

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

Japan's Solution for the Recent Corporate Scandals: Corporations' Positive Actions for Reinforcing Ethical Behavior

by Kazuhide Ito, Nippon Keidanren

The recent spate of corporate scandals in the United States and Japan has intensified public distrust of big corporations, and in some cases – most notoriously Enron, Global Crossing, and WorldCom – have devastated shareholders, investors, and employees.

Other corporate misconduct has also fueled distrust. Recent reports of labeling fraud by some Japanese food makers, for example, have greatly undermined consumers' confidence in corporations in general, as well as their products.

In order to recover public trust, the U.S. Congress passed a far-reaching corporate governance bill, the so-called Sarbanes-Oxley Act, last fall with unprecedented speed by a landslide vote.

By contrast, Japanese authorities have tended to focus on reinforcing employees' sense of trustworthiness and morality. Tighter legal control, functions only when high ethical standards exist in the first place.

Stepping forward to win back public trust is Japan's most prominent economic body, Nippon Keidanren, the Japan Business Federation. Keidanren has actively promoted its voluntary ethical code, the "Charter for Good Corporate Behavior" since its establishment in September 1991.

Keidanren has long sought to contribute to harmonious relations

between Japanese corporations and society by urging companies to be good citizens. In April 1991, for example, it established the "Global Environment Charter" to promote the business community's cooperation on environmental issues. Under this ambitious plan, companies commit themselves to meet Keidanren's goal of reducing their carbon dioxide emission levels from manufacturing and energy fields by FY2010 to levels lower than those in FY1990. Publishing each participating company's progress in achieving this goal (Keidanren Voluntary Action Plan of the Environment) every year, helps

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Dear Readers:

We are pleased to announce that the Keizai Koho Center US office launched our new website. And, to provide better service to our readers, we will begin to provide our monthly newsletter, "Japan Economic Currents," a down-loadable, searchable electronic version. Please visit www.kkc-usa.org and register to subscribe an electronic version of the newsletter at Publications, Japan Economic Currents.

The KKC homepage will feature a wide range of bilateral economic data; a sweep of US-Japan economic relations 1970 to the present; information about Japanese politics; analysis of Japanese society today.

As always, we look forward to hearing your comments and suggestions.

Japan's Solution for the Recent Corporate Scandals: Corporations' Positive Actions for Reinforcing Ethical Behavior

Keidanren reinforce the Charter's effectiveness.

Background

Keidanren's 1991 "Charter for Good Corporate Behavior" was introduced in order to encourage corporations, specifically top executives, to undertake concrete steps to maintain ethical business standards. Unfortunately, it failed to prevent illegal or unethical corporate behavior, primarily because of four factors:

- A drastic change of economic conditions after the Japanese "bubble economy" burst.
- Increasing complexity of business activities in general.
- Insufficient legal protections for whistleblowers.
- Traditional business customs which meant that for most companies, it was business-as-usual.

Given this reality, Keidanren revised its original Charter in 1996, and since then has made substantial efforts to gain more support and understanding of corporations. Nonetheless, recently several well-known food producers were indicted for fraud. These scandals shook the consumers' confidence in corporations' integrity and reliability, and evoked harsh

criticism of the entire business community. Many business leaders are seriously concerned about the enduring depth of public distrust and suspicion, which could spread to the market economy itself thereby undermining the fundamental relationship between corporations and civil society.

The recent corporate scandals in United States and Japan do not share many parallels. In the United States, top executives behaved unlawfully and as a result, reforming corporate governance has been a focus of the debate. In Japan, on the other hand, front-line employees failed to act in accordance with laws and regulations, raising compliance issues instead. Such different experiences naturally led the two countries to a different approach in responding to the recent scandals: the enactment of the Sarbanes-Oxley law in the United States, compared to more aggressive promotion of corporate positive actions for reinforcing ethical behavior in Japan.

In order to ensure employees' compliance with laws and ethical standards, Keidanren urges corporations to adopt three principles: (1) the establishment and promotion of an effective internal

system that contributes to preventing scandals; (2) strong leadership of the top executives in taking the initiative to cultivate corporate ethics; and (3) in case of the occurrence of any scandal, prompt actions, led by top executives, to clarify its causes and prevent its recurrence.

To help its member companies, Keidanren provides the following checklist with detailed action plans to assist corporate management to establish and properly manage the recommended internal systems:

- (1) Establishment and/or improvement of guidelines for legal and ethical business practices (e.g. establishment of a company specific charter for good corporate behavior);
- (2) Internal and external announcement of the top management's business philosophy, followed by disclosure of its detailed enforcement plan in progress (via homepage, annual report, and report to society, etc.);
- (3) Organizational improvements (appointment of directors in charge of corporate ethics, establishment of Corporate Ethics Committee, as well as a department in charge, with clearly defined authority, etc.);

- (4) Adoption of internal measures to reinforce ethical behavior among employees, such as a telephone hotline that front-line employees can use to report wrongdoing to top executives. Whistleblowers should be shielded from retribution and their privacy should be protected;
- (5) Introduction and/or improvement of training sessions, possibly by positions or job types;
- (6) Examination and the subsequent assessment by companies of their progress in cultivating high ethical standards; and
- (7) In case of the occurrence of any scandal, there should be timely disclosure of appropriate information, an investigation of its causes, enforcement of measures capable of preventing its recurrence, and stern punishment upon identifying

authority and responsibility, not excluding the top executives.

It is extremely difficult to completely prevent any occurrence of corporate scandals. Even with tighter legal controls, success will depend on how diligently the people involved will follow such enforcement.

Nonetheless, as declared in the preamble of Keidanren Charter for Good Corporate Behavior, “corporations, in addition to being economic entities engaged in the pursuit of profit through fair competition, must be useful to society as a whole.” Only by continuously striving to maintain a high ethical standards will corporations will be able to win back sufficient trust and support from society.

In the absence of dedicated efforts by companies to adopt and maintain clean business practices, there can be no further development of corporations, as well as the entire society. The

Japanese business community is committed to actively promoting voluntary corporate ethical behavior, based on a belief that fair competition among corporations with a high ethical standard is essential in sustaining capitalism. ■

Kazuhide Ito is Manager of the Business Ethics Group, Nippon Keidanren.

Charter of Corporate Behavior –Nippon Keidanren–

Member corporations of Nippon Keidanren (The Japan Business Federation) are expected to conduct themselves in a socially responsible manner and observe both the spirit as well as the letter of all laws and regulations applying to their activities both domestically and overseas in accordance with the following ten principles. We believe that corporations exist not only as economic entities designed to pursue profits through fair competition, but also as social entities which must make a contribution to society at large.

1. Member corporations of Nippon Keidanren (hereafter referred to as “members”) by the development and provision of socially beneficial goods and services in a safe and responsible manner shall strive to earn the confidence of their consumers and clients.
2. Members shall promote fair, transparent, and free competition between corporations. They shall also ensure that their relationships and dealings with government agencies and political bodies are of a normal and proper nature.
3. Members shall engage in the active and fair disclosure of corporate information, not only to shareholders but also to members of society at large.
4. Members should recognize that a positive involvement in environmental issues is an essential part of their activities and their very existence as a corporation, and should therefore approach these issues positively.
5. As “good corporate citizens,” members should actively engage in philanthropic and other activities of social benefit.
6. Members should strive to respect the individuality and differences of their employees, to promote safe and comfortable workplaces, and to ensure the physical and mental well being of their employees.
7. Members shall reject all contacts with organizations involved in activities in violation of the law or accepted standards of responsible social behavior.
8. Members shall respect the culture and customs of other nations and strive to manage their overseas activities in such as way as to promote and contribute to the development of local communities.
9. The highest levels of management within member corporations must assume the responsibility for implementing this charter and for taking all necessary action in order to promote awareness of it among all those concerned. Management must also heed the voice of their organization’s stakeholders, both internally and externally, and promote the development and implementation of systems that will contribute to the achievement of ethical corporate behavior.
10. In the event of a violation of the principles of this charter, management of member corporations must investigate the cause of the violation, develop reforms to prevent its recurrence and make information publicly available regarding their intended actions for reform. After the prompt public disclosure of appropriate information regarding the violation, responsibility for the violation and its effects should be clarified and disciplinary action should be taken which includes the highest levels of management where necessary.

Note: The original Japanese language version of this document is the official version used by Nippon Keidanren. This document is an English language translation of the Japanese language original and has been prepared as a public service. Charter established: September 14, 1991; 2nd version released: December 17, 1996; 3rd version released: October 15, 2002

Japan's Demographic Challenge

by Leonard Schoppa, University of Virginia

It's getting to be routine. Every five years, Japan's National Institute of Population and Social Security Research (NIPSSR) releases new population projections that show fertility rates dropping lower than last calculated. The figures show the working age adult population shrinking faster, pushing the elderly dependency ratio steadily higher.

We first saw this pattern in 1992, when NIPSSR first projected that the fertility rate would stabilize below replacement level, at about 1.8. In response, the government announced increased funding for public childcare centers under the "Angel Plan." Five years later, NIPSSR announced that the fertility rate was likely to stabilize at a substantially lower level of around 1.6. Another round of study groups met, producing a plan "to make child-bearing and rearing a dream again." There would be more spending on childcare services, an effort to create a "gender equal society," and support groups for young mothers with newborn children.

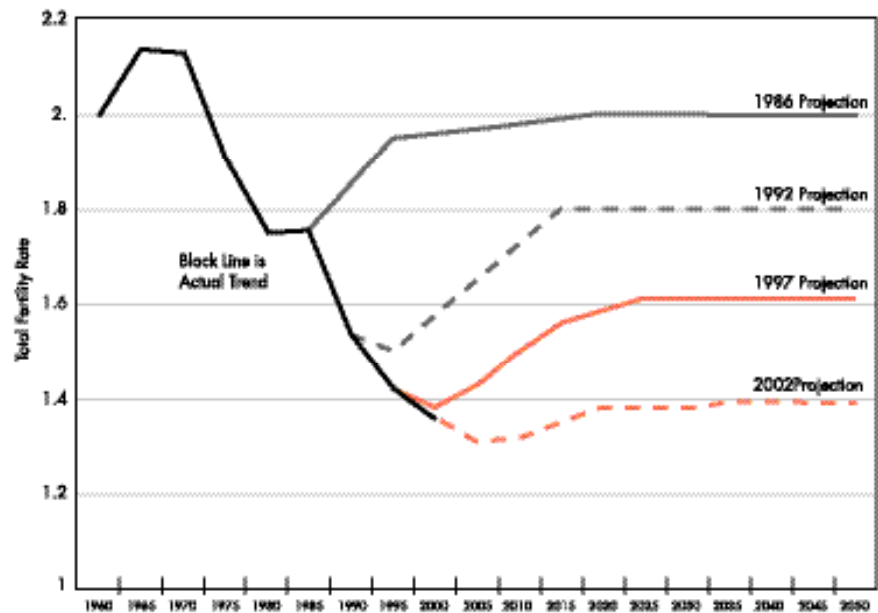
Despite all these efforts, the population projections issued by NIPSSR a year ago lowered fertility projections once again. The official

government agency now expects them to stabilize around 1.4, reflecting the decision of increasingly more women to marry later or not at all, and the decisions of married couples to reduce their target number of children. The government expects 31 percent of the cohort of women who are just entering their period of fertility to never have children. Another significant proportion will have just one child.

Concerned about plummeting birth rates, the government has once again announced declining-fertility-counter-measures (*shoshika taisaku*). Hinting that it would like to see each woman have one additional child, the Ministry of Health, Labor, and Welfare titled its latest proposals the "Plus One Plan." This time, the government is going so far as to urge employers to reduce work

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FIGURE 1
SAGGING FERTILITY PROJECTIONS FOR JAPAN



SOURCE: NATIONAL INSTITUTE OF POPULATION AND SOCIAL SECURITY RESEARCH CENSUS RESULTS

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“...the steady decline in the government's fertility projections has already given rise to a variety of anticipatory effects—most of them negative—on the Japanese economy.”

demands on new fathers, so that they will have more time to help out at home.

Impact on the Economy

The number of babies born today will only affect the number of workers and taxpayers in 20 years or so. Nevertheless, the steady decline in the government's fertility projections has already given rise to a variety of anticipatory effects—most of them negative—on the Japanese economy. With the economy still struggling to overcome the after-effects of the collapse of the “bubble economy” over a decade ago, the pre-effects of the coming demographic transition are making self-sustaining recovery all the more difficult to achieve.

The most direct impact of Japan's fertility rate on the economy comes through its effects on the size of the future workforce. After decades of sustained growth in the number of workers, falling fertility rates caused this figure to turn down at the end of the century. Japan is now looking ahead to a steady decline in the size of its working age popula-

tion that is projected to leave it with 32 million fewer residents in this age group by 2050.

Since the number of Japanese who will be elderly in the coming half century is already set, any shrinkage in the number of future Japanese workers translates directly into a larger fiscal burden. Whereas 86 million working-age citizens currently bear the burden of providing pensions and health care to 22 million elderly citizens (a ratio of four to one), the latest projections mean that by 2050, just 54 million working-age adults will be supporting 36 million over-65 residents (a ratio of 1.5 to one).

Since the government is required to adjust its pension policies each time NIPSSR issues new population projections, Japanese citizens have been getting regular updates on

what these demographic trends mean for their future premiums and benefits. One Japanese news weekly reported last summer that the government's “low variant” fertility projection (where fertility rates keep falling until they reach 1.11) means employee pension premiums would have to double to 35.4 percent of monthly salaries by 2025.

The government is considering alternatives to premium hikes as the sole measure to deal with the demographic transition. One possibility, announced in December as part of the government's pension reform proposals, calls for pension benefits to be cut once premiums reach a ceiling of 18 or 20 percent. How deeply they would have to be cut would depend on economic performance, fertility rates, and how long Japanese elderly live. In a worst-case scenario, pensions could end up providing retirees with far less than the 59 percent salary-replacement that is currently guaranteed.

Another alternative is to raise consumption taxes and use this

“...while there is still room for creative thinking and long-term planning, Japan's political leaders should be building public support for the “third great reform” that is needed to get Japan through its difficult demographic transformation.”

general revenue to increase the subsidy to pension and health care programs. Nippon Keidanren Chairman Okuda Hiroshi recently proposed that the government begin raising the consumption tax rate from the current 5 percent in increments of one percentage point a year until it reaches 16 percent. This strategy, he said, would reduce the burden on Japan's workers and corporations by having all of Japanese society share in financing the burden of Japan's demographic transition.

Yet pensions are only one part of the fiscal challenge. The Japanese government also has the immense task of determining how to finance government programs that provide health care and nursing services to a growing population of elderly citizens. In this area too, premium hikes, benefit cuts, and subsidies from general revenue are all on the agenda.

All advanced industrialized nations, including the United States, face the challenge of financing health care and pensions for a growing population of elderly citizens, and nowhere will this be easy. But Japan's rapid pace of aging, the sharp contraction in the size of the future workforce, the

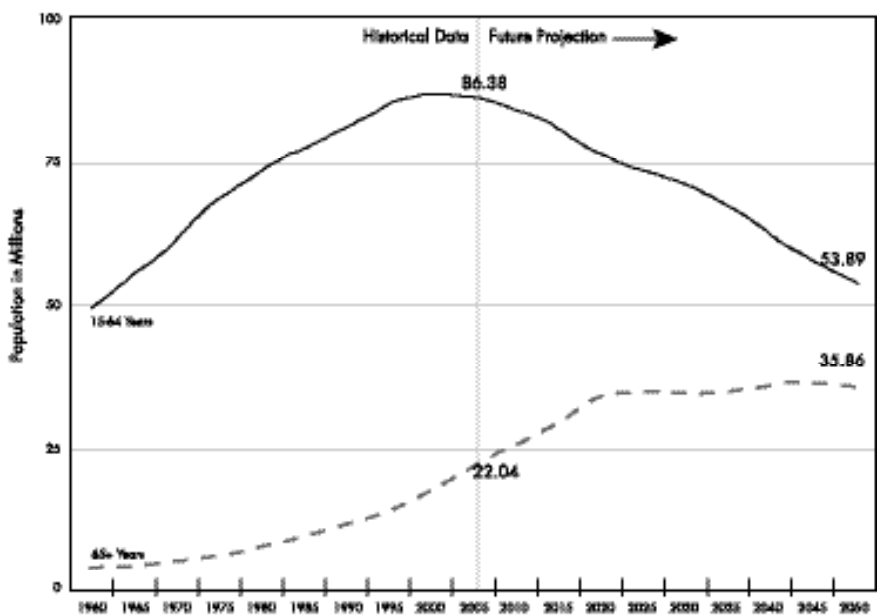
already huge public debt, and the weak state of the economy make Japan's challenge particularly daunting. It is very doubtful the government will be able to raise premiums and taxes or cut benefits fast enough to stay ahead of the rising tide.

The likelihood that the government will be unable to meet the fiscal challenges associated with

demographic transition has caused Japanese to start taking matters into their own hands and, in ways that make the problem worse. A growing number of Japanese are rejecting the national pension scheme, with the number in default on their payment obligations up from 1.7 million in 1995 to 2.65 million in 2000. Their refusal to pay is

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FIGURE 2
POPULATION TRENDS AND PROJECTIONS FOR JAPAN



SOURCE: NATIONAL INSTITUTE OF POPULATION AND SOCIAL SECURITY RESEARCH CENSUS RESULTS; PROJECTIONS BEYOND 2000 ARE BASED ON THE 2002 NIPSSR MEDIUM-CASE PROJECTIONS.

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making it even more difficult for the program to remain viable.

Many others are simply increasing their personal savings to insure themselves against likely reductions in future pension benefits. A 1997 Bank of Japan study showed that Japanese elderly actually increase their savings rate after they reach the age of 60, in contrast to Americans, who typically begin drawing down savings at this age. More and more Japanese tell pollsters they worry the pension program will not be there for them in their older years. This hesitance of elderly Japanese to spend their money is making it all the more difficult for government authorities to engineer a self-sustaining economic recovery.

Japanese households are not the only segment of the economy that is deeply concerned about the coming demographic transition. Employers can expect to pay much higher wages to workers once the looming labor shortage begins to bite. At the same time, firms have reason to worry that a stagnant and aging population will not generate large increases in demand for their goods. This combination has had a dampening effect on new business investment, particularly in manufacturing. Why invest in Japan, with high wages and stagnant demand, when one can invest in

China, with its plentiful labor and booming domestic demand?

Need for a Comprehensive Approach

With such a variety of economic problems associated with its demographic challenge, Japanese society should be actively debating how to navigate this transition. With the right approach—including a sharp increase in immigration, a revolution in gender roles, and the structural transformation of the economy—Japanese could come out of this transition with a much higher standard of living. So far, however, Japanese have preferred to leave the thinking to bureaucrats whose incremental, reactive plans have failed to present an effective response.

By the time the NIPSSR presents its next set of population projections in 2007, Japanese baby boomers will have already started retiring in large numbers—dramatically constraining fiscal maneuvering room. Before that happens, while there is still room for creative thinking and long-term planning, Japan's political leaders should be building public support for the "third great reform" that is needed to get Japan through its difficult demographic transformation. Unfortunately, the government's reactive once-every-five-year plans have not been up to the task. ■

Leonard Schoppa is Associate Professor, Department of Politics, University of Virginia

Correction on page 8 of the 2003 January issue of Japan Economic Currents. Last summer Sankei Shimbun stopped issuing its evening edition, not Yomiuri Shimbun.

Publisher, Keizai Koho Center

Director, Hideaki Tanaka
kkc1@kkc-usa.org

1900 K Street NW
Suite 1075
Washington D.C. 20006
202 293-8430

www.kkc.or.jp

Keizai Koho Center (KKC) is an independent, non-profit organization designed to promote the understanding of Japan's economy and society at home and abroad. Its financial resources are derived entirely from the private sector.

KKC fosters a deeper understanding of Japan's basic social structure. Furthermore, it conducts public affairs activities to improve the Japanese people's recognition of Japan's global role.

The views expressed in this newsletter are of the contributors and do not necessarily represent those of the Keizai Koho Center.