

JAPANESE TRANSACTION CUSTOMS: CAUSES AND FUTURE*

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In this paper I shall try to explain the phenomenon of the characteristically Japanese style of business transaction (secs. I and II). I shall also aim to predict its future (sec. III), and offer an evaluation on the subject (sec. IV).

One caveat: Since I am only a philosopher interested in this topic as a theorist, and have not undertaken any empirical research myself, my remarks are based on research by other scholars and common knowledge among Japanese.

I. *Relational Contracts in General*

Generally speaking, transactions between Japanese companies tend to be continuous, long-term ones that are highly specific as to the contractual relationship among the parties rather than discrete, one-off transactions. Let's call the former type of transaction "relational contracts" and the latter "market contracts". I will include among "relational contracts" not only legal contracts but also business relations of horizontal and vertical integration, interchange of executives and other employees between companies, and collusion among them. But I will *not* include relationships *within* a business organization.

An obvious approach to relational contracts is that of economics. Relational contracts, as distinguished from discrete market transactions which are usually assumed in economic literature, can be explained by work in such fields of economics as "Economics of Property Rights", "Economics of Transaction Cost", and "Neoinstitutional Economics". These branches of economics focus on the nature of various economic institutions such as the firm and the agency. Relational contracts may be seen as falling between typical market contracts and relations within a company. It is therefore instructive to review economic analysis of the firm.

Writers within these schools of economics often differ among themselves in their views and terminology. But I will ignore those differences as irrelevant to this paper. Rather I will synthesize and summarize more important arguments of those writers as follows.

(1) The firm can be more efficient than market transactions in the following ways, some of which may overlap to a degree.

(i) Cutting down transaction costs by a hierarchical organization.

In the case of market contracts, it can cost enormous amount to find a partner, to

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negotiate the terms of a contract, and to ensure its enforcement by legal and other means. Those transaction costs can be reduced in a company because of the hierarchical system which is controlled by the managers.

(ii) Production by teamwork, and easy and efficient use of information about workers.

An economic organization makes team play possible, which would not be the case where contracts are negotiated by isolated agents. An organization can produce more than the sum of the output of its members. Also, managers can make effective use of their work force because it is easier in an organization than in the market to know the workers' respective characteristics.

(iii) Economies of scale.

It is often true for technological reasons that if the scale of production is larger, the productivity is higher. Such large-scale production is usually done by organizations rather than by networks of individual contracts between independent agents.

(iv) Use of specific information and assets.

Investment in specific places and resources are hard to convert into other uses. If one organization possesses such resources, it can use them all in an efficient way.

(v) Making big investments easier.

An organization can make a big investment which is difficult for individuals or small groups because it can make use of such institutions of limited liability and stocks.

(vi) Dispersion of risk.

Entrepreneurial adventures become possible, since it is now possible to disperse the risk of both success and failure throughout a whole organization. Without such business organizations, entrepreneurs have to self-finance their enterprises.

(vii) Reliance engendered by long-term commitments.

Cooperative relationships may be hard to maintain in market transactions since the disadvantage that accompanies the breaking of the relationship is comparatively small. Indeed, since it is possible for a member of repeated games to evaluate other members' behavior over the long term and to react accordingly as many game theorists have pointed out, one can cope with the problem of moral hazard by an organization.

(viii) Enhancement of morale by a sense of belonging.

Many workers do not work simply as a means to earn a livelihood: they often identify with their work, and even with their companies. That identification may be natural as they spend several hours, 5 or 6 days a week at work. Therefore, we expect higher morale among full-time employees than part-time ones or contractors of a company. (Speaking about myself, I confess I can hardly apply as much energy to teaching part-time as to teaching full-time.)

Compared with the factors mentioned above, the importance of the morale factor seems to be underestimated among economists. But that factor is especially important in Japanese companies.

(2) It is easy to think of ways in which the firm is inferior to market transactions, however. (But, in fact, there does not seem to be much economic literature on this topic.)

(i) Difficulty in assessing each member's contribution and the danger of opportunism.

Since it is difficult to assess an individual employee's contribution to the whole team production in a company, salaries have to be paid in terms of working hours rather than true productivity. That would give a motive for opportunism to employees.

(ii) The inflated cost of organization and administration.

The bigger an organization is, the more it costs to maintain itself and to prevent opportunism within. Such costs may increase disproportionately to scale.

(iii) Bureaucratism.

The organization of a big company is liable to be bureaucratic in that it cannot adapt itself to changing situations. It is relatively easy to cut off inefficient branches in market transactions, but it is much more difficult to do so in a company. One way to cope with the danger is to weaken the bureaucratic nature of the organization and to make each department more independent. But success may be limited.

II. *Why are "Japanese" Transaction Customs Prevalent in Japan?*

Relational long-term contracts and horizontal and vertical integration can be regarded as ways to make use of the merits of the firm (sec. I (1) above) while avoiding its demerits (sec. I (2) above). Thus a company's continuing contract with its suppliers has the merit of cutting transaction costs, use of specific information, and reliance made possible by long-term commitment. And it also cuts down administration costs by assessing its suppliers' contributions in quantitative, rather than qualitative, terms, and avoids the danger of gigantism by keeping the suppliers out of the company itself.

One may be led to expect Japanese transaction custom not only in Japan but also in other market economies. Indeed, Macaulay's classical paper (1963) on non-contractual relationships in American business suggests so. Nevertheless, it is reported to be characteristically Japanese. Why is this so? I suggest some reasons.

(1) Lifelong Employment.

Lifelong employment is a standard custom in contemporary Japan: Once employed as a full-timer, an employee is not usually supposed to change his job until retirement; the company seldom fires its employees even when its finances are in poor shape. And the system of promotion in status and salary has a great deal of seniority. It may well be better for an employee to remain in one company until retirement than to change jobs. In fact it is often difficult to move to a more advantageous job after being employed as a full-timer. Owing to the lifelong employment custom, it is easy for a company to acquire, collate and assess information about its workers. And it pays to do long-term on-the-job training.

(2) The Firm as a Community of Workers (Not as Stockholders' Property).

Related to life-long employment, there is the strong idea that a company does not exist for fleeting stockholders who have only monetary interest in the company but for the employees who have long-term stakes there. Many Japanese workers think of their companies as their own communities, not merely as a place of labor. They may be proud of belonging to their companies, find the meaning of life in their work there, and even search for and find their close friends and spouses there. To add to this: the gap between management and labor is less sharp than in most western nations in terms of both salary and decision-making power; the greater part of management come up from the bottom of the company and are not recruited from outside; the profit of the company is supposed to be distributed not only among the stockholders but also among the employees. These factors all help to make a company a community of employees. (An obiter dictum: Some political and social theorists today advocate communitarianism against liberal individualism which is supposed to be an orthodox

doctrine in contemporary societies. They claim every human being is a member of some particular concrete community, not a rootless atom detached from any personal commitment. But they do not usually make clear what kind of groups they refer to as communities. I suspect communitarians' idea of community is easily applicable to Japanese companies. Some Japanese scholars call them pseudo-communities. But if they are so, there would be few genuine communities in contemporary Japan except families.)

Since a Japanese company is a kind of community, the risk of opportunism is relatively small. The internalized sense of comradeship and loyalty is specially valuable in those sections where work is inventive and hard to formulate in advance.

The communitarian character of Japanese companies also makes transactions among the firms personal. Long-term human relationships often matter more than discrete profit in the short term. I understand Japanese companies treat their business partners in a more personalized manner than their counterparts in other nations. The American "power lunch" is not comparable to a drinking bout at night among Japanese businessmen.

Hence the transactions between Japanese companies can be personal rather than business-like. And it is also flexible in that the parties do not adhere to the letters of contracts. That would be better for both parties in case of unforeseen accidents.

(3) Cultural Homogeneity.

No contemporary culture is completely homogeneous. Still, that of Japan can be said to be relatively homogeneous. Thus almost all people living in Japan speak and read Japanese while few people in other countries do so. This relative homogeneity makes it easier to reach an implicit agreement and to predict people's behavior. This is probably one of the reasons why Japanese companies often fail to specify the details of their contracts, especially when they are not of a routine nature, and why they do not necessarily construe the contract in a strict manner.

Next, since Japanese society is not only relatively homogeneous but also close-knit, informal social sanctions can work very well. Once discredited, it is often difficult to regain good public relations. Also, many Japanese still feel uneasy in the company of the foreigners. I do not want to emphasize the uniqueness of Japanese society at all. But I think those factors make the Japanese market hard to penetrate for foreigners.

(4) The Closed Nature of the Business World.

But it is not the homogeneity of Japanese society alone that makes the Japanese market seem closed. With the possible exception of big companies that are fully competitive in the international market, many companies try to expel newcomers from their own fields and to avoid competition in the market through trust-like collusions ("dangō" in Japanese). They cherish their vested interest among themselves against outsiders. There is some internal competition there too, but it may be severely restricted in terms of both membership and permitted behavior. In addition, there exists a close relationship among politicians, bureaucrats and business people in Japan. Bureaucrats in different ministries and departments and local governments in Japan control economic activities through both ordinances and informal administrative guidance ("gyōsei-shidō" in Japanese) that is not legally binding but very effective. Hence the network of vested interests from which politicians benefit through contributions from business, bureaucrats benefit from getting jobs with private business after retirement from public service, and business benefits from governmental protection and jobs provided by the administration.

Such a network clearly consists of relational transactions, not market transactions. And those relational transactions did not grow spontaneously in the market: they developed among the closed in-group of vested interest.

III. *Will "Japanese" Transaction Customs Change?*

If my suggestions in the last section are largely true, it may seem to be natural to conclude that Japanese transaction customs will not change in a near future because they are so deeply rooted in Japanese society. But I also suggest they will fall into a decline, though they will die hard, for the following four reasons. They roughly correspond to the four reasons for the prevalence of Japanese transaction customs that were mentioned in the last section.

(1) *The Probable Decline of Lifelong Employment.*

Lifelong employment in Japan is not an age-old custom. It became a standard custom only about 40 years ago, and the system is now stumbling under the pressure of recession. The change will prevent employees from identifying with their companies.

(2) *Disenchantment with a Company-centered Way of Life.*

Related to that factor, younger generations in Japan have less intimate ties with their jobs, and do not find the communitarian aspects of their companies very attractive. They may identify with other kinds of communities or find private life more meaningful. And the growing independence of women in both economic and psychological terms helps the tendency of disenchantment with a company-centered way of life. The tendency makes the work force more volatile.

(3) *Foreign Pressure on a Closed Market.*

More and more foreign companies are trying to get into the Japanese market, and there is an increasingly strong pressure from overseas to remove the barriers to international business. There may be some legitimate reasons for the Japanese government to keep *some* of the barriers, but since many Japanese companies have already got into foreign markets, and since Japan greatly benefits from international trade, it would be impossible for the government to keep artificial barriers, though such barriers as the relative homogeneity of Japanese society are not artificial but only natural. But even that homogeneity is now weakening partly because of the influx of foreign workers.

(4) *Deregulation.*

One important reason for Japanese transaction customs is the close connection among politicians, bureaucrats and business people. The demerit of the connection is widely criticised these days. If deregulation of administrative control over economic activities is realised as has been promised by recent several Administrations, the market in Japan would become more open. For instance, if selective nominated tendering, which is a standard custom in public works in Japan, is superseded by open competition, Japanese construction industry would change radically. And if such public works and subsidies that exist for protecting privileged companies are abolished or at least reduced, then a great part of connection among politicians, bureaucrats and business, and relational transaction that results from that connection would cease to exist.

IV. *Concluding Remarks*

In this paper I inquired into the causes of Japanese transaction customs and predicted they will fall into a decline. I end with some evaluative remarks on Japanese transaction customs and their putative causes.

If Japanese transaction customs grow from free competition and do not impose negative externalities on third parties, then they should be permitted as rational behavior. Since free competition is open to all, anyone who prefers relational contracts to market contracts can enter into such an activity whenever appropriate partners are available. Relational transactions formed there have a legitimate economic rationale; they are not anachronistic feudal bonds. Rather, the economic success of postwar Japan probably partly lies in making use of relational transactions which are neither market contracts nor interoffice transactions.

And if Japanese transaction customs are spontaneous phenomena which owe much to Japanese culture, they should not be condemned outright either. Thus, if a foreign company cannot succeed in the market in Japan because it has no goodwill or little Japanese-speaking staff there, that failure would be only natural.

But restriction of competition where the purpose is to create and protect the vested interests of politicians, bureaucrats and companies ought to be abolished, since it sacrifices outsiders such as consumers, taxpayers, and potential competitors. They are taken advantage of in terms of higher prices and taxes and closed opportunities. That is one reason why Japanese do not feel rich although their income is high by an international standard. (Another reason is long working hours which is partly due to employees' personal commitment to their companies.)

I think, however, that the people of Japan in general also share some responsibility. Japanese consumers are not usually very sensitive to prices and do not appreciate reasonably priced goods made in developing countries. And Japanese traditionally have a prejudice against economic competition; they often think it quite legitimate for the government to protect small shops and industries in decline in an interventionist way. Such a mentality would be fine in a community, but it should be regarded as a form of collective egoism of the vested interests in an open society, be it national or international.

Lastly, I welcome the decline of the company-centered way of life. I do not condemn that way of life, but I guess only a few people can wholeheartedly embrace that ideal. The rest could enjoy life better outside of their job, whether in private life or in some public activity. Many Japanese workers today work after hours routinely, partly because they have too much work to be done, partly because they do not mind staying at the office at night very much, or perhaps because they want to get an allowance for after-hours work. But in my opinion a life that is totally committed to one's company could be too narrow for many people and impoverish one's family life. The workplace in postwar Japan may have been a good place for workaholics, but not for the others. I hope Japanese employees have a more detached attitude toward their work and workplaces.

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