

# JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

## Structural Reform of the Economic Society Through Regulatory Reform

by Akira Kawaguchi, Japan Business Federation

Conventional wisdom in the United States seems to hold that structural reform is not really progressing in Japan. But compared to five years ago, regulatory reform is steadily advancing in many different fields, including the rescinding and easing of governmental regulations.

### Establishment of Action Programs for Regulatory Reform Develops its Own Momentum

Upon taking office in August 1993, Prime Minister Hosokawa launched systematic, full-scale regulatory reform. His reforms ranged from the modest (the removal of the ban on small-scale local beer breweries) to the ambitious (the introduction of a system to sell cellular phones).

One of the most important reforms was the inauguration of the

Economic Reform Study Group – the so-called Hiraiwa Study Group, named after then-Chairman Hiraiwa of Keidanren, Japan's most prominent business organization. The Hiraiwa Study Group was requested by Prime Minister Hosokawa to examine basic concepts of regulatory reform and to propose recommendations.

Accordingly, in February 1994, based on the Hiraiwa Study Group's report, the following principles were established: the abolishment of economic controls and reducing controls in social service fields like medical care, nursing, welfare, education...etc. to a bare minimum. As a vehicle to promote these principles, the Hosokawa government decided to establish the Action Plan for Regulatory Reform and set up the Administrative Reform Committee, a third-party organization that was given the power and authority to monitor progress toward reform.

With this body in place, the government revised its regulatory reform promotion planning at the end of each fiscal year and established methods to promote systematic regulatory reform. Despite subsequent changes in the

administration, the Action Plan and Administrative Reform Committee did much to promote reform.

### Shift of Focus from Economic to Societal Controls

In the mid-1990s, at the onset of the new era of regulatory reform in Japan, most eyes focused on excessive economic regulation. Particularly important, most reformers believed, was the abolition of regulations designed to adjust supply/demand in order to prevent excessive industrial competition and to stabilize corporate management. These supply/demand adjustment restrictions applied to a wide range of industrial areas, including transportation (railways, aviation, buses, taxis), energy (electric power, gas, gasoline stations), distribution (large-scale retailers, alcoholic beverages/ tobacco) and finance (banks and securities firms).

Over time, though, it became clear that supply/demand adjustment restrictions restrained new entrants into the market. Lacking competition, established corporations had little incentive to innovate and did their best to stifle rationalization efforts, thereby

Currently No. 21 June 2002

**The Business Roundtable's 2002 Principles of Corporate Governance** 5  
*by John J. Castellani,  
The Business Roundtable*

**Japan Business Dialogue** 8  
*Mr. Takahashi,  
Keidanren, Japan*

## Structural Reform of the Economic Society Through Regulatory Reform

failing to meet the needs of the consumers. Moreover, not surprisingly, ample research shows that the government often failed to accurately predict demand.

Thanks to the efforts of Administrative Reform Committee and its succession organizations, today most of the supply/demand adjustment restrictions have been gradually removed or eased. In February 2002, for example, the last existed supply/demand restrictions on bus and taxi businesses were abolished. However, the government still maintains lengthy and cumbersome pre-approval requirements in a wide range of industrial areas (in which the government must check on new entrants into the market or on the provision of new products/services, for example). Reformers urge the government to shift its efforts from requiring prior approval to monitoring correct business practices.

Moreover the real delay in reform lies in the area of so-called societal controls; in Japan, there really is no market competition in the provision of public services, such as medical care, welfare, care-giving and education. On the contrary – public entities and non-profit organizations operating under governmental control have become the sole providers of such services, resulting in the creation of so-called

“sacred areas” immune from regulatory reform.

But walling off public services from real competition is a serious mistake – in light of Japan’s rapidly aging society, the application of competitive market principles should be exercised to the fullest extent possible in all sectors in order to adequately meet the diverse needs of the citizenry. At the same time, in order to ensure open competition, a review should be undertaken about how to best distribute public subsidies.

### **Need for Regulatory Reform in Harmony with Changes in the Situation**

Japan finds itself caught up in an era of tremendous change, due to the globalization of the economy, the IT revolution, and is racing to keep pace. To deal with such changes, areas are emerging in which new reforms will be necessary.

The field of information communication, for example, has grown tremendously and the market has expanded as a result of regulatory reform. There are now more than 60 million cell phone subscribers in Japan – about half of Japan’s entire population of 120 million. Just ten years ago, the center of mobile communications was automobile phones, available

only to a limited number of people such as corporate executives with company-provided cars.

Today’s explosive diffusion was triggered by the introduction of the cellular phone sale system in 1994, along with cost reductions due to a new rate filing system introduced in 1996. But even so, the Japanese cellular phone business is by no means altogether free of restrictions today. In order to sell cellular phones with advanced communication functions, companies must secure certification and permission in advance from government-designated entities charged with determining whether legal technical standards are being met. Such regulations impede newcomers to start business immediately and consequently slower technical progress and the quick entry of new products in to the marketplace. Moreover, despite the rapid evolution and diffusion of information-related technologies, much of the administrative procedures, including application for governmental permission and approval are still carried out off-line, on paper. And, due to excessive governmental regulation, distance education and distance medical care by using information related technologies have not attained a level in which they can be conducted freely.

## Consumption Surplus Created by Regulatory Reform

(Unit: ¥ One hundred million)

Field <sup>2</sup>	Amount created as a consumption surplus <sup>1</sup> (Cumulative through 1998)	Difference over previous year		Notes
		Fiscal 1997	Fiscal 1998	
Domestic telecommunications	38,555	8,530	8,222	Privatization of NTT, easing of regulations on new entrants, easing of regulations on rates, introduction of the cellular phone sale system
International telecommunications	2,623	169	141	Privatization of KDD, easing of regulations on new entrants, easing of regulations on rates
Domestic aviation	3,575	997	737	Abolition of double triple tracking standards, fare discounting system
Vehicle registration/ inspection system	6,122	1,005	424	Simplification of vehicle inspections/periodic inspection items
Electric power	17,138	1,258	6,816	Rate reduction via yardstick method
Petroleum products	14,492	2,122	2,182	Gasoline price reduction before and after abolition of the Special Petroleum Products Law
Gas	132	0	51	Rate reduction via yardstick method
Commissions on sale/purchase of stocks	3,185	1,185	509	Liberalization of commission rates
<b>TOTAL</b>	<b>85,822</b>	<b>15,266</b>	<b>19,082</b>	

### NOTES

1. As a result of regulatory reform, a theoretical cumulative consumption surplus was created through fiscal year 1998. During fiscal year 1998, consumers achieved a consumption surplus larger than there would have been in the absence of regulatory reform.

2. Only those fiscal year 1998 consumption figures exceeding 10 billion yen have been compiled. There was also an additional 3.1 billion yen for taxis.

Continued on page 4

## Structural Reform of the Economic Society Through Regulatory Reform

### Significant Effect of Regulatory Reform: Raising the Citizenry's Income by 2.3 Percent

There are many other examples in which business has grown and the market expanded as a result of regulatory reform, including three-storied wooden homes, local breweries, self-service gasoline stations, health drink sales at convenience stores, real estate securitization, temporary employment services, and those sectors were all under regulations. At the same time, as a result of sustained efforts on the part of the private sector, consumers have benefited from a diversification of services and cost reductions.

A January 2000 report by the Economic Planning Agency, *"Economic Effects of Recent Regulatory Reform: Analysis of the Advantages for the Users,"* found that positive advantages brought about by regulatory reform were in eight fields – domestic and international telecommunications, domestic aviation, vehicle inspection, electric power, gasoline, gas, and commissions on the sale/purchase of stocks. According to the EPA report, a total of approximately 8.6 trillion yen (cumulative figure through the 1998 fiscal year) in consumption surplus funds\* were reaped in those eight fields

alone. That is equivalent to an increase in the citizenry's income by 2.3 percent. Assuming reforms continue, Japanese citizens will continue to benefit. (See table on page 3).

\*[Consumption surplus] is [the difference between what consumers/users actually paid to purchase goods or services, deducted from the maximum amount they would have had to pay]. That amount is the level of satisfaction that consumers/users receive through the transactions. If, in the process of regulatory reform, prices/rates are reduced and purchases increase, then the [consumption surplus] will increase.

### Conclusion

Looking back on the history of regulatory reform to date, it is fairly clear that the single most important factor is political leadership and a system set in place to promote it. It was the Hosokawa administration's initiative for regulatory reform in the mid 1990s that set the regulatory reform movement in motion and the initiation of a system to promote its follow-through, including the setting up of the Administrative Reform Committee and the establishment of regulatory reform promotional planning.

In order to advance regulatory reform by overcoming resistance by vested interests and the bureaucracy (which will likely intensify in the future), powerful political leadership is essential. To the extent that such exists, the current promotional organization, Council for Regulatory Reform, will be able to exert a stronger influence. As a result, much will depend on whether the Koizumi Administration, which has demonstrated a deep interest in administrative and regulatory reform, will exercise forceful leadership in aiming toward structural reform without avoiding the so-called sacred areas. ■

---

Akira Kawaguchi is Administrative Group Manager, Japan Business Federation.

# The Business Roundtable's 2002 Principles of Corporate Governance

by John J. Castellani, The Business Roundtable

JAPAN  
ECONOMIC  
CURRENTS

The controversy surrounding the collapse of Enron and other recent events have prompted a host of proposed reforms by Congress, President Bush, the Securities and Exchange Commission (SEC), and the major U.S. securities markets. Some of these reforms would improve the corporate governance practices of American corporations, while others could harm the vitality of American businesses.

All publicly-traded corporations in the United States are subject to regulation by a variety of sources. Though created under and governed by the law of the state in which they are incorporated, corporations are also subject to the requirements of the Federal securities laws, which are administered by the SEC. To list their securities on a U.S. market (such as the New York Stock Exchange (NYSE) or Nasdaq Stock Market (Nasdaq)), corporations must comply with listing standards that mandate adherence to certain corporate governance practices.

Many corporations have also voluntarily responded to corporate governance guidelines issued by private sector groups and institutional investors. These "best practices" provide guidance on issues like the responsibilities of the

board of directors, and board structure and independence.

In the wake of recent events, institutional investors, corporate governance experts and others have recommended expanded regulation of corporate governance. As a first step, the SEC urged the NYSE and Nasdaq to recommend ways to strengthen their listing standards. Proposals under consideration include tougher definitions of director independence, mandatory codes of conduct, new director education and competence requirements, and stockholder approval of option plans. Some have suggested requiring the NYSE and Nasdaq to develop their own sets of corporate governance best practices, supplemented by an SEC requirement that corporations disclose whether they have complied with those practices, and if not, why they have not done so.

## **The Business Roundtable and Corporate Governance**

The Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and \$3.5 trillion in revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth, a

dynamic global economy, and a well-trained and productive U.S. workforce essential for future competitiveness.

The Roundtable believes that the United States has the best corporate governance, financial reporting and securities markets systems in the world. Our systems work because public corporations have adopted best practices within a framework of laws and regulations. While there have been exceptions to the overall record of success, generally these systems have worked very well.

The Business Roundtable has been an authoritative voice on corporate governance for more than a decade. Since the publication of its 1997 Statement on Corporate Governance, many of the practices suggested in that statement have become common practice.

In light of recent events, the Roundtable undertook an expedited review of its 1997 Statement. The Roundtable recently released its 2002 Principles of Corporate Governance, a set of guiding principles to assist management and boards in implementing corporate governance best practices.

Continued on page 6

## The Business Roundtable's 2002 Principles of Corporate Governance

### 2002 Principles of Corporate Governance

No single structure is right for every corporation and its board of directors, and not all suggested practices will be appropriate for every corporation in every circumstance. Nevertheless, the Roundtable believes that the corporate governance practices outlined in the Principles provide an effective approach for public corporations to follow:

**Role of the board and management.** A corporation's business is managed under the direction of the board, which delegates to the CEO authority and responsibility for managing daily affairs. Effective corporate directors are monitors – not managers – of business operations. The board's most important function is the selection, compensation, and evaluation of a competent and ethical CEO who, along with senior management, is responsible for operating the corporation.

The Principles emphasize that the CEO should be a person of integrity who takes responsibility for the corporation adhering to the highest ethical standards. Senior management, and particularly the CEO, should set a "tone at the top" that establishes a culture of ethical compliance communicated to

employees at all levels of the corporation.

**Board leadership.** The Principles note that most American corporations are well served by a structure in which the CEO also serves as chairman of the board, but that some corporations have found it useful to separate the roles to provide continuity of leadership in times of transition. The Principles state that each corporation should determine what leadership structure works best for it. They also suggest that the board have contingency plans to provide for transitional leadership if questions arise concerning management's conduct, competence, or integrity or if the CEO dies or is incapacitated.

**Independence.** It is essential that directors be able to exercise independent judgment to perform their oversight responsibilities effectively. Accordingly, the Principles state that a substantial majority of the directors of a publicly owned corporation should be independent of management, both in fact and appearance. While business and employment relationships are considered under current independence standards, the Principles emphasize the need for boards to examine the variety of relationships that may impact independence, including close

personal relationships with senior management and relationships with non-profit organizations that receive corporate support.

**Committees.** The boards of large public corporations typically operate using committees to assist them. The Roundtable believes that the functions performed by three committees – the audit, corporate governance/nominating, and compensation committees – are essential to effective corporate governance. The Roundtable does not believe that a specific committee structure is essential for all corporations. What is important is that key issues be addressed effectively by the independent members of the board. The Principles state that every corporation should have an audit committee comprised solely of independent directors and independent committees responsible for addressing compensation and corporate governance/nominating issues. While the functions of the audit and compensation committees are well established, the role of the corporate governance committee has expanded in recent years beyond that of a nominating committee; today it typically provides a leadership role in shaping corporate governance.

**Evaluations.** Regular evaluations are important in assessing whether a corporation's board and management are functioning effectively. The Principles state that the board should have an effective mechanism for assessing on a continuing basis the effectiveness of the full board and its committees, individual directors, and management. Board and committee performance should be reviewed annually, and a director's ability to contribute to the board should be considered each time the director is considered for renomination.

Under the oversight of a committee of independent directors, the board should review the CEO's performance annually. Results of the review should be promptly communicated to the CEO by representatives of the non-management directors. The board should participate with the CEO in the evaluation of senior management.

**Compensation.** Levels of executive compensation and the incentives created by executive compensation packages have received widespread public attention. The Principles emphasize that a diverse mix of compensation can foster the right incentives and prevent a short-term focus or an overly narrow emphasis on

particular aspects of a corporation's business. The board and its compensation committee should look broadly at a corporation's overall compensation structure to determine whether it establishes appropriate incentives – not only for directors and senior managers, but for employees at all levels.

**Stock option plans.** Because stockholders have a particular interest in the amount and nature of equity compensation paid to directors and senior management, the Roundtable recommends that corporations obtain stockholder approval of new stock option and restricted stock plans in which directors or executive officers participate.

**Corporate governance principles.** The Principles recommend that each corporation adopt and publicize its own statement of corporate governance principles. The process of formulating these principles can have the beneficial effect of focusing the board's attention on governance issues and on the development of practices that fit the corporation's culture. Corporate governance principles should be communicated to the corporation's stockholders and be readily available to prospective investors and other interested persons.

## **Conclusion**

The Roundtable is committed to taking proactive steps to strengthen corporate governance. While revised regulations and listing standards may be appropriate in certain areas, the Roundtable believes that the most effective way to enhance corporate governance is through conscientious and forward-looking action by a business community acting with the highest degree of integrity.

There is no substitute for the commitment by business leaders to responsible and ethical leadership. As CEOs of some of America's largest companies, the Roundtable's members have made that commitment. ■

---

John J. Castellani is President of The Business Roundtable, an association of chief executive officers of leading corporations.

## Japan Business Dialogue

*KKC's monthly program featuring Japanese experts on the economy.*

### **"Global Warming: The Views of Japanese Industry"**

Mr. Takahashi, Keidanren, Japan Business Dialogue, April 23, 2002

The 1997 Kyoto Protocol builds on the "fruitful discussions" of the 1992 Rio Summit by setting country targets to cut harmful carbon dioxide by 2010, explained Mr. Hideo Takahashi, Keidanren's Director of Environment, Science and Technology.

Under the Protocol, Japan would be required to cut its so-called greenhouse gasses to pre-1990 level by 6 percent, while the US would be required to reduce emissions by 7 percent, the EU by 8 percent, and Australia by 10 percent.

Notwithstanding President Bush's repudiation of the Kyoto Protocol in March 22, 2001, the governments of Japan and Europe have resolved to move ahead," Takahashi said.

While the Ministry of Foreign Affairs considers the Kyoto Protocol to be a diplomatic victory, Japan's business community is extremely concerned about its impact on the Japanese economy and industry because the burden of cutting CO<sup>2</sup> emissions will be unequally distributed, Takahashi stressed.

China is exempt from the commitments as is Korea, Malaysia, and Singapore. And, in addition to the US, Australia will probably

refuse to ratify the Kyoto Protocol. "As a result, we don't see any friends in the Pacific area, except Canada, that would be bound by the Kyoto Protocol. And even in that country, the provincial governments of Alberta and British Columbia are resisting."

For this reason, China and other developing countries must show their willingness to participate in the second phase of the Kyoto Protocol in 2012. Without the US, China, and the participation of the rest of Asia, it will be very difficult for Japan to carry the entire burden."

If, as expected, the Kyoto Protocol is ratified by the Diet, even more Japanese production will continue to shift to China. Not only will this trend worsen the "hollowing out" phenomena (a transfer of Japanese manufacturing to other countries in Asia), but it will not reduce overall carbon emissions. And moving production to China isn't even an option for some industries – Japan's heavy smoke stack industry can't transfer, so they will simply lose their competitiveness to other Asian producers.

Government mandates to cut emissions is not necessary, Takahashi insisted – under Keidanren's 1997 Voluntary Action Plan, Japanese industries have achieved a voluntary target of zero

percent increase from 1999 to 2000. Industries must do their best to achieve their own targets, he said, regardless of the status of the intergovernmental talks.

But the full effect of cutting CO<sup>2</sup> emissions is necessary limited without US participation, because one fourth of the world carbon dioxide emission is from the US. Citizens should also think of the changes they can make in their daily lives and take corresponding concrete actions that will help offset global warming. ■

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](http://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.