support rate that Hatoyama continues to enjoy is not necessarily due to the DPJ’s policies but due to the expectations for change.

The Japanese people do not feel an imminent threat right now—security or otherwise. Rather, the public is frustrated by rigidity in society. I believe people are looking for change.

There are many factors behind this mood. Since the administration of Junichiro Koizumi,

there has been a widening of income disparities and increases in the burden of an aging society.

I think that one major factor is the media factor.

The Japanese are not very active when it comes to participating in public debate and have low awareness of the need to participate. At the same time, there is pent up dissatisfaction in society. This is the result of media reports critical of the way government and politics are run. While not actively participating themselves, dissatisfaction has built up among the Japanese people over their political leaders.

Each morning, at eight, nine, and ten o'clock, Japanese television viewers tune into what are called "wide shows," which are essentially gossip shows dealing with celebrity scandals, sports, and to some extent, political news. These shows have stirred up considerable discontent.

Review of Governmental Programs

So, in that sense, the Japanese are looking for change. And the DPJ's answer to this public mood has been the creation of the Governmental Revitalization Unit within the Cabinet Office.

The Government Revitalization Unit was established in order to reform the overall national administration, including the budget and system of national administration, from the people's standpoint, and also to review the division of roles among the national government, local public authorities, and private companies.

Their first task was to reassess the budget requests for fiscal 2010. It held budget-screening hearings called *jigyo shiwake* to assess the need for around 450 publicly funded programs, out of the total of some 3,000 for which the ministries and agencies of the central bureaucracy had filed funding requests for fiscal 2010.

Jigyo shiwake is something that we proposed at Japan Initiative, a private think tank I founded in 1997 and still serve as president. We conceived of this idea seven years ago and have been working to have it implemented. We began a campaign of public budget-screening hearings at the municipal level and then moved forward to the national level. We conducted the first hearings for the national budget with the then ruling LDP in August 2008 and also with the DPJ in June 2009 when the party was still

in the opposition.

The original intent of this review was not to achieve spending cuts per se but to ring about changes in public administration, whether at the prefectural, municipal, or national level, and also to achieve structural changes to the system itself.

The DPJ promised many new programs in its manifesto, including a child allowance, and it needed to find revenue sources to finance them. Hatoyama became prime minister in September, and the fiscal 2010 budget needed to be put together very quickly. There was not much time. That is why the administration decided to prioritize budget cuts before embarking on the task of making institutional reforms.

The spending review process in full public view was held over nine working days from November 11 to 27, with three working groups handling the assessments.

One feature of the process was that people outside of government would be tapped as reviewers. Things would be seen from the eyes of an outsider. In this regard, the budget assessors (*shiwakenin*) included private-sector analysts, in addition to DPJ Diet members and the senior vice-ministers and parliamentary secretaries of each ministry.

The review took place in a school gymnasium, where the senior bureaucrats from each ministry were seated on one side, and the assessors seated on the other. The assessors asked questions, and the officials responded to those questions.

Another feature was that the process was completely open to the public. All the proceedings were broadcast live via the Internet. This process generated great public interest. Nearly 20,000 people came to watch these proceedings in person, and an additional 340,000 people viewed them online each day in real time.

Before this process began, I warned Prime Minister Hatoyama that once it starts, it will be like a sporting event where the results would be reported daily on television and the newspapers, much like a baseball game or sumo match. And this is exactly what happened.

It is a bit populist in its approach, but I believe that the discussions that took place were at a very high level. Nevertheless, we have only just exposed the issues that need to be tackled going forward.

Around 90 percent of the conclusions of the review process were reflected in the budget

for fiscal 2010. Future tasks include reviewing those government programs that were not evaluated this time and deepening the scope of debate to the systems underlying each program.

According to a joint opinion poll conducted by the *Sankei Shimbun*, a conservative daily, and the Fuji News Network, a nationwide TV station, the Hatoyama cabinet's approval rating was 68.7 percent right after the inauguration, then dropped to 60.9 percent in October. Unlike his three LDP predecessors, whose approval rating continued to drop, however, Hatoyama's approval rebounded slightly to 62.5 percent in November. During the review of government programs, it came close to 90 percent at one point. It no doubt helped to boost Hatoyama's popularity.

There have been some media polls indicating that the approval rating for the Hatoyama cabinet has dipped below 50 percent. The lowest so far has been 48 percent in the survey conducted by the *Asahi Shimbun*. The aforementioned *Sankei Shimbun*, incidentally, reported a support rate of 51.0 percent.

One factor behind the decline has no doubt been the money scandals that have surfaced involving both Hatoyama and DPJ Secretary General Ichiro Ozawa. The administration is only three months old, however, and it still remains to be seen whether it can leverage the momentum gained during the budgetary review process to advance the political reforms that the public is seeking. The administration's ability to make good on its promises is being put to the test.

I would like to conclude my talk at this point with the observation that the success of the Hatoyama administration will probably hinge not just on the personal competence of Mr. Hatoyama but on the effectiveness with which each member of his cabinet and the Prime Minister's Office fulfill their functions.

February 5, 2010

Is Futenma Really the Litmus Test for Commitment to the Alliance?

By Watanabe, Tsuneo

The Hatoyama Administration's vacillation over the relocation of Marine Corps Air Station Futenma has given rise to the suspicion among concerned circles in Japan and the United States that, unlike the previous LDP (Liberal Democratic Party) governments, this administration is setting out to lessen its commitment to the Japan-U.S. alliance. This is reading far too much into the administration's intention. It seems unlikely that the Hatoyama Administration is contemplating such a serious and fundamental shift in foreign policy. Nor would it be in keeping with the wish of the people.

For over half a century, with short-lived exceptions, there has not been a real debate in Japan over fundamental foreign policy choices, due in part to the continuation of LDP governments. The last full-fledged debate was the nationally divisive one on "Overall Peace" versus "Separate Peace" regarding the peace settlement with the Allied Powers of the World War II, i.e., whether to seek peace with all the Allied Powers including the Communist Bloc led by the Soviet Union or to conclude a peace treaty with only the Free World led by the United States. At the San Francisco Peace Conference in 1951, Japan chose to conclude a separate peace treaty with the Free World as well as to enter into an alliance with the United States. As the Right and Left wings of the Japan Socialist Party joined forces to oppose the peace treaty, the two conservative parties of the time rallied together to form the Liberal Democratic Party in 1955.

In view of this history, one may well be tempted to think that the demise of the LDP rule may presage the demise of the commitment to the Japan-U.S. alliance. But is the Hatoyama Administration really engaged in such a fundamental rethinking of foreign

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policy priorities? Is it really bent on reducing its dependence on the United States, diluting the Japan-U.S. alliance and replacing it with some multilateral framework represented by the idea of an East Asian Community? In fact, such an option had not been presented at all in the course of the general election last summer, nor would it be likely to gain much sympathy given the high degree of support for the Japan-U.S. alliance in public opinion polls.

It is true that the first full-scale change of government in half a century has lowered the hurdle for changing the directions of Japan's foreign policy. However, it would be too one-sided to see this as a "crisis" for the Japan-U.S. alliance. Rather, if the people's support for the alliance can be reaffirmed, it may even make it easier to bring into reality some ideas that have so far been considered "taboo" politically, such as changing the interpretation of the Article 9 of the Constitution.

It is not easy to obtain consensus on foreign policy issues. For example, the Obama Administration finds itself in a quandary regarding Afghanistan. It is because the United States dispatched troops to this region where restoration of security and governance are hard to come by, and has involved itself in the difficult task of nation building, for which there is no short-term answer. President George W. Bush, who first dispatched troops to Afghanistan, was saying in the course of the presidential election debate in 2000 that the United States would not involve itself in nation building anywhere in the world, which could sap its own energy. However, the terrorist attacks of 11 September 2001 drastically changed the mindset, and it has been believed since that it is vital, ultimately for the United States' own security, not to allow Afghanistan to become a hotbed for terrorists. By dispatching 30,000 additional troops to Afghanistan this year, the Obama Administration is inevitably involving itself in the country's nation building. This question of involvement in nation building will probably continue to be a contentious foreign policy issue in future U.S. elections.

If there is an issue for continuing foreign policy debate in Japan, it is likely to be the future of the Japan-U.S. alliance, under which nearly 50,000 U.S. military personnel are stationed in Japan. There is no way that Japan, as an independent sovereign nation, can get around the subject. The key is whether Japan can find an optimal solution, which is based on a correct perception of the threats to Japan and to the region and takes account of the benefits and costs arising from the alliance with the United States. Already, Japan and the United States share the perception that, in order to maintain the alliance on a sustainable basis, they need to work toward reducing the burden on

Okinawa, where more than 70% of the U.S. bases in Japan are concentrated. Given this overall perspective, it would be wrong to focus solely on the current issue of Futenma relocation as "the" litmus test for the Hatoyama Administration's commitment to the alliance. (*Reprinted from "Japan in Their Own Words," a column published by the English-Speaking Union of Japan.*)

January 8, 2010

Program Review: The First Step to Budgetary Reform

By Tanaka, Hideaki

As part of the fiscal 2010 budget process, the Government Revitalization Unit, which was established under the Cabinet Office by the new Japanese government, implemented a program review to eliminate wasteful spending in ministries and agencies. The GRU asked private experts and ruling party politicians, rather than budget examiners in the Ministry of Finance, to examine about 450 public programs.

(Please see the end note for more information on the program review.)

They assessed the efficiency and effectiveness of various programs through intensive discussion with officials from relevant ministries. This was open to the public and broadcasted live via the Internet. The process of program review drew great public interest. Based on this experience, we must explore ways to further improve budgetary procedures.

For the first time, a program review was carried out at the national level as part of the compilation of the government's budget for fiscal 2010. This was a process to examine public spending done not by budget examiners but by private experts and politicians. What is most interesting is that the public could see the discussion between experts and officials from ministries and the final decisions by experts. Citizens were surprised to find that large amounts of tax revenue are being spent for programs whose performance is not clear. On the other hand, government ministries and agencies reportedly felt they were not afforded sufficient time to adequately explain their programs, and some even expressed anger at having programs unilaterally rejected. Some people have claimed the discussions were one-sided and disorderly. This was a first-time experiment implemented within a limited timeframe, and the review itself can undoubtedly be improved in some ways.

As one example of the findings of the program review, a certain foundation authorized

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by a relevant ministry has an approximately ¥1 billion budget, mostly from government funds. Until now, the public was not aware that the half of the total budget goes toward personnel expenses and other overhead costs. That foundation hired ex-officials who had previously worked in the relevant ministry; thus, it can be said that most of the public money put into the foundation was spent to maintain their daily living. This was brought to light as a result of the change of government.

The program review has generated a great deal of commentary and criticism. People are wondering about the authority of private experts and politicians who do not have a position in the government to examine public programs. Why can they cut or propose to cut public spending without delegation? Most of these objections, however, are based on misunderstandings. What matters most is not just cutting spending but realizing the problems of the budgeting system in Japan.

Information Asymmetry in Budget Negotiation

The first thing that struck me about the program review was the question of why there are so many wasteful programs—despite that fact that the Ministry of Finance assesses the annual budget, the Ministry of Internal Affairs and Communications evaluates programs, the Board of Audit and the National Diet's Committee on Audit conduct ex-post evaluations, and many other bodies review budgets—and why so much tax revenue is spent so inefficiently. The private experts, who are mostly businesspeople or academics, do not have experience in reviewing spending and programs, but they can do it. How did the Finance Ministry and all the other government bodies involved in budgeting overlook so much questionable use of budgetary resources? It is indeed of great value to implement the assessment of programs in an open manner. In previous years political intervention in the budget process was common practice, and the annual budget process was not transparent. That is why so-called pork-barrel politics are prevailing in Japan. It is of course difficult to assess the outcomes of government-backed programs correctly, and thus it is political values that in the end decide the choice of programs. Nevertheless, the government should explain the efficiency and effectiveness of programs to the public.

Why are there so many wasteful programs? Generally speaking, guardians, who are budget examiners in the Finance Ministry, fail to cut spending in the process of budget negotiations with spenders. This is because spenders monopolize the information on programs needed to assess the funding, so the availability of information is asymmetrical. Normally, spenders do not tell the truth about the effectiveness of

programs, simply because to be honest means the loss of budgets and resources. Spenders need not consider raising tax revenues; thus, their behavior is just to maximize their budget. The relationship between guardians and spenders is ambiguous and give-and-take. Therefore, traditional budget examinations and negotiations cannot eliminate wasteful programs.

The second issue is the information necessary for evaluation and assessment and the lack of incentives. At the program review session, government ministries and agencies sought to convince reviewers by explaining the necessity of their programs and budgets, based on program sheets explaining the purpose, background, and budget for each program. Their explanations, however, primarily consisted of reasons why the country must carry out the program—simply put, they were trying to create a pretext. Most of the ministry officials argued that their programs are necessary because they are necessary for the country or public. When there is a fiscal surplus, large numbers of programs can be carried out, provided they serve the people's needs. The issue is whether the nation should support such programs in the midst of severe fiscal conditions, as well as whether they are efficient and cost-effective. Reviewers told officials from ministries and agencies that they had studied programs in advance, and they did not simply arrive at their decisions of whether programs are to be maintained or not in one-hour meetings. The bureaucrats, however, generally failed to provide information on efficiency and cost-effectiveness.

Another criticism was that it is inappropriate to cut spending for education, research and development, and other such programs due to budget deficits—that the nation should invest public money for future generations. I do not disagree with that in general, but in a fiscal situation in which government debt is rising to 200% of gross domestic product, we have to consider carefully whether the cost of such programs should be passed on to future generations. Even if these programs are to be carried out, we must make every effort to achieve more efficiency. At all times, budgetary constraints determine the necessity of any given program, rather than the objective of programs. If the overall constraints are too tight, then the government should ask the public about the possibility of tax increases. It is often argued that public spending for education and health care service in terms of GDP is low in Japan compared to other developed countries. That is to be expected, since our taxes and contributions are among the lowest of any developed country.

In the private sector, cost effectiveness is critical for management. Why don't public

services care about it? That is because those who obtain more resources are praised as good officials, and their concern is the input of resources. Therefore little attention is paid to how those budgets are spent and what they achieve and produce. To put it extremely, virtually no information on cost effectiveness or the like exists. Ministries have had to evaluate their relevant policies or programs since the Public Policy Evaluations Act was enacted in Japan in 2001, but in reality this results only in printing documents as thick as telephone books. The Act does not work as expected. There also exists the problem of incentive compatibility. If programs' performance was assessed as "not good," it might result in cutting budgets, so there is little incentive for government officials to provide accurate information for assessment. The management idea of getting feedback on results and using it to make improvements does not exist among government employees. It is no use to simply put more resources into a program, unless they are spent efficiently and effectively.

Political Leadership Must Be Here

What is needed most is political leadership. Legislators from the ruling party including parliamentary secretaries took part in the program review, but where were the relevant ministers themselves? They were instructed by the prime minister to act as "internal finance ministers" before their budget requests for the next year, but in actuality there was little evidence that they assessed their budget requests seriously, and it can be said that they just authorized budget figures that bureaucrats made to maximize their available resources. By the middle of November a guideline for compiling the next budget had finally been worked out, but it seems too late to ask third-party experts to review programs and spending within such a short period of time. The cabinet members should share the sense of fiscal severity and prioritize programs in accordance with budgetary constraints. Before finding fault with the program review, should ministers and vice ministers take the initiative to assess their own budget requests?

Needless to say, the results of program review will not be automatically put into the next year's budget. It is the cabinet that makes a budget, and thus the question of political leadership will be urgent. Well before the approaching end of the year, ministries, bureaus, and interest groups involved in programs that were assessed to be abolished by the program review had already begun lobbying against any such abolition. Political negotiation and decisions are needed for reducing spending as well as increasing spending. If there were no budgetary constraints, anything would be possible. However, to implement various programs to which the DPJ committed itself in the election

manifesto without spoiling fiscal discipline, it is critical to reallocate resources in a “pay-as-you-go” way.

The program review has provided many lessons to us. It was done under severe time constraints in its year, but by evaluating the process itself, we can make the most of the experience for the next year’s effort. A program review is primarily done by ministries and agencies themselves as their own business. Ministers, with the help of outside experts, must exert their leadership in deciding priorities and reallocating resources in order to ensure that policies can be achieved. A ministerial committee will make a decision on politically important issues. The role of budget authorities is to clearly define the budgetary limitations and set rules of the game in order to enable resources to be redirected to the areas of highest priority. Unless efforts are made to stop the game of maximizing budget resources, streamline the budget process itself, and assess results and performances, wasteful budgets will not be eliminated. It is urgent to ensure efficient and effective implementation of budgets, including public procurement. For that purpose, it will be necessary to foster government employees with expertise in contracts and competitive tendering.

In conclusion, we have to proceed in reforming the budget system based on the first year’s program review. Without this reform, the vicious cycle will continue and wasteful programs will go on being reproduced. Since the 1980s, other developed nations have reformed their respective budget systems in a variety of ways in an effort to ensure fiscal discipline, but Japan has been left behind. International comparative research verifies the relationship between budget deficits and budget institutions or the budget process. Japan’s fiscal deficit, said to be the worst among all developed countries, is rooted in her budget institutions, such as lower transparency. Canada, which had struggled with deficits since the 1980s, underwent a change of government in 1993. The new administration reformed the national budget system, primarily through the introduction of a program review, and succeeded in fiscal consolidation. Government expenditures were drastically reduced, with some ministries and agencies cutting spending by as much as 20% or 30%.

Finally, I would like to present some proposals for more effective utilization of the program review. The process should be carried out before summer, which means “start before the preparation of the budget begins” so that we analyze and discuss various programs for structural reform, rather than just cutting spending. Subsequently, strict expenditure ceilings over several years should be placed on government ministries and

agencies, and these bodies should tailor their budget requests based on government policies, using various reviews and assessments including a program review by external experts, an evaluation by the Board of Audit, and information from their own evaluations. The results of program reviews represent one type of value assessment, and others may be possible, but it should be noted that the reviews should be done by those who are knowledgeable about how programs are going on the “front lines.” If ministries and agencies do not follow the limitation guidelines, they must provide sufficiently persuasive rationales to convince experts, and offset spending with other cuts in order to maintain expenditure ceilings. When new programs are proposed, resources must be reallocated within the relevant ministry or agency budget. Provided they abide by expenditure ceilings (or baselines), ministries and agencies should be given some discretion to reallocate resources. Expenditure ceilings over several years will also mean a guarantee that ministries and agencies will be provided with resources as long as certain conditions are met. This is because conflicts between spenders and guardians on budget formulation will be eased and ministries will be able to pay attention to increasing program efficiency rather than maximizing their budget. Most importantly, ministers will perform the function of deciding budget priorities.

It will also be necessary to streamline various programs that are already included in budgets. When the same program is carried over from the year before with the same level of funding, little effort is made to improve its efficiency, and this is all the more true in light of the current deflationary economy. Efforts must be made to get ministries and agencies to produce consistent—or even better—results with less funding. But Japan’s problems will not be resolved by cutting spending alone. Despite the severe fiscal conditions, economic growth must be achieved and measures must be taken for the next generations.

Background Information

How the program review (jigyo shiwake) was carried out

The public hearings to review various programs on the budgeting process were carried out by the Government Revitalization Unit, a new body formed under the Yukio Hatoyama cabinet that took power in September 2009. The GRU was established in order to reform the overall national administration, including the budget and system of national administration, from the people’s standpoint, and also to review the division of roles among the national government, local public authorities, and private

companies. The GRU's first task was to examine budget requests from the perspective of their necessity and efficiency. It held budget-screening hearings to assess the need for around 450 publicly funded projects, out of the total of some 3,000 for which the ministries and agencies of the central bureaucracy had filed funding requests for fiscal 2010.

The program review process took part over nine working days from November 11 to 27, 2009, with three working groups handling the assessments and hearings. All the proceedings were open to the public and broadcasted live via the Internet. This process captivated the public interest: nearly 20,000 people came to watch these proceedings in person over the nine days they took place, and an additional 340,000 people viewed them online each day in real time.

The budget assessors (*shiwakenin*) included the DPJ's Diet members, private-sector analysts and thinkers, and senior vice ministers and parliamentary secretaries for each ministry. They examined various programs by such criteria as necessity, urgency, and efficiency and announced their judgments based on working-group discussions.

The process of the program review of one item goes as follows:

- Officials from relevant ministries and agencies describe their program in 5–7 minutes
- Ministry of Finance Budget Bureau officials suggest issues and problems that appeared in the previous budget process in 3–5 minutes
- The DPJ's Diet member heading the session defines an agenda and summarizes major issues to be discussed in around 2 minutes
- Debate takes place, with Q&A between assessors and ministry or agency officials, for around 40 minutes
- The DPJ's Diet member heading the session concludes discussions and presents the final assessment in 2 minutes

Japan Initiative, a private think tank founded in 1997 by Hideki Kato (currently chairman of the Tokyo Foundation), has been recommending a program review in order to reform Japan's administrative and fiscal systems. Hideki Kato, who still serves as Japan Initiative's president, was tapped as a member of the GRU; he is now secretary-general of this new government body.

November 20, 2009

Japan's Security: 10 Proposals for the Hatoyama Administration

The Tokyo Foundation

Foreword

Following a historic change of government, Japan's foreign and national security policies are set to be reevaluated by the new Democratic Party of Japan administration. In its election manifesto, the DPJ expressed its intention to "build a close and equal Japan-US alliance to serve as the foundation of Japan's foreign policy" and to develop "an autonomous foreign policy strategy for Japan." The party also pledged that it would "propose the revision of the Japan-US Status of Forces Agreement," and would "move in the direction of reexamining the realignment of US military forces in Japan and the role of US military bases in Japan."

Prior to the election, DPJ President Yukio Hatoyama suggested that his party would end the Maritime Self-Defense Force's refueling mission in the Indian Ocean and have the US Marine Corps Air Station Futenma relocated outside Okinawa. Now that the party is in power, there is considerable interest in Japan and overseas in whether these plans will be carried through.

The Tokyo Foundation's National Security Policy project has compiled 10 proposals that we regard as essential to the new Hatoyama administration's rethink of Japan's foreign policy and national security strategy. It goes without saying that these are minimal guidelines addressing only the most urgent issues; they should not be taken to represent our vision for Japanese foreign policy or national security strategy in its entirety.

For a more comprehensive set of recommendations on Japan's national security strategy, see the "New Security Strategy of Japan: Multilayered and Cooperative Security Strategy" published by the Tokyo Foundation in October 2008. This presented proposals for a new security strategy, grounded in a national vision, in response to changes in the security environment since the National Defense Program Guidelines of 2004.

The change of government offers an ideal opportunity to revisit the fundamentals of Japan's domestic and foreign policies and reevaluate their significance and effectiveness, and to introduce new approaches suitable for dealing with a changing international

environment. We hope that the new administration will change Japan's foreign and national security policies in ways that promote the national interest.

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Japan's Security: 10 Proposals for the Hatoyama Administration

The new administration of Prime Minister Yukio Hatoyama marks a historic change after more than 50 years of Liberal Democratic Party domination. The new government's stance on foreign affairs has caused misgivings in some quarters, but the issues prioritized in the party's manifesto and in the prime minister's statements to date include many praiseworthy suggestions, among them close and equal Japan-US relations, stronger diplomatic ties with Asia, and advocacy of a role for Japan in peace building. It is to be hoped that the government will formulate systematic and concrete policies to realize these aims as a matter of urgency. Backed by solid public support, the Hatoyama administration has an excellent opportunity to move Japanese policy forward by fulfilling its pledge to scrap the bureaucrat-dependent system that has so far dominated national policymaking, in which too much emphasis is placed on precedent and protocol. As Japan enters a future in which genuine changes of government can take place, the Tokyo Foundation's National Security Policy project proposes the following policies to the Hatoyama administration.

The Japan-US Alliance

Proposal 1: The administration should not insist on the relocation of an air station outside Okinawa but should deal flexibly with the agreement regarding the realignment of US forces in Japan. Otherwise, the US bases in Okinawa might end up becoming fixed in their present locations.

Although it may not represent the ideal arrangement for any single party, the current US military realignment plan agreed between Japan and the United States was the result of lengthy negotiations aimed at finding the best compromise acceptable to both countries and to the people of Okinawa. Given the current political climate in the United States, the Obama administration does not have the option of undertaking a fundamental reevaluation of the plan.

Insisting on revisions to the plan now might result in long delays in achieving the original aim of reducing the burden placed by the US military presence on the people of Okinawa. Changing the agreement would require substantial work, would consume a sizable chunk of the new administration's political assets, and would cause serious friction between the Japanese and US governments. This could lead to a failure to deal with the dangers posed by the Futenma air station (currently located in the middle of a built-up area), could stall plans to relocate 8,000 marines from Okinawa to Guam and return all US military facilities in or south of Naha, and, further, could cause a sense of powerlessness among the US military negotiators who have worked so hard to resolve this issue. This, in turn, could result in the bases in Okinawa becoming fixed in their present locations.

Proposal 2: The administration should avoid rushing to alter the Japan-US Status of Forces Agreement, which should be raised as a long-term bilateral issue. The immediate aim should be to improve implementation of the agreement so as to reduce the burden on local residents.

Reexamination of the Japan-US Status of Forces Agreement has been regarded as a kind of taboo because of its potential to open a Pandora's Box for officials on both sides. The new Hatoyama administration should demonstrate its readiness to deal with the issue proactively. It needs to be clear about its purpose in reexamining the agreement and about the aspects of the agreement that it wants to prioritize and emphasize. It is important to narrow the focus of discussions and treat the problem as a medium- to long-term issue between the two countries, including the possibility of signing special

agreements. At the same time, the government needs to engage positively with the problems faced by residents who live close to US bases. The reduction of noise pollution from the bases is an example of an issue on which Japan should press the United States to improve implementation of the Status of Forces Agreement. There have been cases, for example, in which voluntary measures such as restrictions on late-night take-off and landing exercises involving fighter planes have not been passed on accurately following the appointment of a new base commander. It is important to reduce the burden on local residents so that they have a tangible sense in their daily lives of an improvement in the way the agreement operates.

Challenges to Global Peace

Proposal 3: As part of its efforts to achieve global peace and prosperity, the administration should expand Japan's involvement in antipiracy activities off the coast of Somalia to include refueling missions for other nations' naval vessels. At the same time, the administration should increase Japan's participation in United Nations peacekeeping operations with a long-term vision.

In order to achieve global peace and prosperity, it is important for Japan to play a visible role commensurate with its international standing. There is a growing need for efforts to assist development and stability in the world's poorest regions, which otherwise risk becoming hotbeds of international terrorism, piracy, proliferation of weapons of mass destruction, and disease pandemics.

The international community expects Japan to make an active contribution to these efforts. Refueling the naval vessels of countries engaged in antipiracy activities off the coast of Somalia is one particular area where a latent need exists and where Japan can make a positive contribution. At present, however, the reality is that Japan has fewer than 50 personnel involved in United Nations peacekeeping operations. The DPJ made a commitment in its manifesto to expand Japan's involvement in UN peacekeeping operations; greater involvement would also dovetail with the Obama administration's stance of emphasizing the United Nations. Dealing with nontraditional threats of this kind was one of the "common strategic objectives" agreed at the Japan-US Security Consultative Committee (2+2 Meeting) in 2005, and the government should take the initiative in suggesting this to the Obama administration as a new area of cooperation between Japan and the United States.

Proposal 4: In the short term, Japan should support reconstruction efforts in Afghanistan by

continuing its refueling operations in the Indian Ocean in some form or by pursuing suitable alternative cooperation. In the longer term, Japan should aim to contribute by training personnel for reconstruction work in Afghanistan and by building and running international training and support facilities for such personnel either in neighboring countries or Japan.

While it is to be hoped that Japan's refueling operations in the Indian Ocean will continue in one form or another as part of the Japanese contribution to reconstruction efforts in Afghanistan, at the same time the Hatoyama administration should initiate proactive policies to help maintain law and order, improve infrastructure, and rebuild the Afghan economy. International policing efforts led by Europe and the United States are making progress, but there is considerable scope for Japan to assist these efforts by expanding and enhancing auxiliary support functions. This might involve training the emergency medical teams that form part of policing and firefighting services outside the country and sending them back to Afghanistan along with rescue equipment, ambulances, and other necessary supplies. The effectiveness of this assistance could be further improved by offering post-provision services, such as maintaining and replenishing equipment and retraining personnel. In the medium to long term, Japan should also begin training professionals with expertise in agricultural production and product-processing technology, who will be essential for building Afghanistan's social and economic infrastructure.

Proposal 5: Japan should actively make and implement proposals to realize the ideal of a "world without nuclear weapons." Nuclear disarmament is important, but it must not impair the reliability of the US nuclear umbrella.

It is not a contradiction for Japan to pursue the reduction or elimination of nuclear weapons while at the same time adhering to a policy of maintaining the US nuclear umbrella. President Obama declared in Prague that the United States would act to eliminate nuclear weapons but that, as long as such weapons existed, would acknowledge the role of nuclear weapons in global peace and security and would continue to possess such weapons to deter attacks against itself and its allies. The Hatoyama administration should align itself with this thinking. The recent increase in the impetus behind the push for global nuclear disarmament is an opportunity for Japan to disseminate again its ideas about disarmament to the world and to take the lead in developing practicable policies. At the same time, there remains the issue of how to secure the safety of Japan, which does not possess nuclear weapons, until the ideal of eliminating nuclear weapons is achieved. With Russia maintaining its massive nuclear

arsenal even 20 years after the end of the Cold War, China stepping up the modernization and expansion of its nuclear capabilities, and North Korea conducting repeated nuclear tests and missile launches, the level of nuclear threat in the vicinity of Japan has, if anything, increased. The key to defending Japan from these threats is the deterrent effect of US nuclear weapons. Nuclear disarmament is important, but it must not diminish the reliability of the US nuclear umbrella, thereby exposing Japan to security risks. Japan's continued adherence to a nonnuclear policy while trusting in the nuclear umbrella is itself a major contribution to global efforts to reduce and eliminate of nuclear weapons.

Proposal 6: To prevent further nuclear proliferation and compel North Korea to abandon its nuclear programs, Japan should strengthen both its diplomatic efforts through the Nuclear Non-Proliferation Treaty regime and the military pressure it applies on North Korea principally through the Japan-US alliance.

Nuclear nonproliferation is an even more urgent challenge than nuclear disarmament. Japan's security would be directly threatened if North Korea's attempts to arm itself with nuclear weapons were to become a fait accompli or if international terrorists were to obtain a nuclear weapon. Diplomatic efforts through the Nuclear Non-Proliferation Treaty (NPT) are crucial to prevent such scenarios. The Hatoyama administration should comprehensively support the activities of the International Atomic Energy Agency. Nuclear nonproliferation cannot be achieved through diplomatic efforts alone, however. To prevent North Korea from possessing nuclear weapons, which would gravely impact on Japan's security, and from supplying such arms to other states or international terrorist organizations, it is essential to apply international pressure of every kind, including military pressure. It is especially crucial that the administration firmly maintain the Japan-US alliance. Besides securing protection through the US nuclear deterrent, Japan must maintain a stance of confronting the North Korean threat through conventional arms, missile defense, and other means, in close communication and cooperation between the Self-Defense Forces and the US military.

Proposal 7: Japan should dramatically strengthen its UN diplomacy and continue its efforts to become a permanent member of the UN Security Council, while boldly taking the lead in "human security," a field Japan itself proposed. First, the prime minister should attend without fail the General Debate of the UN General Assembly held every September, and the administration should also strive to exercise leadership in UN activities by dispatching more Japanese to serve in key UN posts, such as UN representatives for peacekeeping operations.

As seen by the positive global reaction to Prime Minister Hatoyama's visit to the United Nations and bold proposals on climate change, the United Nations, which is the only universal organization, is the most appropriate forum for transmitting Japan's message to the world and can also serve as a venue for bilateral meetings. It is important for Japanese people to play a more active role in the UN, to obtain more posts like under-secretary-general and assistant secretary-general, and to exercise leadership on the front line of conflict resolution, as Yasushi Akashi did when he served as special representative of the UN secretary-general to Cambodia and the former Yugoslavia. Japan should lead the UN in spreading the idea of "human security," which emphasizes human dignity and support for self-reliance, and should make particular efforts in such fields as the peaceful resolution of conflicts, the rule of law, and respect for human rights. To this end, steps must be taken to promote Security Council reform so that Japan can gain the status of a permanent member of the Security Council. Japan will assume the presidency of the Security Council for the month of April 2010, so either the prime minister or the foreign minister should begin preparing now to attend the council and spearhead its discussions. Such efforts to invigorate the UN would contribute to the stability of the world and the Asian region, as well as enhancing Japan's own security.

Relations with the Asia-Pacific Region

Proposal 8: To establish "intra-regional cooperative mechanisms in the Asia-Pacific region," as the new Hatoyama administration aims, it is essential to strengthen Japan's cooperation not only with its ally the United States but also with South Korea, Australia, ASEAN, and other partners while pursuing a strategic relationship with China. The administration should pursue regional stability by building multilayered cooperative relationships.

The Asia-Pacific region has no effective multilateral security framework, and there is mistrust among the nations of the region stemming from past wars, territorial issues, and differences in political systems. The new administration should improve and strengthen Japan's relations with its neighbors, China and South Korea, and at the same time build other frameworks for regional cooperation. Since it would be impossible to achieve regional stability without the cooperation of the United States, it is important to establish organic coordination between the framework for regional security cooperation and the "close and equal Japan-US relationship" espoused by the DPJ in its election manifesto, and this will necessitate the simultaneous deepening of regional and Japan-US cooperation. The administration should forge and link multiple networks in the region, such as by strengthening cooperative relations with Australia, South Korea,

and other US allies and collaborating with bodies like the ASEAN Regional Forum.

Building relations with China is one of the key challenges. While China's development contributes to the global economy, its military buildup is a latent cause of regional instability. The difficulty in gaining an overall picture of China's military strength and the lack of transparency in the country's policymaking process are fomenting concern in other countries. China must be urged to ensure that its rise does not threaten regional or global stability.

Specifically, the Hatoyama administration should establish a strategic cooperative relationship with China by resolving one by one the matters of concern in bilateral relations, such as the need for transparency regarding China's military strength, the development of gas fields in the East China Sea, and food safety.

Guidelines and Policy Infrastructure to Defend a Peaceful Japan

Proposal 9: There is an urgent need to develop new National Defense Program Guidelines, setting out clear guiding principles for defense policy and, based on these, systematically establishing defensive capabilities. This is important because it will also serve to demonstrate clearly to those both in Japan and overseas the new administration's national security and defense strategy.

Actively engaging in international security cooperation activities and pursuing closer and more equal Japan-US security cooperation in the aim of achieving global peace and prosperity can become the central concepts of new National Defense Program Guidelines. To realize these concepts, there is an urgent need to improve the organization and equipment of the Self-Defense Forces so that the SDF can serve in peacekeeping and similar operations while cooperating organically with the military forces and governmental and nongovernmental organizations of other countries. Forging a system like this would also have the immediate benefit of reinforcing the SDF's cooperative relationship with US forces. In addition, efforts to control and reduce missiles and weapons of mass destruction are vital in terms of discouraging North Korea's nuclear ambitions.

The administration should also counter existing threats by advancing missile defense and measures to protect residents. A further challenge is that since the Cold War the SDF's capabilities have been overly focused on hardware, such as military vessels, aircraft, and vehicles. The administration should enhance the effectiveness of the SDF

by bolstering its nonhardware capabilities, such as information-technology-based surveillance/warning/reconnaissance and command and control functions, by networking these capabilities, and by improving SDF members' skills through education and training.

Proposal 10: To address global security issues effectively, the administration should both strengthen Japan's own intelligence capabilities and the system for Japan-US intelligence sharing. This is necessary to enable Japan to make independent judgments and to realize a more equal relationship with the United States.

Among the priority tasks for enhancing Japan's intelligence capabilities is the strengthening of detection functions for gathering satellite, human, and other forms of intelligence; of analysis and processing functions for compiling, processing, and distributing intelligence; and of information and communication functions for securely conveying the intelligence. The administration should place high priority on putting in place the legal foundations and infrastructure for this purpose. Such efforts are also vital in terms of Japanese policymaking and of maintaining a close Japan-US alliance, for they will enable Japan to reach appropriate decisions while making effective use of intelligence from the United States, which boasts the world's greatest intelligence capabilities. One of the urgent tasks in establishing legal foundations is to write Diet members' duty of confidentiality into law; for the Hatoyama administration, with its stated intention of establishing political leadership, this would also be an effective means of promoting the sharing of information between bureaucrats and politicians.

May 20, 2009

Japan's Watershed Forests in the Cross Hairs

The Tokyo Foundation

The Tokyo Foundation has been engaged in research on the crisis facing Japan's watershed forests and recently announced proposals for protecting the country's forests and water cycle from interests backed by global capital. These proposals were subsequently addressed by Sentaku, a magazine that carries substantial influence with Japanese policymakers.

Buyers backed by global capital are stealthily reaching their hands out toward Japan's forests. In January 2008, a Chinese concern approached the town of Odai in Mie Prefecture with an offer to purchase a large tract of its mountainous forestland. The group's intention was to log over 1,000 hectares of forest surrounding the upstream section of a dammed lake and ship the harvested timber to China from Nagoya Port. Although caution on the part of the local government prevented the deal from going through, the buyers, who were acting as intermediaries, merely turned their attention to a different locality.

There was a similar occurrence in June 2008 in the village of Tenryu in Nagano Prefecture. A buyer from Tokyo looking to purchase forestland reportedly told his associates of China's demand for lumber and potable water, explaining that a wide expanse of watershed forest could easily sell for several times the market price. Amid a protracted slump in the market for forestry products, talk of such deals is happening behind the scenes all over Japan.

A Fire Sale in Japan's Battered Provinces?

An increase in purchases of forestland can be explained by any number of factors; in the case of Japan, however, the immediate cause is unreasonably low prices. Forestland prices in Japan have declined for the past seventeen years in a row and are now lower than the levels seen in the mid-1970s. Prices for standing timber, too, began declining in the 1980s and have continued to fall for over 25 years. With prices so low, there are no profits to be made by properly managing and maintaining a mountain property. On the other hand, a buyer that purchased forestland cheaply and harvested all the timber without bothering to replant it (although this is against the law) would reap handsome

profits. This explains the growing number of incidents all over Japan in which speculative real estate companies buy up mountain plots from struggling landowners, harvest the standing timber, and then abandon the land.

Water is another motive for purchases of mountain forests. As rising demand puts ever greater pressure on global water supplies, countries around the world are intensifying their efforts to secure water resources, including watershed forests. In China, in particular, demand for bottled water is growing rapidly, increasing fourfold between 1997 and 2004. Annual consumption of bottled water has ballooned to 9.8 billion liters. The so-called water barons—major water companies—are frantically buying up land all over the world to obtain rights to the water resources located there. The flow of money into water resource businesses through investment vehicles known as water funds has also increased in the past few years. Amid these global trends, water market players view Japan's undervalued forests as a "buy."

In the Chubu and Kyushu region, the problem extends beyond direct purchases of forestland. According to reports, sake brewers and bottlers have also been bought up for their groundwater sluice gates and accompanying forestland. With provincial economies in tatters, alarming numbers of breweries have been going under. Brewers and bottlers desperate to sell off their capital as their businesses slump present ideal targets for overseas buyers.

A common thread in each of these stories is the widespread use by buyers of intermediaries and dummy corporations. The buyers behind the deals managed to conceal their true identities by interposing two or three extra links in the purchasing chain. Without realizing it, local landowners forced to part with their forestland due to economic hardship end up selling their property to an unknown buyer via a complicated resale process.

Administrative Failure

Gaining an accurate grasp of the facts behind the rumors circulating in various parts of the country, however, is extremely difficult. Roughly 60% of Japan's woodlands are private forests owned by individuals or corporations. Although sales of land, including privately owned forests, must be reported after-the-fact under Article 23 of the National Land Use Planning Law (though this applies only to plots of 1 hectare or more outside of city planning zones), the data provided by such reports are not subjected to the kind of rigorous compilation and analysis needed to understand what is happening.

To make matters worse, the comprehensive survey of Japanese land based on the National Land Survey Law is still less than halfway toward completion. Astonishingly, the authorities do not even know how large most areas of forestland are, let alone who owns them. Because of the lack of progress in completing the national land survey, real property registers do not provide an accurate picture of the present status of forestland. Omissions in information regarding landowners (caused, for example, when a new owner neglects to register the change in the name of the titleholder) and the sheer number of plots make it nigh-on impossible to get a clear picture of who owns what using land registers alone.

In short, there is no mechanism for the national authorities to identify who owns Japan's forestry resources and for what purpose. Jurisdiction over the country's forestry and water resources, including groundwater, is split among a number of government agencies: the Ministry of Land, Infrastructure, Transport, and Tourism is in charge of the national land survey and regulation of land use; forests are generally administered by the Forestry Agency; and tasks relating to the environment, including groundwater, are generally handled by the Ministry of the Environment. With the Ministry of Health, Labor, and Welfare, the Ministry of Economy, Trade, and Industry, and other agencies also involved, Japan's forestry and water resources are not being administered in a comprehensive manner.

In January 2009, the Tokyo Foundation issued a proposal titled "Japan's Forestry and Water Resources in Crisis." In it, the Foundation points out that while forestry resources are the private property of individuals, corporations, and others, at the same time they generate the water resources on which Japan depends and are a fundamental part of the country's infrastructure.

In the days when Japan's forests were properly managed, the public benefit derived from forestry resources was maintained to some extent by landowners, who took good care of their mountainside plots. But now, with rural villages impoverished and a mere 50,000 or so forestry workers in all Japan (26% of whom are aged 65 or older), many forests lie neglected, the identities of their owners unknown.

The existing legal framework was erected back when there was high demand for domestic lumber and forest management was thriving. At that time it was impossible to foresee the increase in overgrown forests and the lack of reforestation that have resulted from factors such as foresters' financial hardships and the growing number of absentee landlords; consequently, the current laws are incapable of dealing firmly with such

nonfeasance. Moreover, almost nothing has been done to put in place rules to protect forests and groundwater from global interests bent on realizing short-term profits. With the exception of farmland, the laws that are supposed to restrict the resale of land are simply not functioning. According to Article 207 of Japan's Civil Code, "Ownership in land shall extend to above and below the surface of the land, subject to the restrictions prescribed by laws and regulations." In other words, it is possible that landowners could also lay claim to the groundwater and hot springs under their land.

In the event of a dispute over the rights to groundwater lying under private forestland purchased with foreign capital, local residents would be opposed in any legal action by an organization (most likely a corporation or fund) that might fiercely defend its position based on the legality of its ownership of the watershed forest and groundwater on and below the land. Already such a conflict over water rights is being played out in the US state of Michigan between local citizens and a bottled water company funded by Perrier, a subsidiary of the Swiss corporation Nestlé. In such cases, it is imperative that residents start a debate with the organization about the public and social significance of the resources. During a drawn-out conflict, the land in question continues to be used by the organization and is not returned.

Once structural changes like land subsidence occur due to excessive extraction of groundwater, it takes hundreds of years to restore the surrounding environment. If water and forestry resources are sold to an unknown buyer who proceeds to threaten the safety and peace of mind of local residents through reckless development or excessive water usage, it will already be too late. For this reason, the government's nonfeasance in administering Japan's water and forestry resources is unforgivable.

Viewing Japan's present system from this perspective, the rules put in place to safeguard the country's watershed forests and groundwater can only be described as alarmingly inadequate. To give watershed forests their rightful status as a key element in Japan's infrastructure, the government must swiftly establish a cross-ministry form of administration for the conservation of watershed forests and groundwater. *(Reprinted from the May 2009 edition of Sentaku. Courtesy of Sentaku Shuppan K.K.)*

March 10, 2009

Priority Issues in Japan's Resource and Energy Diplomacy

By Abiru, Taisuke and Hiranuma, Hikaru

The financial crisis that started in the United States has touched off a great upheaval in the world economy, the likes of which are said to come once every 100 years. A new world economic system will take clearer shape in the coming years, and whether Japan will continue to play a major role will depend on its planning and execution of industrial and technology policies suited to the new global economic system, as well as closely related resource and energy policies. It must do this while keeping an eye on the medium- and long-term trends underpinning the rapid changes in the international order, including the rise of such emerging countries as China and India, a relative decline in American influence, instability in the medium- and long-term supply of fossil fuels accompanying the growth of the emerging economies, and the increasing seriousness of global warming. With respect to resource and energy policy in particular, Japan, which depends on imports for nearly all of its needs, can do little by itself. Moving away from traditional diplomatic frameworks and building global relations of coordination and cooperation are urgent tasks for Japan, and strategic diplomacy with the public and private sectors working together will be essential.

Based on this recognition, the Tokyo Foundation has conducted surveys and studies on energy trends in Japan and throughout the international community since April 2007 as part of its research efforts in the field of Energy Issues and Japanese Foreign Policy. These studies have suggested resource and energy diplomacy policies that Japan should adopt, and have resulted in the proposals presented below.

We hope that these proposals will be reflected in the nation's resource and energy strategy.

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**Priority Issues in Japan's Resource and Energy Diplomacy:
Relations with the United States and Russia in Nuclear Energy
and with China in Rare Earth Metals**

The major thrust of Japan's resource and energy diplomacy has traditionally been to secure a stable supply of fossil fuels, namely oil and natural gas. These efforts first evolved around Middle Eastern and a few Asia-Pacific countries, and then since the end of the Cold War have spread to include former republics of the Soviet Union, mainly Russia, Azerbaijan, and Kazakhstan.

In recent years, however, against the background of global warming and uncertain medium- and long-term supplies of fossil fuels, we have seen a rapid rise in the importance of nuclear power; wind and solar power, renewable energy sources that take advantage of advanced technology; and electric and other next-generation vehicles. At the same time, new movements in resource and energy diplomacy have appeared.

In June 2008, just before the G8 Hokkaido Toyako Summit, which focused on global warming issues, the International Energy Agency released its Energy Technology Perspectives 2008. This includes multiple scenarios for the realization of sustainable energy in the future, and simulations together with the technical background necessary for these scenarios. The harshest of those scenarios is one in which CO₂ emissions are reduced by half by 2050, for which dramatic energy savings and technical innovations will be essential. This will require an additional annual investment equivalent to about 1.1% of average annual global GDP, with the total cost rising to \$45 trillion. Even including technical innovations in a range of fields—energy savings and increased energy efficiency; renewable energy from solar, wind, and biomass resources; carbon capture and storage; and in the transport sector, electric, plug-in hybrid, and fuel-cell vehicles—calculations indicate that there will be a need to build 32 new nuclear power plants each year worldwide.

In Japan, as seen for example in the New National Energy Strategy presented by the Ministry of Economy, Trade, and Industry in May 2006, the focus in energy trends both domestically and internationally is on (1) promoting the use of nuclear energy and (2) increasing energy efficiency through the use of advanced technology, reducing reliance on petroleum and other fossil fuels, and raising nuclear energy generation efficiency. The measures and policies needed to achieve this are considered to be priorities in the field of resource and energy diplomacy.

In the light of the above, the Tokyo Foundation offers the following two proposals for Japan's resource and energy diplomacy, which will be needed to promote the use of nuclear energy and energy efficiency through the use of advanced technology.

Proposal 1

In the area of peaceful use of nuclear energy, Japan should focus on building a reciprocal relationship with Russia, actively contribute to strategic stability in US-Russia relations, and create a framework for Japan-US dialogue on cooperation with Russia on nuclear energy.

Promotion of further peaceful use of nuclear energy is essential to cope with global warming. In this area, Russia, as a major nuclear power, cannot be ignored.

It is possible for Japan and Russia to build a reciprocal relation in the field of peaceful use of nuclear energy.

Since Japan's and America's nuclear energy programs are unified for all practical purposes, as seen by the Toshiba-Westinghouse and Hitachi-GE alliances, stability in US-Russia relations is essential. However, the Iranian nuclear development program continues to be a problem, and US-Russia relations remain strategically unstable.

The outbreak of the Georgian crisis in August 2008 forced the administration of George W. Bush to withdraw a US-Russia nuclear energy agreement that had been signed in May and submitted to Congress for approval. Future measures will be left to the new Obama administration.

Therefore, Japan should act positively to contribute to strategic stability in US-Russia relations. Various frameworks exist between the United States and Russia and between Japan and Russia for dialogue on the possibility of cooperation in the field of nuclear energy. Between Japan and the United States, however, no framework exists for discussions of nuclear energy cooperation with Russia. We therefore propose establishing a framework for Japan-US dialogue, timed with the inauguration of the new Obama administration, that will allow the participants to exchange views on nuclear energy cooperation with Russia.

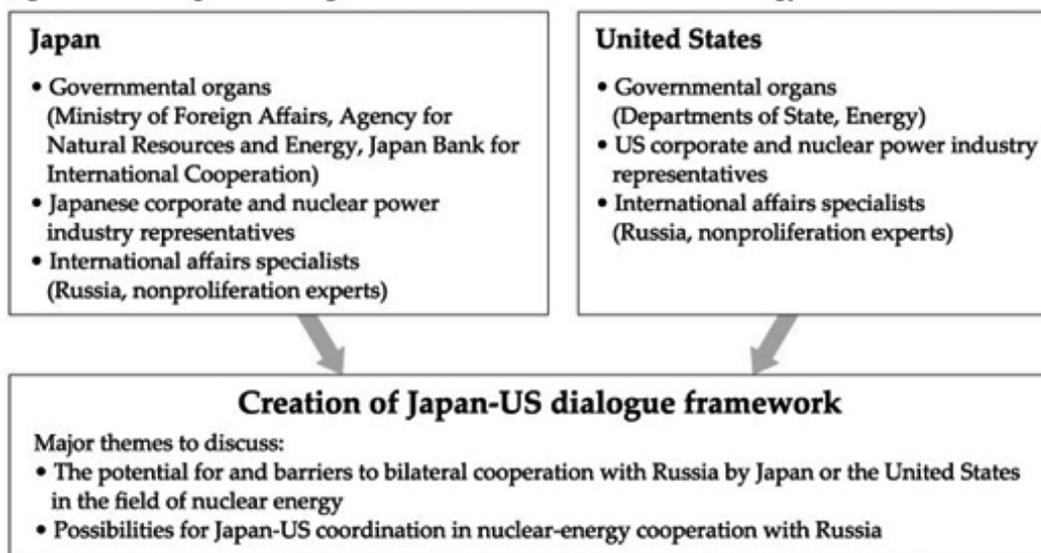
Exchanges of views should be started on how to proceed with cooperation between the United States and Russia and between Japan and Russia, and to identify the obstacles to such progress, in the areas of both peaceful nuclear energy use and nuclear

nonproliferation. As an extension of these talks, Japan can search for possible ways to work together with the United States in regard to nuclear energy cooperation with Russia. This will not, obviously, resolve points of US-Russia strategic conflict, but it will undoubtedly help to stabilize the situation. It may also lead to building a stable trilateral relationship centered on cooperation in the field of nuclear energy.

In Washington, there are influential groups that show deep understanding of the importance of cooperation with Russia in the field of nuclear energy, including the authors of a report by the Center for Strategic and International Studies, a US think tank, on nuclear energy agreements between the United States and Russia. There is a real possibility that such a framework could be established through cooperation with these groups.

The new Obama administration officially starts on January 20, 2009. However, it will take several months to set a direction in its Russia policy, including resubmitting the US-Russia nuclear energy agreement for ratification by Congress. If the first meeting in this new framework could be held in Washington by March 2009, before that direction is established, it may be possible to provide input to the Obama administration with regard to the importance of nuclear energy cooperation with Japan and Russia.

Japan-US Dialogue on Cooperation with Russia on Nuclear Energy: Framework Overview



Proposal 2

To create a stable supply environment for rare earth elements, Japan should initiate opportunities for continuous joint Japan-China research in the fields of developing recycling

technology and addressing environmental problems that accompany rare earth development, in order to build a reciprocal relationship between Japan and China.

Rare earth elements are uncommon mineral resources, referred to as the “vitamins” of industry.

These elements are used in the high-performance, high-efficiency motors in next-generation automobiles, energy-saving home appliances, and nuclear reactor materials. They have a high level of use in advanced energy-saving and environmental technologies, and the global demand for them is expected to increase. They are essential elements in the technical support of Japan’s energy policies.

Rare earth elements, more than other rare minerals, have properties that make them difficult to replace with other materials and difficult to recycle and store. Deposits and production of rare earth elements are heavily concentrated in China.

Today Japan imports nearly 100% of its rare earth elements from China. Even with diversification of supply countries or development of the ocean floor resources near Japan, the facts that demand will continue to grow and that good deposits exist in China lead to the conclusion that it is desirable to maintain a stable supply from China as a primary source.

China is positioning rare earth elements as important national strategic materials with its resource policy of “Middle Eastern oil, Chinese rare earth metals.” Development with foreign capital is prohibited, and “resource nationalism,” such as restricted export licensing, is intensifying. This gives rise to concerns in terms of stable supplies for Japan.

Past activities between Japan and China in the field of rare earth elements include the launch of Sino-Japanese rare earth conferences in 1988, based on an agreement between the director-general of the Agency for Natural Resources and Energy of Japan and the vice chairman of the State Planning Commission. In these conferences Japan and China share information and ideas on the production and sales of rare earth and nonferrous metals, as well as government policy trends regarding them.

Recent developments have shown China, despite the rising intensity of its resource nationalism, to be approaching Japan with interest in advanced technology including Japan’s superior processing, application, and recycling technologies. China must also deal with issues related to environmental problems from excessive mining and other

causes.

In consideration of these circumstances in China, Japan should cooperate in technical fields, where it is allowed, for the development of Chinese rare earth elements, build a reciprocal relationship by advancing Sino-Japanese cooperation in dealing with environmental problems, and create an environment that promotes a stable supply of these elements.

To promote a continuing stable supply from China, the Sino-Japanese relationship should not be limited to one of simple Japanese imports from China, as it has been up to this point. Rather, it will be important to promote stability by building a reciprocal relationship in which Japan and China jointly develop and use rare earth elements.

One proposal, therefore, is to initiate opportunities for continuous joint Japan-China research in the fields of recycling technology development and coping with the environmental problems that accompany rare earth development, in order to build a reciprocal relationship between the nations.

Japan's cooperation in environmental measures in the development of rare earth elements in China will be a useful experience for environmental measures when Japan itself develops sources of these elements in countries other than China.

Appendix. Proposals for Japan-China Joint Research on Rare Earth Development

Aims

To ensure a stable supply of rare earth elements from China by building a reciprocal relationship through Japan-China joint research on rare earth recycling technology and measures to address the environmental problems that accompany rare earth development, which are challenges faced by both countries.

Research Topics

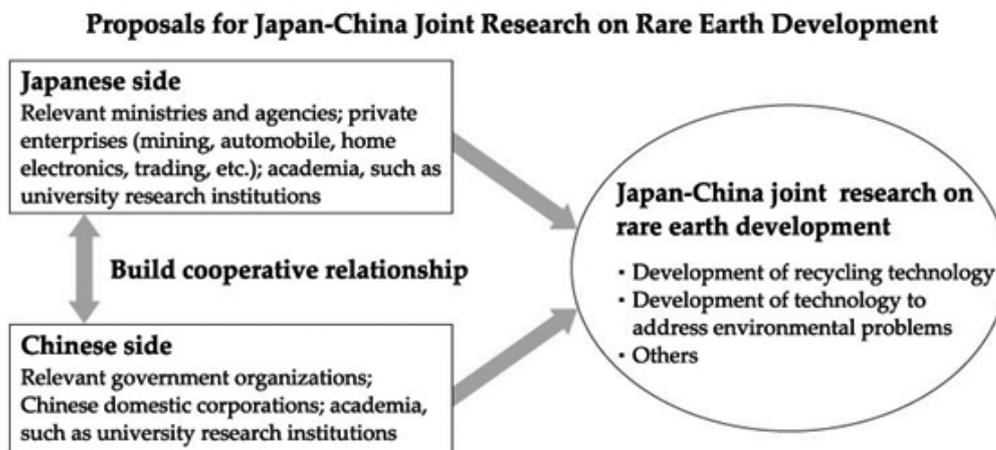
Rather than haphazardly providing China with the cutting-edge processing and application technologies that are the basis of Japan's competitiveness, the proposals call for joint research in fields that constitute shared challenges for Japan and China, thus building a reciprocal Japan-China relationship.

1. *Development of rare earth recycling technology*

- Develop technology to collect and recycle rare earth elements from commercial products
- Develop less expensive recycling technology

2. *Technology to address environmental problems in rare earth development*

- Develop more environmentally friendly extraction technology
- Develop technology for disposing of and managing radioactive waste, including thorium produced in the development process.
- Other, such as anti-aging technology for withstanding storage of rare earth elements



(This is an excerpted translation of the Tokyo Foundation proposal released on January 15, 2009.)

January 21, 2009

From Cash Handouts to Refundable Tax Credits

By Morinobu, Shigeki

Prime Minister Taro Aso has announced the distribution of around ¥2 trillion in cash benefits to all Japanese citizens. The purpose of these handouts remains unclear, though, and the argument is tangled over whether to set income limits for eligibility for them. Many decry the move as mere political largesse. How can this measure be made more effective in meeting the real needs of the people?

Refundable Tax Credits: The Better Choice

A number of developed Western nations have had great success with the introduction of a system of refundable tax credits aimed at providing economic support to lower- and middle-income taxpayers. Let me explain this system simply in terms of the proposed ¥2 trillion outlay for Japan's cash handouts. Divided equally among the roughly 10 million dependents aged 15 or younger in households with less than ¥6 million in annual income, this would come out to ¥200,000 per head, to be distributed to the households where those dependents live. A family with two eligible children would receive a credit of ¥400,000. If that family's tax bill for the year was higher than this amount, it would be deducted from the taxes due; if the tax bill was lower, or if the family's income was below the taxation threshold, the family would receive the difference, which makes the credits "refundable." This is an effective, efficient approach that combines the taxation and social security systems to achieve the same income-redistribution goals that they do, and it is in broad use in the other developed nations of the world.

The refundable tax credit systems in place in Western nations can be placed in four

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categories according to their policy aims.

The first of these is earned income tax credit (EITC) systems. These credits are granted in defined amounts to lower- to middle-income households where the taxpayers have worked at least a minimum number of hours. This system aims to prevent the moral hazard of the situation where it makes more economic sense to rely entirely on welfare benefits and to keep people from falling into the poverty trap. It is meant to encourage people's efforts to improve their job skills and live more self-reliant lives, and as such it is often implemented in concert with jobs training and education programs.

The second category is child tax credit (CTC) systems. These provide credits to households with children, with the amount increasing along with the number of minors. This approach helps to prevent poverty among single-parent households and to provide child-rearing support; in these ways it serves as a measure to counter dwindling birthrates as well.

Systems in the above two categories saw expanded use in Britain under Prime Minister Tony Blair and in the United States under President Bill Clinton. Based on the concept of "workfare," which helps people attain self-sufficiency through work, they are today fundamental parts of the UK and US taxation systems.

The third category is tax credits to offset social insurance costs. Here the aim is to reduce the burden on those in lower income brackets of taxation and social contributions. The Netherlands and South Korea have introduced systems along these lines, although the Dutch system merely offsets the contributions required of lower-income taxpayers and involves no rebates to them.

In the fourth category are tax credits to offset consumption tax liabilities. Such systems are in place in Canada and Singapore to reduce the regressive impact of consumption tax hikes on people in lower income brackets. They involve deductions and refunds of liabilities for consumption tax on basic necessities from the income tax amount. This approach is far more effective than straightforward tax rate reductions in countering the regressive nature of taxation.

Approaches in these categories have recently come to be viewed as potentially beneficial for Japan as well. The government's Tax Commission clearly stated in its recommendation report on tax reform for fiscal 2008 that exploring these options would be a meaningful task for Japan, as many nations were making use of these systems to

provide “assistance to low-income people, particularly among the younger generations, childrearing assistance, employment assistance, and an approach to offset the regressivity of consumption tax. Some countries take the tax and social security regimes as a whole and use refundable tax credits to lessen the social insurance premium burden.”

Two Issues to Tackle

There are a number of challenges to overcome if a refundable tax credit system is to be introduced in Japan. Below I examine two of the major challenges in detail.

The first of these is the need to create a framework for managing the system. In all the nations that offer refundable tax credits, a single taxation authority handles both the tax reductions and the provision of benefits. People who fall below the minimum income threshold apply directly to the tax authority for inclusion in the system and receive their benefits from that same authority after an examination of their situation. For salaried workers, it would be quite possible to follow the example of Britain when it first introduced its system and have their employers handle the necessary calculations in the year-end adjustment of payment records for taxation purposes.

The problem with this approach is that to include the self-employed in the system, the state must get an accurate picture of their income levels. The Japanese expression *kuroyon*, or “nine-six-four” taxation, expresses the difficulty faced here: the authorities are said to be able to monitor some nine-tenths of salaried workers’ income, but just six-tenths of that of the self-employed and four-tenths of what farmers make. This leads to varying accuracy in assessing the incomes of those who make salaries and others, giving rise to unfairness in the system. Another problem is that calculating income on a household basis will require considerable extra work to square the current individual tax filing system. Overcoming these issues may require the introduction of a system of taxpayer identification numbers.

A November 2008 report issued by the National Commission on Social Security called for consideration of the introduction of a system of social security numbers. Giving each citizen a number for life would allow the centralized management of personal information connected with social security schemes, thus clarifying the balance between pension, medical care, and nursing care benefits and obligations. Ever since the governmental Council on Economic and Fiscal Policy recommended such a system in its 2006 Basic Policies for Economic and Fiscal Management and Structural Reform,

deliberations have moved forward with the goal of implementing social security numbers in fiscal 2011 (April 2011-March 2012). Japan could use these numbers for taxpayer identification as well, framing them not merely as a tool to facilitate tax collection but also as a means of identifying taxpayers so that they can receive benefits under the refundable tax credit system.

The second issue that must be faced is the need to fundamentally rearrange and unify the disparate systems now in place for social security and taxation in Japan, creating a new framework to bring these tasks all together. We will need to reexamine from the ground up a whole raft of the country's present systems-including child benefits and childcare allowances, welfare and other benefit systems, basic income reductions, for spouses and the like, and minimum-wage regulations-as we design this framework.

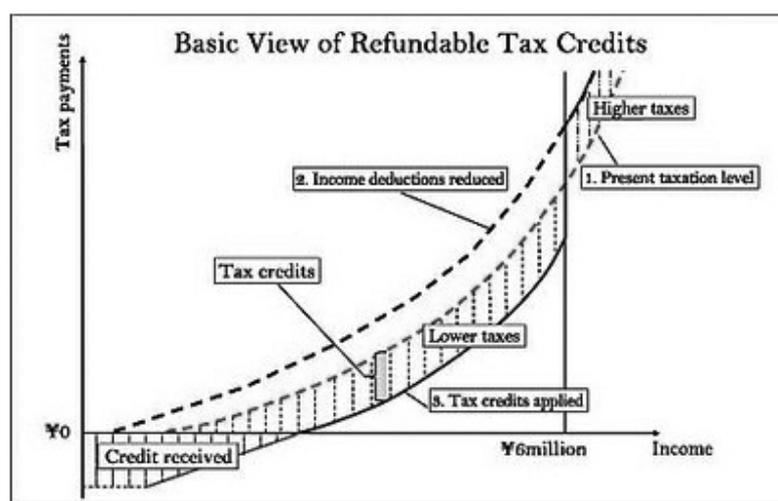
At its November 12, 2008, meeting, the pensions subcommittee of the Social Security Council listed eight areas of focus for reform of Japan's pension systems. Topping the list was a recommendation for the creation of a system to lower insurance fees as a way to offer relief to people with low incomes or receiving scant pension benefits. The approach of using public funds to help people in low-paying jobs meet the required level of pension payments is one that matches the Dutch and Korean systems of refundable tax credits to offset social insurance costs outlined above. In the Dutch version, the high insurance (payroll tax) payments made by low-income individuals are deducted from their income taxes, thereby reducing their overall burden. The system is designed so that the amount deducted climbs along with their income, however: the more they work the more they can reduce this burden, thus providing them with an incentive to work harder. This approach is considerably less likely to produce a moral hazard than the straightforward insurance fee reduction system being considered by the Japanese government council, and is naturally a better choice from the perspective of making effective use of public funds.

Needed in Kasumigaseki: Creativity and Decisiveness

Strong political leadership will be a must in implementing policy on this scale. In the administrative system in place today in Japan, tasks are divided among multiple entities, with the Ministry of Finance in charge of taxation and the Ministry of Health, Labor, and Welfare in charge of social security matters. As things now stand it is nearly impossible to execute policy that goes beyond these narrow fiefdoms. The introduction of refundable tax credits, involving as it does the distribution of those credits by tax officials and the formation of a new consciousness viewing both taxes and social security

contributions as the same sort of public obligation, may end up bringing about a reorganization in the nation's central bureaucracy in Tokyo's Kasumigaseki district, including such steps as the unification of the collecting authorities. There will be serious resistance to the introduction of such a system for this very reason. In short, bringing refundable tax credits to Japan is deeply tied to doing away with sectionalism in Kasumigaseki. Korea's Ministry of Strategy and Finance, which launched that nation's new system in January 2008, successfully overcame resistance from the offices in charge of social security, and the Office of the President showed leadership in designing and implementing the new program.

On December 24, 2008, the cabinet of Prime Minister Taro Aso approved a medium-term reform program for Japan's tax and fiscal system. This program will involve a reappraisal of various tax deductions and the tax rate structure with a view to restoring the individual income taxation system's original function of smoothing out disparities and redistributing income. It involves moves to increase the burden borne by high-income taxpayers, such as by adjusting the maximum tax rate and the upper limit to allowable deductions. At the same time, it will take a comprehensive approach to taxation and spending, including refundable tax credits and other aspects of the expenditures side, looking at ways to reduce the burden on middle- and lower-income households with attention paid to areas like child-rearing. The first step should be to secure needed revenues by paring back income deductions while converting them into tax credits, thereby increasing the system's income redistribution capacity. In the meantime we will also need to begin putting together concrete plans for a system tying together tax credits and refunds whose benefits will extend even to those whose income is below the minimum taxable level.



The attached chart in the above illustrates the idea nicely. In designing this system, the basic idea is to ensure that the overall system remains revenue-neutral. The present taxation scheme is represented by line 1; when income exemptions are reduced the effective taxation climbs to the level in line 2. This additional revenue is then used to provide refundable tax credits, amounts of which are determined by the number of children, for example, to households with total income below ¥6 million. This lowers the effective taxation on their income to the level in line 3. The result is that households below the ¥6 million income threshold pay lower taxes, while those with higher income pay more, thereby enhancing the income redistribution effect of the system.

If Prime Minister Aso were to position his proposed ¥2 trillion in cash handouts as the first step toward the creation of a system like this, they would be seen as more than mere political largesse. The decision of which form the system should take of the four categories described above—one aiming to reverse the falling birthrate, one to aid the working poor, one to make up for missed pension contributions from low-income individuals, or one to counter the regressive nature of consumption tax hikes—should be made on the basis of discussion among the people of Japan from now on.

Whatever the end result, what Japan needs today is strong political leadership that can overcome the divisions between the bureaucratic organs in Kasumigaseki. In this sense, the achievement of a new structure for Japan's income taxation will represent a touchstone for Japan as a state whose political leaders are firmly in charge.

HATOYAMA OKINAWA SECURITY CULTURE ELECTION DIET POLITI

CHANGE AGRICULTURE HATOYAMA OKINAWA SECURITY CULTURE

NONPROLIFERATION CLIMATE CHANGE AGRICULTURE HATOYAMA C