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Manifest for a Market-Oriented Economy

Action Program for Japan toward the 21st Century

Koichi Minaguchi
Chairman,
Advisory Committee for the Chairman
(Vice Chairman and President, Keizai Doyukai)

Introduction

In the general election held in October 1996, every party campaigned on pledges of administrative reform. As promised, the second Hashimoto Administration has now launched the Conference on Administration Reform; studies are under way to bring about a "Big Bang" through reform of the financial system; the Administrative Reform Committee has delivered its opinions on deregulation and the division of functions between the public and private sectors; the Committee for the Promotion of Decentralization has made its recommendations; and the Economic Council has presented proposals for structural reform in six areas. Thus, there are signs of progress in the long-delayed structural reform of the Japanese economy. We welcome and actively support these moves. We believe that genuine reform must now be a reality.

With the twenty-first century just four years away, economic structural reforms are progressing on a worldwide scale. In the United States and Europe, these efforts began in the 1970s and have accelerated still further since the 1980s. Having already been slow to start, if Japan is to secure an affluent life for her citizens and a respected and trusted place in the global community of the twenty-first century, it will require a more rapid pace of reform than is presently under discussion. In this sense, structural reform is a race against time. The very foundations of the Japanese economy are subsiding, and unless action is taken they will collapse. The stock market and foreign exchange market have already issued many warning signals. There is no more time to waste. We must act now to prevent the subsidence of Japan's economic base and ensure that the next generation will

have freedom of choice in building anew on the foundations of the national economy they will inherit from us.

For the past year, Keizai Doyukai (the Japan Association of Corporate Executives) has discussed the prospects for the twenty-first century and studied the form of the national economy we should seek and the measures necessary to achieve it. We believe that creating a fair and efficient market is the way to overcome the present difficulties confronting Japan and open up new potential. To achieve this goal, it will not be enough for the government to change; the attitudes and behavior of companies and of every member of the Japanese people, as citizens, consumers, and employees, must also change. The following Action Program is both a call to the government for political and administrative reform and an appeal to the Japanese people to overcome the pain that must accompany reform; to an even greater extent, however, it is a manifesto of our own resolve to pursue structural reform as corporate executives.

Part 1. Our Basic Ideals

Structural reform is a means to an end, not an end in itself. Thus, we must first make clear the goal of reform. The ultimate goal of structural reform, as we see it, is to ensure the quality and security of the national life in the twenty-first century. To attain this goal, a solid foundation of economic activity is essential, but the creative and efficient economy that we seek cannot be achieved under present conditions. The aim of reform is to reshape the Japanese economic system with the market at its center.

1. The Three Basic Ideals

We believe that the national economy of the twenty-first century must be solidly underpinned by the following three basic ideals:

a. Activation of Market Functions and Emphasis of Market Rules

We are no longer in an era when the government can lead by building a national consensus in order to attain a single clearly defined goal, as it did during the high-growth era of the 1950s and 60s. In the absence of such conditions, government intervention in the market to secure a preordained result restricts the free exercise of choice and initiative by market players, precludes the possibility of

a diversity of outcomes, and actually increases the likelihood of failure. Today, amid the continuing trends of globalization, advances in information technology, economic liberalization, and diversification of values, no one can see into the future without calling on the predictive abilities that the market mechanism makes available. The economy of the future will be shaped through the operation of free competition and consumer choice in the marketplace. While this may be a new and challenging direction for Japan, it is already well established as a worldwide trend, and much has already been accomplished as a result. The market must operate as freely as possible, and competition must have as broad a scope as possible; there is little need to point to the examples of countries that have led the way in pursuing reform.

Of course, the market is not a world of unbridled laissez-faire. For the market to function effectively and the judgments passed there to be fair, it must be supported by an adequate basis of competition policy and access to information, together with market oversight mechanisms and other safeguards. The operation of the market, while being as free as possible, must be based on clear rules.

b. Reaffirmation of the Division of Roles between the Individual, the Corporate Sector, and the Government

The market is an excellent mechanism for the efficient allocation of resources through competition. As a basic principle, the operation of the economy should be entrusted to the market to the maximum extent possible. At the same time, however, not all the problems which the Japanese people must address can be solved by means of the market alone. Accordingly, we must clearly distinguish between problems that should be entrusted to the market and problems which the market cannot solve, and reaffirm the division of roles between the individual, the corporate sector, and the government. The activities of the market will be left to the free actions of individuals and corporations, while the government will avoid participating directly in market activities and instead devote its efforts to ex post surveillance. It then becomes the role of the government to resolve problems which fall outside the scope of the market; these include extending relief to the socially disadvantaged, and acting to remedy the income gap if this should exceed the socially acceptable limit.

It is through democracy as a mechanism of political decision-making that such a governmental structure is built and provided with a sound basis of support for its activities. In order to ensure that democracy does not turn into a distorted populism or protection of special interests, and that it does not invite bloated government

and excessive market intervention, we must not rely on the government to solve all of society's problems. Instead, the individual citizen must act on his or her own behalf wherever possible, according to principles of self-help and self-reliance and with an awareness of the balance between benefits to be received and costs to be borne. Only when it goes hand in hand with a mature democracy supported by such heightened civic awareness will a market-driven national economic system gain a high degree of public trust.

c. Globalization

Economic activity today knows no national borders. We have entered an era in which companies and consumers make choices which cross national borders in pursuit of better conditions for competition. Traditionally non-tradable goods are being transformed into trade goods. Under these circumstances, it is essential to make Japan a more attractive place to do business, both to enable Japanese companies to maintain sufficient international competitiveness while basing their operations in Japan, and to attract economic activity to Japan from the rest of the world. The true danger of hollowing-out lies not in Japanese companies relocating overseas in search of optimum conditions, but in the risk that Japan will cease to be viewed by the rest of the world as a location for economic activity. It is thus of prime importance to Japan to promote the success of all companies which are active in this country, regardless of their nationality.

2. The Principles of Action for Structural Reform

The four years that remain before the twenty-first century are the critical period for structural reform. In order to take decisive action for reform during this time, we must first clarify the goals and basic ideals of reform, and then develop and implement an Action Program with the following principles:

a. Comprehensive Reform

If we are to create dynamism and prosperity in a society which is simultaneously undergoing aging, maturation, and the shift to a service economy, and if, moreover, Japan is to thrive under conditions of global mega-competition, it is vitally important that we conduct an across-the-board review of the old institutions which have become established in every sphere of activity during the past fifty years, and that we carry out reforms on a comprehensive basis. Meaningful reforms will not

be realized as long as reform efforts continue to be divided between ministries in isolation from one another. A comprehensive vision is essential. At the same time, it is important to make no exceptions to reform; efforts to address a problem can no longer be put off because they meet with difficulties or great resistance. The complete picture of reform should be presented at the initial stage, leaving nothing sacred. This makes it possible to view the expected outcome squarely, reduces uncertainty to a minimum, and allows more latitude for response. For example, reform of the financial system should include reform of the postal savings system and fiscal investment and loan system, and reform of the fiscal structure should encompass an integrated review of both revenue and expenditure.

b. Target Date 2000

A clear time schedule is essential to the Action Program for structural reform, both to ensure steady implementation and to enable progress to be monitored. In determining this schedule, we must taken into consideration the fact that Japan is already lagging behind at the starting point of reform and will fall still further behind the rest of the world unless we accelerate the pace, and also the fact that there will be a time lag before the results of structural reform appear.

Thus, structural reform is a race against time. We believe that the time schedule should have as its target the completion of the institutional basis by not later than the year 2000, so that January 2001 will mark a fitting start to the new century for a renascent Japan. Needless to say, this does not mean that action on problems can be postponed until the year 2000.

c. Clear Priorities

Because there will be a limit to expansions of scale of the kind that has been possible in the past, we cannot hope to meet every need by dividing up a larger whole. In future, we must make difficult choices between competing needs. It is therefore essential to set clear priorities in the Action Program, and to make negative choices involving some losses for the sake of greater potential gains. There are inherent trade-offs between efficiency and fairness, and between equality of opportunity and equality of outcomes. In the past, Japan has attempted to achieve both at once by restraining competition, as seen, for example, in the "convoy escort system," in which all members of a domestic industry move together under government protection. As a result, it can be said that the market's functions were prevented from coming fully into play and the high-price, high-cost structure of the Japanese economy became established. In view of the urgent

need to correct this structure, the highest priority must now be assigned to the policy goals of improving efficiency and achieving equal opportunity through the market mechanism. At the same time, a clear distinction should be made between economic policy and policy instruments for securing fairness of outcomes by redistributing income or wealth to assist the socially disadvantaged, and these policy instruments should be clearly separated from the market.

Part 2. Action Program for Structural Reform

In seeking to sustain the basis of a vital economy and ensure affluence and security for the nation in the twenty-first century, the greatest issues presently facing Japan are, first, the high-price, high-cost economic structure, and, second, the growing burden due to bloating of the public sector. Unless we meet these challenges successfully, we cannot create a strong economic base which will enable us to thrive under conditions of global mega-competition, nor can we create a high quality of life in the coming aged society.

Thus, we believe that actions to address these two problems must be the mainstay of the Action Program for structural reform. And the key principle of these actions is to build an economic system centered on the market. The price differential between products purchased at home and those purchased abroad must be closed by fully activating market mechanisms and improving economic efficiency, and the public burden must be contained by realizing a small and efficient government.

I. Enhancing Market Functions: Correcting the Domestic-Foreign Price Gap

In the course of the past fifty years, in some respects the restriction of competition in Japanese markets has undeniably contributed to the nation's social stability. However, the accompanying enormous costs have now exceeded a level which can be borne by business and consumers. Besides visible costs, a further serious problem is the magnitude of invisible costs, in the form of loss of opportunity, which result when market entry is restricted and the creation and growth of new industries and new jobs are inhibited by restraints on competition.

In order to reduce these costs, it is essential to shift the coordinate axes of Japan's economic system from stability and maintenance of the existing order to a new emphasis on efficiency. The price differential between foreign and domestic goods must be corrected by realizing a competitive market with minimum regulations and

full scope for creativity; at the same time, the growth of new industries must be encouraged by realizing a market with greater breadth and depth. Further, in order to enhance the vitality of the Japanese economy, we must go beyond addressing costs and provide a more favorable business environment for corporate activity from a global perspective.

1. Lowering Prices

To correct the high-cost, high-price structure, the productivity differential among industries, measured in terms of a uniform exchange rate, must be substantially reduced by improving productivity through the introduction and promotion of competition in all areas of the economy, with the goal of reducing the weight of government-regulated sectors from the present 40 percent of GDP to less than 10 percent (comparable with that of the United States). To this end, in addition to deregulation, it is also necessary to review business practices in the private sector, including the activities of industrial associations, to ensure that these do not restrict competition.

1.1. Eliminate and relax government regulations.

We have already made many proposals concerning deregulation, and the government has also recognized the importance of this issue and addressed it accordingly. Nevertheless, the measures implemented so far have been largely confined to partial and gradual improvements while retaining the existing regulatory framework, and they have yet to achieve the major infusion of economic vitality that has been seen in Europe and the United States. What Japan must do now is repeal the regulations which form the hard core of government intervention in economic activity. The contents of the Economic Council's proposals on six areas of structural reform deserve attention in this regard, as they call for radical reform of the existing framework of regulatory administration. We believe that the measures contained therein should be steadily implemented, together with those proposed in the Administrative Reform Committee's opinions on deregulation. In common with other related measures, they should be implemented no later than the year 2000, the target date of our time schedule, in line with the following basic policy:

a. Completely abolish licensing systems for entry to industries, and establish registration systems as the general principle.

Guarantee the freedom to enter and leave an industry. Abolish all licensing systems for entrants to industries and businesses, and establish registration systems as the general principle, having first clearly stipulated in writing the minimum technical requirements and qualifications for entry. Establish the supply of services by the private sector as the general principle, making no exception in those sectors where universal service (that is, the provision of universal access to services) is recognized as a social necessity.

b. Abolish all supply adjustment clauses relating to production, volume, and facilities

Adjustment of supply to meet demand through prices is the most basic function of the market. Completely abolish those clauses under which the government artificially adjusts supply to meet demand in the Large-scale Retail Store Law and laws governing sectors such as transportation.

c. Review the total-cost method of setting public utility rates and introduce varied forms of competition.

In general, it is difficult for competition to operate in those industries where regional and natural monopolies are permitted, such as electric power, communications, and transportation. Review the total-cost method of setting public utility rates in such industries, and adopt pricing methods which encourage further rationalization of management; at the same time, introduce varied mechanisms of competition to ensure the full functioning of incentives to management efficiency.

d. Eliminate regulatory barriers between business fields and promote cross-sector competition.

The existing barriers to entry into other fields of business are highly detrimental, since they not only encourage localized and homogeneous competition, but also impede the growth of cross-sector business which is expected to result from technological advances and other trends. Eliminate restrictions on entry into other business fields and promote competition through mutual cross-entry in the financial, communications, and other industries.

From this viewpoint, the radical reforms of the financial system for which the government has already laid down policy guidelines must be steadily implemented, and the Tokyo market must be revitalized by opening it to broad-based competition, in particular by removing restrictions on entry into other business fields by the

banking, securities, and insurance industries and encouraging firms in these industries to enter one another's fields. These reforms of the financial system should be carried out as an integrated whole, including public financial institutions such as the postal savings system and fiscal investment and loan system.

e. Review the exemptions to the Anti-Monopoly Law.

Comprehensively review and actively revise the system of exemptions to the Anti-Monopoly Law, which currently permits cartels, among other things. This will help to more fully activate market principles, promote corporate rationalization, and lend greater stability to small and medium-sized enterprises.

1.2 Eliminate private-sector self-regulation.

a. Eliminate anti-competitive activities and quasi-administrative self-regulation by industrial associations.

While it goes without saying that the activities of industrial associations should comply with the law and the rules of the market, in order that the market may function more effectively it is strongly expected that industrial associations will immediately carry out voluntary reviews of their activities, and that they will aim toward a smaller presence. In particular, any voluntary controls which have been imposed over and above public regulations should be abolished immediately. Further, any functions carried out on behalf of the government in regulated industries should revert to the proper administrative authorities, and a strict line should be drawn between these industries and the government with regard to such practices as the movement of former public officials to positions in the private sector.

b. Enhance public disclosure of the activities of industrial associations.

In order to make their activities more transparent, it is strongly expected that industrial associations will make efforts toward active public disclosure of information, for example, by issuing regular activity reports and making explanatory materials always available.

c. Break free of conformism within industries, and follow the principle of self-responsibility.

Companies must break free of the conformism which exerts strong control over Japanese corporate behavior and leads to inefficiency of the market as a whole. In essence, this conformism amounts to an evasion of responsibility, and the principle of self-responsibility will not be firmly established until it is eradicated. Conformism also serves as a foundation for administrative involvement. The first step toward eliminating private-sector self-regulation is for companies to break free of conformism and reliance on the "convoy escort system." Corporate behavior should be governed by the principle of self-responsibility; that is, the interests of a firm's own customers and consumers should take precedence over coordinating behavior with other members of the industry.

2. Increasing Freedom of Choice in Business Management

Together with the urgent and steady implementation of deregulatory measures, there is a need to establish a legal system which guarantees a high degree of freedom of corporate activity and gives full scope to corporate creativity in a market without restrictions.

At the same time, if the abilities of individual workers are to be effectively utilized by society as a whole, we must develop a labor market which is more open to movement between companies, and through this market we must encourage mobility and optimum allocation of labor. To achieve this goal, we must first eliminate or ease those regulations which hinder smooth labor mobility; in conjunction with these measures, we must treat the pain of increased unemployment in the process of structural reform as a problem to be addressed by society as a whole.

2.1 Reform corporate law

a. Remove the ban on "pure" holding companies and introduce a consolidated tax payment system.

The complete and uniform ban on "pure" holding companies is an excessive ex ante restraint. Undue concentration of corporate control can be adequately prevented by rigorous enforcement of the Anti-Monopoly Law and ex post surveillance; the ban on holding companies should therefore be lifted by the end of fiscal 1997. In conjunction with repeal of the ban, introduce a consolidated tax payment system.

b. Implement competition policy with an international perspective.

At present, a 25 percent share of the domestic market is the minimum requirement before approval of a corporate merger can even be considered. Increase the transparency of merger approval, and implement competition policy with a more international perspective, including elements other than market share.

c. Revise the provisions of the Commercial Code governing mergers, etc., without delay.

The Commercial Code, the basic legislation governing corporate management, must always be attuned to actual economic conditions. Simplify the merger regulations by the end of fiscal 1997, and consolidate corporate divestiture regulations.

Furthermore, to allow companies flexibility in developing managerial policy, consideration should be given to simplifying the Commercial Code, reducing its provisions to the minimum necessary and, in part, entrusting the matters prescribed therein to the articles of incorporation of individual companies.

In addition, the proper form of the Legislative Council, including the selection of members and the method of operation, should be urgently reexamined in order to expedite revision of the Commercial Code and related legislation.

d. Extend the stock option system to non-venture companies.

In Japan, the stock option system is approved on a limited basis for venture businesses only. By the end of fiscal 1997, provision should be made in the Commercial Code, taxation system, etc., to enable companies of all types to fully utilize stock options in order to offer incentives to managers and employees.

2.2 Support increased labor mobility in employment.

a. Carry out deregulation without delay.

Carry out deregulation by the end of fiscal 1997 in order to provide a greater variety of options, both by facilitating labor mobility, through measures including liberalization in principle of private employment agency and temporary personnel services, and by expanding the free working hours system.

b. Support individual efforts to enhance personal employability (market value).

With increasing worker mobility, the individual should constantly endeavor to enhance his or her abilities and value on the labor market. Accordingly, whereas public assistance for vocational training has mainly been targeted in the past to companies on the premise that workers would remain with the same employer over the long term, redirect it in future toward the individual by, for example, making self-training expenses tax-deductible.

c. Expand and improve employment countermeasures with increased labor mobility as their basic premise.

Structural reforms will unavoidably be accompanied by a certain amount of increased unemployment, partly in the form of increased mobility of labor. While the corporate sector should naturally exert the utmost efforts to maintain employment under these conditions, in view of the fact that a company cannot continue to provide jobs if it cannot survive as a company, this issue must be addressed as a problem of society as a whole, and employment countermeasures must be expanded and improved on the premise of increased unemployment. Further, the employment adjustment subsidy system, which was instituted to maintain employment, tends to have the corollary effect of hindering mobility in the work force; it should thus be reexamined with a view to replacing it, for example, with assistance to employers who hire workers.

3. Expanding and Improving Market-Monitoring Mechanisms and Disclosure of Information

In replacing the prior-adjustment mode of public administration to a large extent with freer market competition, the infrastructure of market-monitoring mechanisms must be strengthened and consolidated in order to ensure that competition is fair. Also, fuller disclosure of information is necessary on the part of market players. Public disclosure not only serves to ensure fair competition but also has a constructive significance for market players, in that they bring an increased discipline to their conduct by allowing it to be checked by the market.

3.1 Expand and improve market-monitoring mechanisms.

If the market is to operate both competitively and fairly, the government must redefine administrative priorities to emphasize the consolidation of market conditions, chiefly by the formulation of rules, and must also expand and improve

market-monitoring mechanisms, including the Fair Trade Commission and the Securities and Exchange Surveillance Commission. In particular, together with the "Big Bang" reforms of the financial system, there is an urgent need to transform the administration of financial markets from its present discretionary basis under the "convoy escort system," into a strictly rule-based administration which emphasizes the functioning of the market according to the market mechanism and the principle of self-responsibility. It is expected that an independent financial inspection and supervisory function will be central to such an administration. Furthermore, market rules must be applied with strict fairness, and penalties must be given sufficient strength to compel compliance by market participants.

3.2 Expand and improve public disclosure of information.

a. Begin deliberations toward the adoption of accounting standards compatible with the International Accounting Standards (IAS).

One of the functions expected of the market is the efficient allocation of funds, but its performance of this function depends to a great extent on the disclosure of accurate information on the state of each company. Amid ongoing globalization, it is especially desirable that common standards of corporate financial disclosure should be adopted worldwide, to the maximum extent possible. Further, from the viewpoint of accurate disclosure of corporate information, it is necessary to clearly separate tax accounting and corporate accounting.

b. Make efforts on the part of corporations to actively disclose information.

Corporations should not only meet the criteria for disclosure required by law, but should endeavor to ensure that disclosure is timely, for example, by expediting publication of financial statements, and should carry out full investor relations activities for shareholders.

II. Realizing Small Government: Keeping the Burden under Control

The state of Japan's public finances is rapidly deteriorating, as indicated by the burgeoning budget deficit of the combined national and local governments; unless this situation is rectified, there is a strong possibility that it will become a constraint on the economy. Further, the rapid aging of Japanese society threatens to impair economic vitality due to the increased social security burden. However, judging by

the debate over the fiscal 1996 supplementary budget and the fiscal 1997 budget, it is evident that Japan's public finances have yet to completely overcome a rigidity based in the protection of vested rights and special interests. Radical reform of the public sector is essential, and is a matter of the greatest urgency.

Above all, there is an urgent need to substantially reduce the scope of activity of the public sector as a whole (that is, government at both the national and local levels together with public corporations), on the basis of private-sector initiative, market principles, self-responsibility, independence, and self-help. Specifically, the activities of the public sector should be submitted to across-the-board review, and the criteria for the proper form of administrative involvement recently presented by the Administrative Reform Committee should be applied to all activities of the administration, at both the national and local levels. Further, the relationship between the government and the market must be converted from the existing preventive mode of prior adjustment with numerous regulations at its core, to a mode of ex post surveillance.

The key point is that administrative reform must not stop at a mere reduction of personnel or superficial reorganization of ministries, but must achieve small government in terms of both scale and direct involvement in the market, by reducing the role of the public sector itself.

Moreover, there must be a radical review of the burden imposed to support the activities of the public sector. The taxation system must not be simply a means of securing revenue, but must be urgently and radically reformed in such a way as to enhance the will to work, encourage the taking of risks, and call forth creative and efficient activity by the private sector. Also, greater importance must be placed on ensuring a balance between the benefits received and their costs.

1. Reducing Public Expenditures

The highest priority in the near term should be assigned to radically reducing government spending in order to place public finances on a sound basis, and the government target of reducing the fiscal deficit (for national and local governments combined) to not more than 3 percent of GDP should be achieved as far as possible before the stated target date of 2005.

1.1 Reduce public expenditures by means of an exhaustive review of existing items.

Expenditures at both the national and local levels must be not merely held to a lower growth rate, but reduced in real terms. To achieve this, reform must begin with the system of budget compilation. The order of priority of policies must be determined from the top down and the total budgetary appropriation decided accordingly. In particular, it is essential that existing items of expenditure be reviewed more strictly to eliminate hidden waste and inefficiency. To this end, a scrap-and-build process for expenditures should be carried on over the five-year period from fiscal 1998 to fiscal 2002; for example, reduce existing expenditures by 5 percent annually while permitting new expenditures equivalent to 2 percent.

1.2 Substantially reduce public works expenditures.

The first essential is cost reduction, which must be as thorough as that carried on in the private sector. At the same time, for all long-term plans concerning public works, carry out an overall review of the distribution of funds, planning goals, and target dates; by combining this review with cost reduction, aim for a 30 percent reduction of total public works expenditures, at both national and local levels, for the period to fiscal 2002. In the process, radically review the nature of specified revenue sources with restricted uses. Further, transfer control of the implementation of public works to local governments wherever possible. These local authorities will then proceed according to their own regional order of priority, while the central government will carry out works at a national level in the form of interministerial projects.

Disclosure of information on public works is also necessary. For example, raise the interest of the general public by making it compulsory to post information on the purpose, scale of expenditure, source of revenue, and related matters at the site of public works.

1.3 Comprehensively reform the social security system, and substantially curb the increasing cost burden.

Limit the public role to guaranteeing the national minimum, and introduce market principles into the area of social security. Carry out comprehensive reforms of the pension, health care, and nursing care systems while clearly distinguishing the roles of taxes and social insurance contributions as revenue sources. Guarantee the national minimum through tax-financed public pensions. Over the longer term, convert health insurance to a regionally based system. Pay for nursing care by means of tax-financed vouchers and introduce private-sector initiative to this area, regardless of whether care is provided in the home or an institution.

1.4 Radically reform the system of public financial institutions and the fiscal investment and loan system.

First, provide the prerequisites for full fiscal democracy by ensuring adequate disclosure in the public sector through improvement of the accounting methodology adopted by public bodies. Also, re-examine the propriety of the government having access to revenue sources other than funds collected through taxation. The key point is to streamline fiscal investment and loan institutions and privatize them to the maximum possible extent. Reexamine the form of management of the postal savings and insurance systems, including the possibility of privatization. Introduce market principles to the fiscal investment and loan system while, as an interim measure, securing funding through bond issues by individual fiscal investment and loan institutions.

1.5 Actively pursue privatization of public corporations.

Since there is no compelling reason for public goods to be supplied directly by the central and/or local governments, jurisdiction over those that can be provided by the private sector should be transferred to private hands. The question of whether direct management of public services is necessary should be strictly weighed from the viewpoint of the pursuit of efficiency, and consideration should be given to a variety of forms including public ownership combined with private management, and contracting out services to the private sector. In particular, it should be made compulsory for publicly managed corporations which are independent managerial entities to bid in competition with private companies, and publicly managed corporations which cannot win contracts under this system should be abolished.

1.6 Increase the independence of local governments and establish their status as the main entities of local management.

In view of the fact that the majority of actual administrative duties are performed by local authorities, and that, moreover, in recent years local government spending has grown even faster than that of the central government, there is an urgent need to streamline local administration and public finances and make them more efficient. In transferring fiscal resources and authority to the regions, allocate subsidies from the general budgetary account after first consolidating and rationalizing those subsidies; at the same time, review the national government's role of adjusting fiscal resources through grants from tax revenue to local governments, with a view to reducing this role to a minimum, and introduce

interregional competition. Introduce bond rating of local government bonds. Further, make the regions' administrative and financial capacities stronger, more efficient, and more broad-based geographically by promoting mergers and reorganizing the municipalities--the basic units of local government--into about 300 entities large enough to be self-sufficient.

2. Reforming the Taxation System

Japan's taxation system is designed with excessive emphasis on vertical fairness, as symbolized by the highest minimum taxable limit in the world and high progressive tax rates, and is structured in such a way that it discourages enterprise and the will to work. Furthermore, if the Japanese taxation system is not changed--and the differences between that system and the systems in other countries remain in place--it will exacerbate the decline of Japan's economic strength. There is an urgent need to transform the taxation system in terms of its basic ideals, including bringing it into harmony with international practices.

2.1 Create a taxation system which encourages individual vitality.

With the maintenance of economic vitality becoming an issue of increasing importance, the taxation system must not act as a disincentive to creative activity by individuals. For this reason, the excessive dependence on taxation of income must be corrected without delay.

Reduce individual income tax in real terms, for example, by setting the maximum rate at 50 percent for national and local taxes combined and further easing the progressive rate structure.

A real reduction of individual income tax and corporate tax which brings the direct/indirect tax ratio to approximately 50:50 is desirable.

Further, the following measures should be studied without delay: correcting the disparity between corporate and individual taxation; introducing a taxpayer identification number system; and reexamining the withholding tax system for wage and salary earners with a view to fostering taxpayer awareness.

2.2 Lower the effective corporate tax rate to 40 percent without delay.

The corporate tax burden should be eased without delay, and in real terms, from an international perspective. It must be said that to insist solely on revenue neutrality is to lose sight of what is most important. A real reduction should be

realized in fiscal 1998, and the effective tax rate should be lowered by 10 percent without delay. Also, special taxation measures and the reserves system should be reviewed within limits which are both rational and harmonized with international practices, from the viewpoint of giving priority to the creation of an environment where all compete under the same conditions.

Part 3. The Corporate and Management Role in Structural Reform

The program of structural reform set forth in Part 2 will put in place the prerequisite conditions for corporate activity. The question that faces companies active in the market is how effectively they will make the most of these new conditions and achieve results depends, first and foremost, on the behavior of companies themselves. In this sense, corporations and their managements have a very major role to play in promoting reform of Japan's economic structure.

The market is the most sensitive indicator of change. In terms of both timing and willingness to experiment, the marketplace is the vanguard of change. The companies and managements who are active in the market and tested daily in the marketplace must take the lead in reform. Of course, provided that they observe the rules, the course of action of individual companies cannot be dictated but should be left to their own judgment. The results of corporate decisions and actions will be evaluated by the market. That is the source of dynamism in the market economy.

The basic direction of the change we envisage in the corporate sector is the establishment of corporate behavior which has the market as its most important point of reference. Corporate performance will be judged only in the marketplace. Of course, the market can also be expected to penalize behavior which violates the corporate ethics demanded by society. Similarly, interactions in the marketplace among various stakeholders will serve to make their relationships transparent and fair. Together, these concepts are what is meant by the market being the most important point of reference. At the same time, it also means that the starting point of corporate behavior should be responsibility to the market. By this we mean that each company, while recognizing that its primary decision-making criterion is the pursuit of profit according to proper principles of corporate behavior and fair rules, must accept the evaluation it receives from the market as a result of its activity, and must found its corporate behavior on the principle of self-responsibility for both the behavior and its outcome.

1. Establishing Self-Disciplined Corporate Behavior Based on Market Principles

We reaffirm our recognition of the market as the most important point of reference for all corporate activity. In pursuing structural reform of the Japanese economy by making the market competitive, it is our goal to establish corporate behavior which respects the market, accepts its evaluation, and is founded on market-based corporate governance; in other words, to convert to management which places the greatest importance on the market.

These corporate concerns bring with them new cost increase factors, such as product liability and public disclosure of information, but companies responsive to the needs of consumers and society must address these issues positively. Further, with regard to issues of the environment, natural resources, and energy, which will continue to take on increasing global importance, companies must respond in a forward-looking way to measures designed to incorporate solutions into the market, in addition to making their own efforts to deal with these problems.

1.1 Seek the evaluation of the market.

a. Concentrate corporate efforts on supplying innovative products and services to the market, whether at the consumer level or other levels of demand, and seeking their evaluation by the market.

b. Make product liability and concern for the environment basic principles in the supply of products and services.

c. Make the return on equity (ROE) obtained through the evaluation of the market an important criterion for managerial decision-making.

1.2 Fulfill the responsibility to ensure fair market competition.

a. Move beyond "hidden-asset" management.

Although in certain respects "hidden-asset" management contributes to the stability and flexibility of operations, there is also a tendency for the exact condition of the company to become less transparent, making managerial discipline less strict. With the market playing a steadily increasing role in fund allocation, there is a need for accurate disclosure of realistic figures, and a shift from book value to

market value is called for. Accounting standards and the taxation system should be adjusted accordingly.

b. Accept rigorous enforcement of the law as it applies to corporations, including stronger penalty provisions.

Market participants should be aware of their great responsibility to ensure that competition in the marketplace is carried on fairly and transparently, and their conduct should obey the rules of the market at all times.

c. Establish corporate self-discipline.

Ensure that company management is based on the widely recognized rules of the market. Judgments should not be made on the basis of "local rules" which apply only within the company, and any disparity between the criteria used inside and outside the company should be eliminated. As part of these efforts, draw up a code of corporate conduct and ensure that it is observed within the company. In the process, the proper form of entertainment expenses should be reviewed, both from the viewpoint of correcting the high-cost structure and respecting fair market competition, and also from the viewpoint of gaining public trust toward the corporate sector.

d. Review business practices.

Stricter competition in the marketplace will eventually lead to the elimination of inefficient business practices, but companies should also work for voluntary improvement of their practices in order to strengthen their own competitiveness.

2. Establishing Managerial Leadership and Systems of Internal Monitoring

In a Japanese company, the board of directors, board of auditors, and general meetings of stockholders are assigned the role of monitoring whether the company is accomplishing its corporate objectives; in practice, however, this has become a mere formality, and an overly large share of this responsibility falls on the shoulders of top management. As a result, there is an inherent danger that misjudgments by top management will lead directly to a loss of momentum and decline of the company; at the same time, top executives are inclined to become too cautious and fail to display the true entrepreneurial spirit. Thus, there is a need to seriously address reform of the corporate management structure.

2.1 Fulfill the responsibilities of management.

During periods of change, corporate managements are required to provide the strong leadership needed to formulate and implement managerial policy. As the company's chief executives they must have the highest ethical principles and must take the lead in setting standards. In corporate management which has the market as its most important point of reference, managers may be called upon to make rigorous decisions, and for that reason they must also be rigorous toward themselves and their own course of action.

2.2 Make the board of directors fully active as a managerial decision-making body.

If companies are to make clear decisions in an increasingly uncertain business environment, it is essential that the board of directors, which is the corporate policy-making board, should be fully active. To this end, we must improve the mechanism of self-governance by separating the board's functions of strategy-making and conduct of business, reviewing its size, and providing access to information for all members, while also introducing outside directors who possess different experience and expertise from those appointed from within the company, with a minimum of 10 percent of the total number of directors as the goal.

2.3 Establish an internal monitoring system by expanding and improving the functions of auditors.

The functions of corporate auditors as a means of checking managerial performance must be improved. It is expected that their role in auditing the conduct of business will be expanded beyond determining its compliance with the law to include determining its soundness and advising management from an alternative viewpoint. To this end, free access to information, full dialogue with top executives, and adequate staffing of the office of audit must be ensured. Inviting persons with top-level management experience to serve as external auditors will also be effective in this regard.

3. Corporate Reform in the Areas of Personnel Management and Employment

To enable companies to be creative and dynamic, employment relationships which make it possible to maximize the potential of their workers must be established. "Japanese-style" employment relations have traditionally been characterized by once-yearly hiring of new graduates, personnel management based on the year of intake, the seniority system, long-term security of employment, and in-house education and training. However, the environment which shaped and made possible these employment practices is undergoing major changes on both the company's and the employee's side. The basic direction these changes are taking is that the advantages of market principles and the principle of personal responsibility are being introduced to the fields of employment and labor, and a relationship is being developed in which both companies and individuals make mutual choices through the market mechanism. Through this process of mutual selection, companies are able to incorporate market evaluations with regard to recruitment, personnel evaluation, and rewards, while individuals can broaden their range of choice and opportunities to display their abilities by casting off excessive dependence on the company and becoming independent. Creating new employment relationships of this type will ensure that the energy and enthusiasm each individual brings to his or her work contribute positively to the company, and will enable society as a whole to realize the optimal allocation of human resources. The company's responsibility is no longer merely to maintain employment; it is to increase corporate efficiency by making the best possible use of human resources, and thus contribute to the increased efficiency of the economy as a whole.

3.1 Reduce excessive dependence on hiring of new graduates, and provide varied forms of employment.

A policy of placing the right person in the right job at the right time expands the range of options for both individuals and companies. As companies take their own initiatives in this direction, the labor market will gain greater depth, to the benefit of both the corporate sector and the individual worker, and this will also contribute to improved productivity.

Make available varied forms of employment, including specialist positions and short-term employment contracts, instead of uniformly recruiting new employees at graduation and filling new positions and promoting only from within the company.

3.2 Actively utilize the abilities of women and older workers.

Companies should endeavor to fully utilize the abilities of women and older people by providing an environment and flexible working arrangements that will make it easier for them to work.

3.3 Establish clear personnel evaluation criteria, definite job descriptions, limits of authority, and precise assignments of responsibility.

In order to design merit-based pay systems, it is necessary to clearly establish the duties and extent of responsibility for each position and to make personnel evaluations more transparent. With increasing worker mobility through the external labor market, these steps are also necessary to ensure objective evaluation of individual ability.

3.4 Design pay systems that reward ability and contribution to the company.

The seniority-based wage system does not accurately reflect the individual's productivity or contribution to the company. Linking the system more closely to merit not only provides an incentive to individual workers; more importantly, it also clarifies the relationship of the pay scale to market value.

3.5 Review the current state of fringe benefits.

With regard to company welfare benefits, which tend to encourage an overly dependent relationship between the individual and the company, consideration should be given to introducing cafeteria benefit plans which allow individuals to choose according to their needs, and to converting benefits in part to salary and wages. Tax provisions should also be reviewed in conjunction.

Conclusion

The structural reform of Japan's economy must be carried to completion; in the process, there will be much pain to overcome. Reform cannot be achieved if we take a narrow approach, attempting merely to adjust the interests of the various parties. The process is a difficult one which, above all, requires a firm foundation in the understanding and trust of the Japanese people.

Keizai Doyukai is a group of business executives whose shared aspirations transcend the limits of particular corporations or industries. In the fifty years since its founding, as the nation's postwar economy has developed, the Association has

at all times thought and acted from the viewpoint of the economic well-being of the Japanese people.

Today, Japan stands at a critical crossroads, facing the choice of our course into the twenty-first century. Reform is a turning away from the past, and in order to make a fresh start we must first be prepared to question every one of the accumulated institutions of fifty years, in the form of the economic system, business practices, and vested interests. Keizai Doyukai is resolved to return anew to our founding principles and press forward for the sake of the nation's future.