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# Enhancing the Productivity of the Service Sector in Japan

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# ENHANCING THE PRODUCTIVITY OF THE SERVICE SECTOR IN JAPAN

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ABSTRACT/RÉSUMÉ

**Enhancing the productivity of the service sector in Japan**

Labour productivity growth in the service sector, which accounts for 70% of Japan's economic output and employment, has slowed markedly in recent years in contrast to manufacturing. The disappointing performance is associated with weak competition in the service sector resulting from strict product market regulation and the low level of import penetration and inflows of foreign direct investment (FDI). Reversing the deceleration in productivity growth in the service sector is essential to raise Japan's growth potential. The key is to eliminate entry barriers, accelerate regulatory reform, upgrade competition policy and reduce barriers to trade and inflows of FDI. Special attention should be given to factors limiting productivity growth in services characterised by either low productivity or high growth potential, such as retail, transport, energy and business services. Finally, it is essential to increase competition in public services, such as health and education, where market forces have been weak.

This Working Paper relates to the 2008 *OECD Economic Survey of Japan* (www.oecd.org/eco/surveys/japan).



*JEL classification*: R11; R21; R31.

*Keywords*: Japan; service sector; productivity growth; regulatory reform; special zones; competition policy; JFTC; service trade; foreign direct investment; retail sector; electricity; gas; harbours; air transport; business services; public services; Japan Post.


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**Améliorer la productivité dans le secteur des services au Japon**

La croissance de la productivité du travail dans le secteur des services, qui représente 70 % de la production économique et de l'emploi au Japon, s'est sensiblement ralentie ces dernières années contrairement à l'évolution observée dans le secteur manufacturier. Ces résultats décevants sont associés à la faiblesse de la concurrence dans les services imputable à la rigueur de la réglementation des marchés de produits, au faible niveau de pénétration des importations et au manque de dynamisme des investissements directs de l'étranger (IDE). Le ralentissement de la croissance de la productivité dans le secteur des services doit absolument être inversé pour accroître le potentiel de croissance du Japon. Il est indispensable d'éliminer les obstacles à l'entrée, d'accélérer la réforme de la réglementation, de renforcer la politique de concurrence et de réduire les obstacles au commerce et aux entrées d'IDE. Une attention particulière devrait être accordée aux facteurs limitant la croissance de la productivité dans les services caractérisés soit par une faible productivité, soit par un potentiel de croissance élevé, comme le commerce de détail, les transports, l'énergie et les services aux entreprises. Enfin, il est essentiel d'accroître la concurrence dans les services publics, comme la santé et l'éducation, où les forces du marché ont peu joué.

Ce Document de travail se rapporte à l'Étude économique de l'OCDE de Japon, 2008 (www.oecd.org/eco/etudes/japon).



Classification JEL : R11; R21; R31.

Mots clés: Japon; secteur de service; croissance de la productivité; réforme réglementaire; zones spéciales; politiques de la concurrence; JFTC; commerce de service; investissements directs de l'étranger; distribution de détail; électricité; gaz; ports; transport aériens; service aux entreprises; Japan Post.

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# ENHANCING THE PRODUCTIVITY OF THE SERVICE SECTOR IN JAPAN

*Randall S. Jones and Taesik Yoon*[1]

1. Boosting productivity in the service sector is a key priority for promoting long-term growth. Services account for a dominant share of economic activity in Japan; its share of output increased from 66% in 1993 to 70% in 2003, matching the OECD average. The disappointing productivity performance in Japan's service sector - which has lagged far behind the manufacturing sector in recent years – is thus a source of major concern. At the same time, the globalisation of service industries is creating more opportunities for domestic firms, while exposing them to stronger competition. This paper addresses the challenges of fostering a more dynamic and competitive business environment that encourages service-sector firms to enhance productivity, offer new services and create new employment. After an overview of Japan's service sector, the paper discusses the main factors hindering its growth. The following sections analyse policies to improve the overall productivity of the service sector as well as the major issues in key service industries. This paper concludes with recommendations, which are summarised in Box 4.

## The role of the service sector in the Japanese economy

2. The upward trend in the share of the service sector in GDP and total employment in Japan is expected to continue in the context of rapid population ageing and intense competition with low-cost manufacturers in Asia.[2] Another factor boosting services is the increased outsourcing from manufacturing, accelerated by the modularisation of that sector. Consequently, the competitiveness of manufactured goods in Japan depends increasingly on the performance of the service sector.[3] The growing size of the service sector and its impact on other parts of the economy make it all the more important to promote efficiency in services and thereby boost economy-wide labour productivity, which was only 70% of the US level in 2006. Japan ranks only 18th among OECD economies in terms of labour productivity.

3. The service sector is largely responsible for low aggregate productivity in the Japanese economy. The growth of labour productivity per hour worked in services decelerated from an annual rate of 3.5% between 1976 and 1989 to 0.9% between 1999 and 2004, with both market and non-market services

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1. Randall S. Jones is head of the Japan/Korea Desk in the Economics Department of the OECD and Taesik Yoon was an economist on that desk and is currently a director of the International Financial Institutions Division in the Ministry of Strategy and Finance in Korea. This paper is based largely on material from the *OECD Economic Survey of Japan* published in April 2008 under the authority of the Economic and Development Review Committee (EDRC). The authors would like to thank Andrew Dean, Val Koromzay, Stefano Scarpetta and Masahiko Tsutsumi for valuable comments on earlier drafts. Special thanks go to Lutécia Daniel for technical assistance and to Nadine Dufour for technical preparation.

2. The share of employment in services rose from 60% in 1993 to 70% in 2003. In terms of its share of GDP (70%), Japan lags the United States and the United Kingdom, where services accounted for 76% in 2005.

3. Services' share of inputs into manufacturing increased from 20% in 1980 to 30% in 2004 (METI, 2007).

recording significant slowdowns (Table 1). Moreover, labour productivity in non-market services declined in absolute terms, while Information and Communication Technology (ICT) services recorded a marked slowdown from a 3.9% annual rate between 1989 and 1999 to less than 2% in 1999 to 2004. In contrast to the across-the-board deceleration in services, labour productivity growth in the manufacturing sector has remained fairly constant at around 4% over the past 30 years. Productivity growth in the service sector was thus less than a quarter of that in manufacturing between 1999 and 2004, a much larger gap than in the United Kingdom and the European Union.[4] Consequently, the contribution of the service sector to overall productivity growth between 1990 and 2002 in Japan was the eighth lowest among the 24 countries surveyed (OECD, 2005a). In sum, the slowdown in the service sector has brought down labour productivity growth in the entire economy from more than 4% in the 1976-89 period to less than 2% from 1999 to 2004.

4. As in most OECD countries, productivity growth in the service sector was driven primarily by growth within each service industry (the "within-sector" effect shown in Figure 1).[5] In contrast, the effect of shifting labour from less to more productive service industries (the "shift effect") has been small or even negative. In particular, in market services and ICT services, labour has been reallocated from more to less productive industries in recent years, in contrast to the 1970s and 1980s. The fact that labour productivity benefited little from a reallocation of labour to more productive service sectors indicates the need for further structural change that promotes the development of the more dynamic service industries.

**Table 1. Labour productivity growth in the service sector by industry**

Within-industry contributions to labour productivity growth in percentage points per year

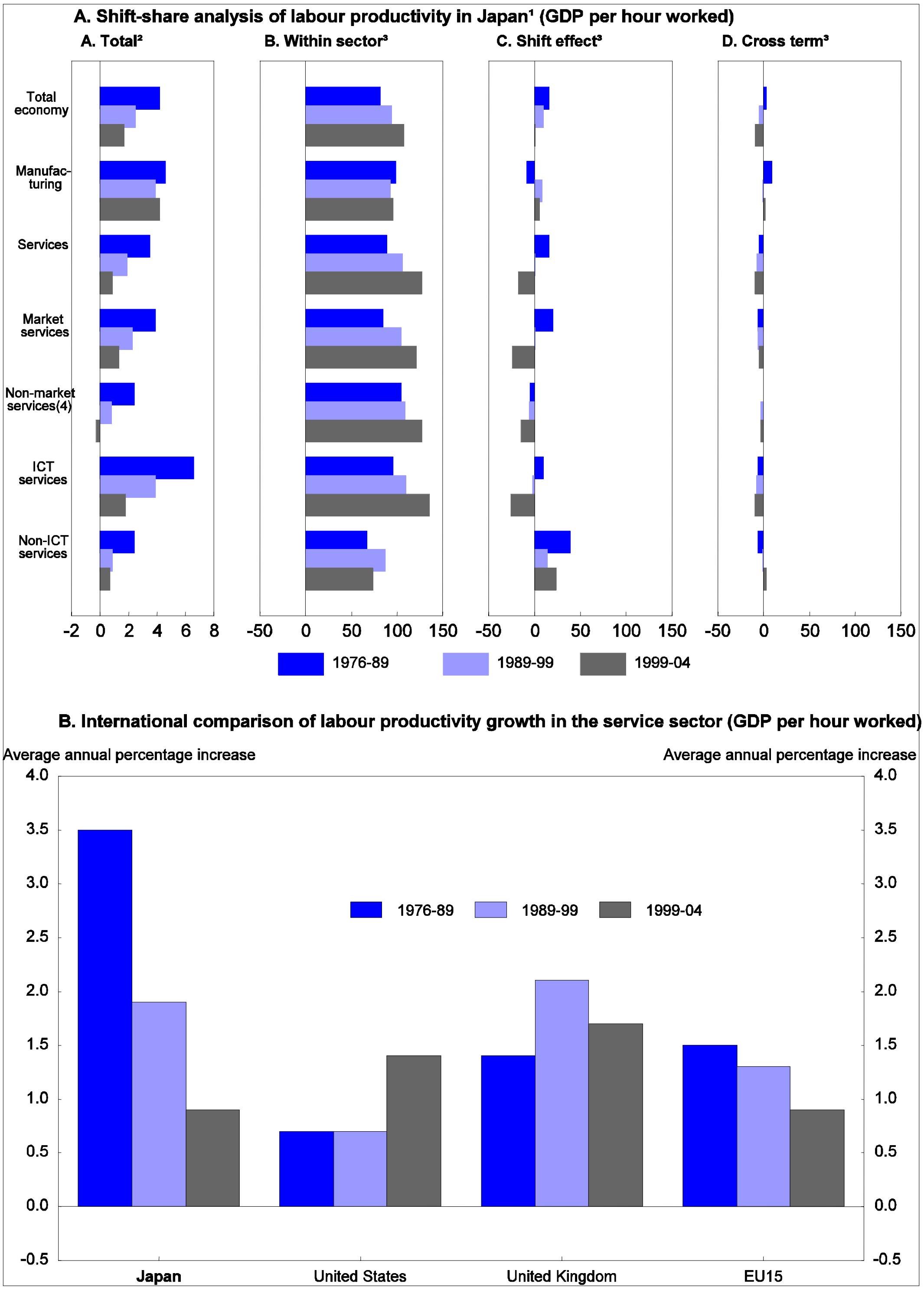
| Industry | ISIC code | 1990-99 | 1999-04 | Change |
|---|---|---|---|---|
| Electricity and gas | 40 | 0.08 | 0.06 | -0.02 |
| Wholesale and retail trade | 50 to 52 | 0.42 | 0.02 | -0.40 |
| Hotels and restaurants | 55 | 0.03 | 0.02 | -0.01 |
| Transport and storage | 60 to 63 | 0.03 | -0.02 | -0.05 |
| Post and telecommunications | 64 | 0.17 | 0.15 | -0.02 |
| Financial intermediation | 65 to 67 | 0.21 | 0.18 | -0.03 |
| Business services | 71 to 74 | 0.34 | 0.29 | -0.05 |
| Education | 80 | 0.17 | 0.14 | -0.03 |
| Health and social work | 85 | 0.08 | 0.06 | -0.02 |
| Market services | 40 to 74 | 1.55 | 0.76 | -0.79 |
| Non-market services | 75 to 99 | 0.39 | 0.30 | -0.09 |
| Total services | 40 to 99 | 1.94 | 1.06 | -0.88 |
| Total economy | 1 to 99 | 2.41 | 1.46 | -0.95 |

*Source:* EU KLEMS Database (2007).

4. In the European Union (the 15 members as of 1999), productivity growth was 2.7% for manufacturing versus 0.9% for services, and in the United Kingdom, it was 2.9% and 1.7%, respectively. In contrast, there was a relatively large gap in the United States: 6.0% for manufacturing and 1.4% for services.

5. The shift-share analysis, shown in Figure 1, decomposes aggregate changes in labour productivity into a within-sector effect, a shift effect and a cross-term effect. The within-sector effect measures the impact on total economy productivity growth from productivity growth within each sector, assuming that labour shares are unchanged. The shift effect measures the impact on total economy productivity resulting from the movement of labour between sectors, assuming that the level of productivity in each sector is unchanged. The cross-term effect measures the change in both labour share and productivity in each sector and accounts for the impact of labour re-allocation between sectors with varying productivity growth rates.

**Figure 1. Labour productivity by sector**




1. See endnote in the text for an explanation of shift-share analysis.
2. Annual increase in GDP per hour worked.
3. Per cent of total increase.
4. Includes activities such as public administration and defence; compulsory social security; education, health and social work.

*Source*: EUKLEMS Database (2007).

5. Breaking down the performance of the service sector by industry shows an across-the-board deterioration in "within industry" productivity growth between the periods 1990-99 and 1999-2004 (Table 1). Wholesale and retail trade recorded the largest decline, while transport and storage reported negative productivity growth. Overall, these finding are consistent with other studies. According to OECD indicators, the growth of value added per person employed in Japan's transport and storage sector was one of the lowest among 18 OECD countries (OECD, 2006b). Another study (Fukao and Miyagawa, 2007) also reported that the largest declines in total factor productivity growth between 1995 and 2004 were observed in distribution and personal and social services. In terms of levels, this study also found significant gaps in labour productivity between Japan and the United States in wholesale and retail trade, transport and finance and insurance.

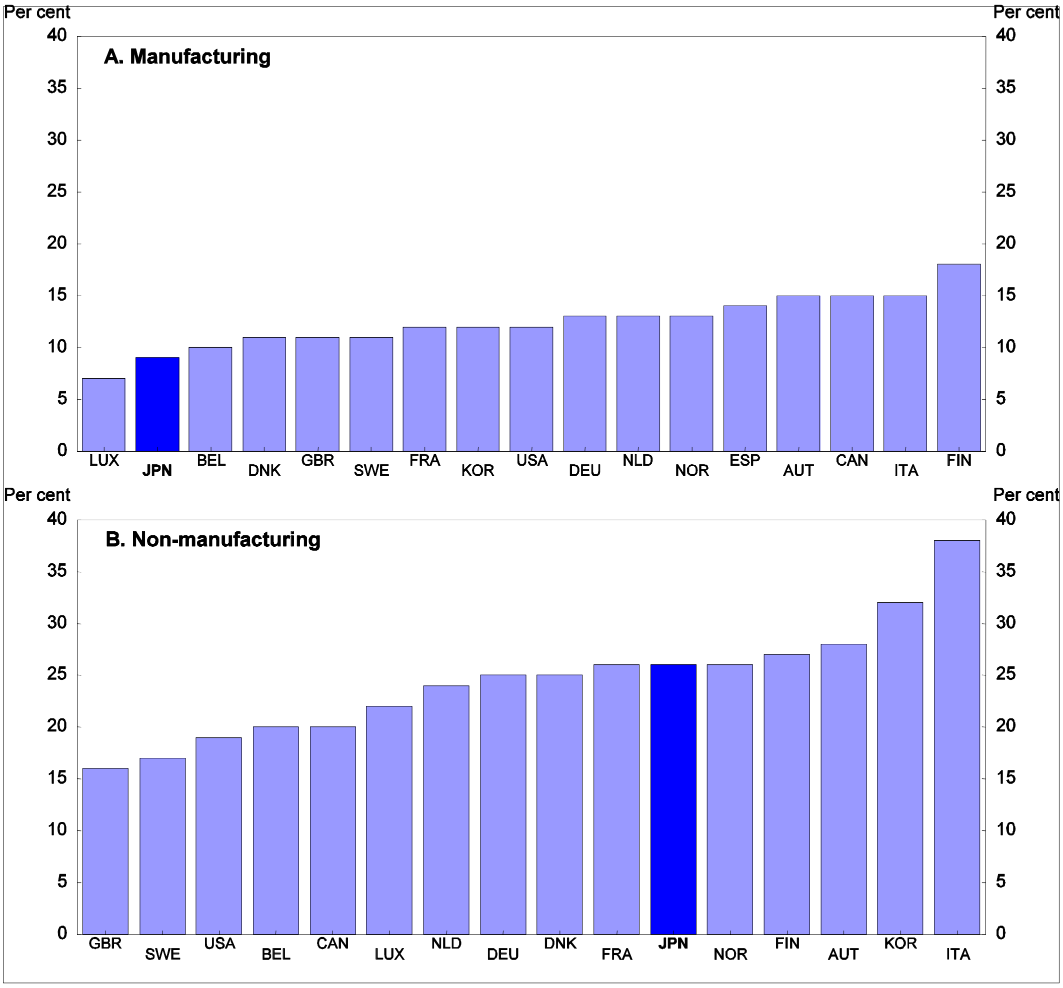
**Factors hindering the growth of the service sector**

6. The manufacturing sector sustained productivity growth through the 1990s, as international competition drove increases in efficiency. The service sector, in contrast, has been relatively sheltered from both international and domestic competition, as reflected in the low level of import penetration and inflows of foreign direct investment in the service sector (see below), thus weakening competition and incentives to boost efficiency. The lack of competition in non-manufacturing is reflected in mark-ups that are three times higher than in manufacturing and relatively high compared to other OECD countries (Figure 2).

7. Market-unfriendly regulations in product markets have been found to disproportionately damage entrepreneurial initiative in services (Nicoletti, 2001). The OECD's indicator of product market competition in seven non-manufacturing industries in 2003 ranks Japan in the middle of member countries, and well below the top performers (Figure 3). This indicator compares regulations that affect competitive pressures, including barriers to entry, public ownership, market structure, vertical integration and price controls (Table 2). For the indicators of public ownership and market structure, Japan has a better score than the OECD average, while for entry barriers, Japan is close to the average. The main problem for competition is vertical integration, where Japan has the worst score among member countries.[6] Moreover, in all areas (except price controls), Japan lags behind the leading countries. In sum, the indicator approach suggests considerable scope to reform market-unfriendly regulations, a conclusion supported by other studies of the Japanese service sector (Ono, 2000). The potential gains from regulatory reform are significant, as illustrated in Panel B of Figure 3. Countries with less restrictive regulations over the period 1985-2003 tended to have a greater acceleration of labour productivity growth over the period 1996-2003.

6. Indicators of vertical integration focus on whether competitive activities, such as the generation of electricity, are separated from natural monopoly activities.

**Figure 2. Mark-ups in manufacturing and non-manufacturing[1]**




1. Mark-ups are calculated for individual two-digit ISIC sectors and aggregated over all sectors using country-specific final sales as weights.

*Source*: Hoj *et al.* (2007).

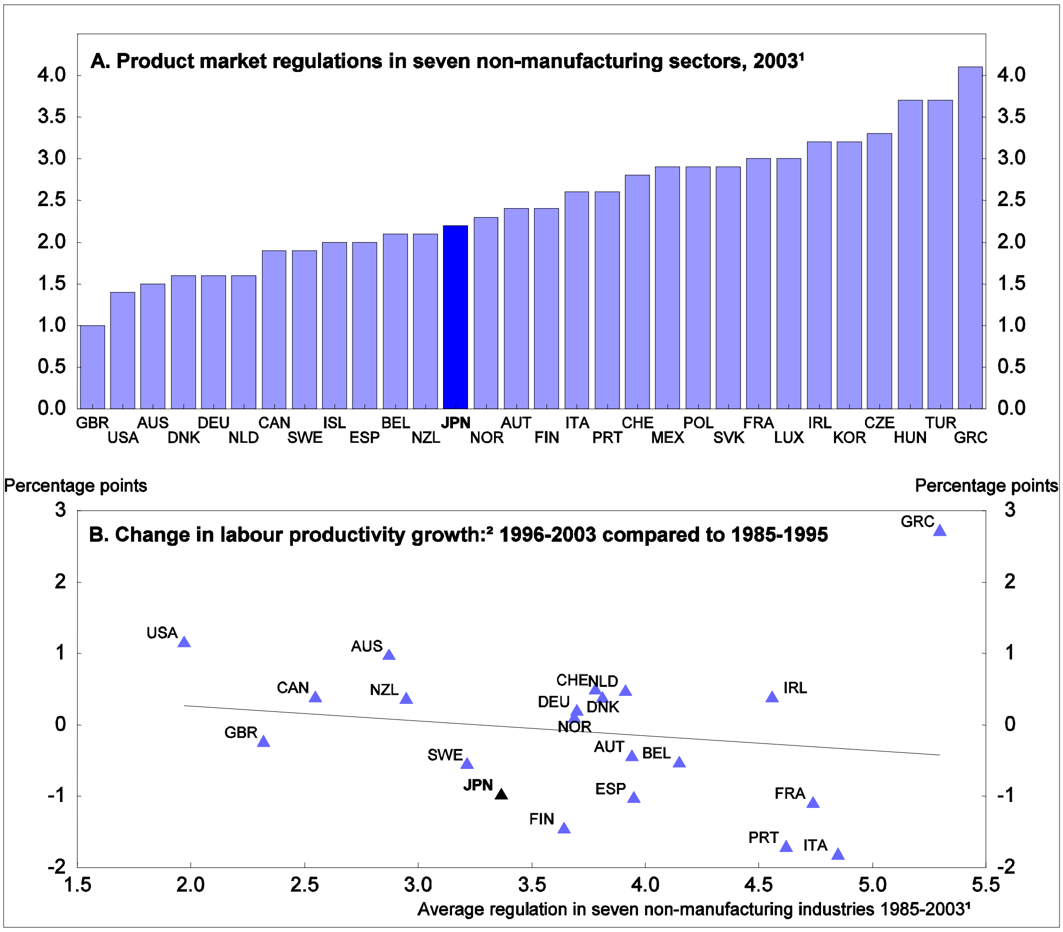
**Table 2. Product market regulations in the non-manufacturing sector in the OECD area**
In 2003[1]

| | Entry barriers[2] | Public ownership[3] | Market structure[4] | Vertical integration[5] | Price controls[6] |
|---|---|---|---|---|---|
| Highest score | 3.6 | 5.6 | 5.5 | 6.0 | 6.0 |
| Average score | 1.8 | 3.2 | 3.5 | 3.2 | 0.5 |
| Lowest score | 0.5 | 0.7 | 0.2 | 1.1 | 0.0 |
| Japan's score | 1.9 | 1.7 | 2.1 | 6.0 | 0.0 |

1. The indicators range from zero (least restrictive) to six (most restrictive). The seven non-manufacturing sectors are gas, electricity, air transport, railways, road freight, post and telecom.
2. Covers all seven non-manufacturing industries.
3. Covers all seven non-manufacturing industries except road freight.
4. Covers gas, railways and telecom.
5. Covers gas, electricity and railways.
6. Covers road freight.

*Source:* Conway *et al.* (2006a).

**Figure 3. Product market regulation and productivity growth**




1. The indicator ranges from (0 least restrictive) to 6 (most restrictive). The seven non-manufacturing sectors are gas, electricity, air transport, railways road freight, post and telecom.
2. Percentage-point change in the annual average growth rate of labour productivity in the total economy between the periods 1985-1995 and 1996-2003.

*Source*: Conway *et al.* (2006a) and Conway *et al.* (2006b).

8. Within the regulatory framework, regulations that limit entrepreneurship tend to be especially harmful for productivity growth, particularly in sectors where firms are dynamic and better placed to adopt new technology. Entrepreneurship in Japan is discouraged by administrative burdens on start-ups, which are slightly above the OECD average (Conway *et al.*, 2005). According to a study by the World Bank, starting a business in Japan is relatively complicated, costly and time-consuming: Japan ranks 18th overall in the OECD (Table 3).[7] Indeed, Japan's weakness in entrepreneurship and new business creation has been a critical disadvantage to enhancing service sector productivity, according to some studies (Ono, 2000). In sum, reducing the administrative burdens on start-ups would strengthen competition by promoting entrepreneurship.

7. Japan also had a low score in the area of entrepreneurship and creation of new businesses, according to an indicator calculated by International Management Development (IMD).

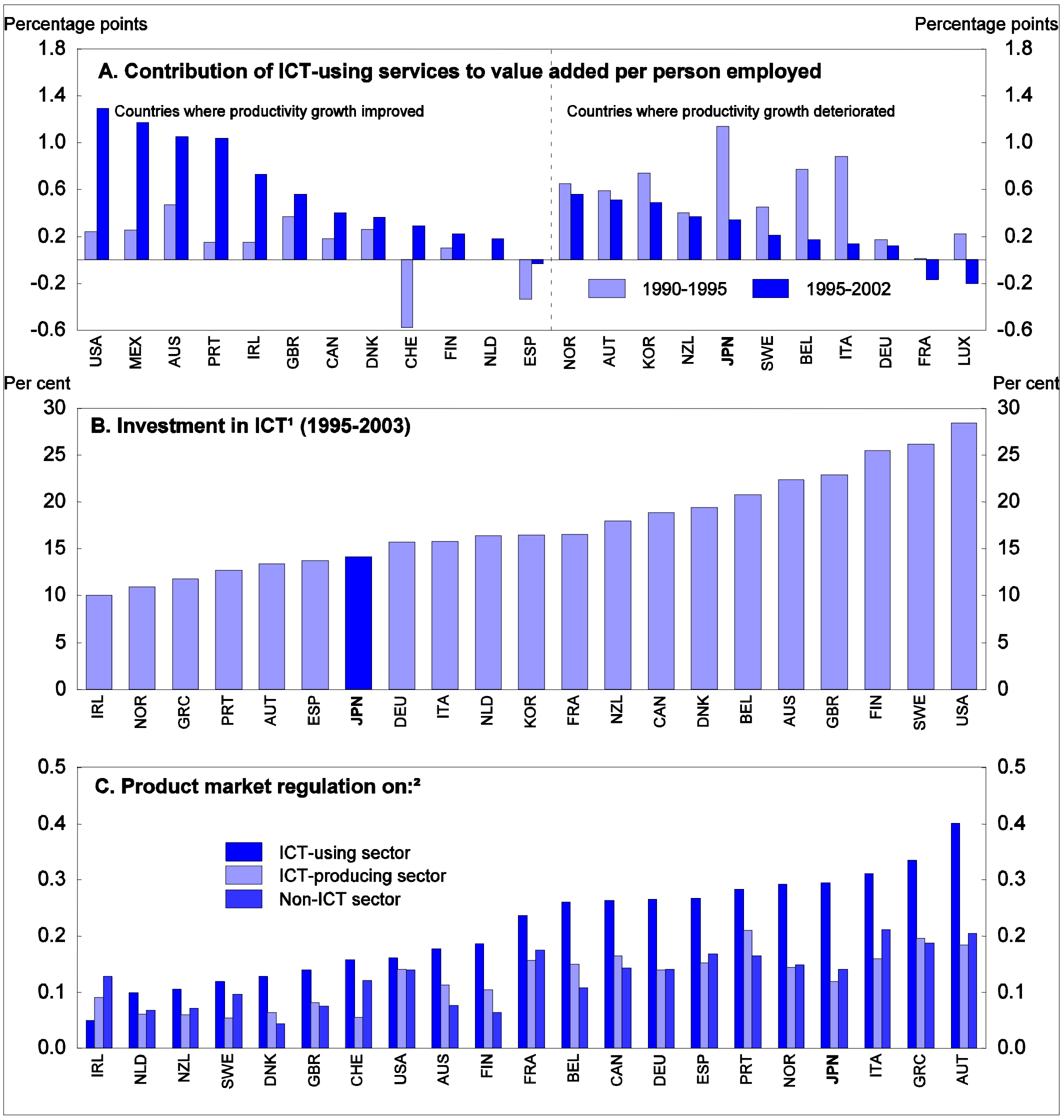
**Table 3. Time and cost of starting a new business**
Countries shown by their overall rank from least to most restrictive

| Countries | Rank in the world | Number of procedures | Time (days) | Cost (% of income per capita) | Minimum capital (% of income per capita) |
|---|---|---|---|---|---|
| Australia | (1) | 2 | 2 | 0.8 | 0.0 |
| Canada | (2) | 2 | 3 | 0.9 | 0.0 |
| New Zealand | (3) | 2 | 12 | 0.1 | 0.0 |
| United States | (4) | 6 | 6 | 0.7 | 0.0 |
| Ireland | (5) | 4 | 13 | 0.3 | 0.0 |
| United Kingdom | (6) | 6 | 13 | 0.8 | 0.0 |
| France | (12) | 5 | 7 | 1.1 | 0.0 |
| Iceland | (14) | 5 | 5 | 2.7 | 14.1 |
| Finland | (16) | 3 | 14 | 1.0 | 7.7 |
| Denmark | (18) | 4 | 6 | 0.0 | 40.7 |
| Belgium | (19) | 3 | 4 | 5.3 | 20.1 |
| Sweden | (22) | 3 | 15 | 0.6 | 31.1 |
| Norway | (28) | 6 | 10 | 2.3 | 23.4 |
| Switzerland | (35) | 6 | 20 | 2.1 | 13.9 |
| Portugal | (38) | 7 | 7 | 3.4 | 34.7 |
| Netherlands | (41) | 6 | 10 | 6.0 | 52.9 |
| Turkey | (43) | 6 | 6 | 20.7 | 16.2 |
| **Japan** | (44) | **8** | **23** | **7.5** | **0.0** |
| Italy | (65) | 9 | 13 | 18.7 | 9.8 |
| Hungary | (67) | 6 | 16 | 17.7 | 65.1 |
| Germany | (71) | 9 | 18 | 5.7 | 42.8 |
| Slovak Republic | (72) | 9 | 25 | 4.2 | 34.1 |
| Mexico | (75) | 8 | 27 | 13.3 | 11.6 |
| Austria | (83) | 8 | 28 | 5.4 | 55.5 |
| Czech Republic | (91) | 10 | 17 | 10.6 | 34.9 |
| Korea | (110) | 10 | 17 | 16.9 | 296.0 |
| Spain | (118) | 10 | 47 | 15.1 | 13.7 |
| Poland | (129) | 10 | 31 | 21.2 | 196.8 |
| Greece | (152) | 15 | 38 | 23.3 | 104.1 |
| Average | | 6.5 | 15.6 | 7.2 | 38.6 |

*Source:* World Bank (2007), *Doing Business 2008*.

9. Moreover, a number of studies have found that increased investment in ICT products results in a pick-up in labour productivity growth (Nicoletti and Scarpetta, 2005). Such investment is particularly important for innovation in the service sector, as it enables firms to engage in process innovation through the value chain, develop new applications and raise productivity. In the United States, a large proportion of the acceleration in labour productivity achieved since the mid-1990s originated in services that use ICT intensively (Figure 4). In contrast, the contribution of ICT-using services to labour productivity was relatively low in Japan and it has declined significantly since 1995. Moreover, as shown in Figure 1, the rate of labour productivity growth in ICT services, which includes both ICT-using and ICT-producing services, has slowed markedly in recent years.

**Figure 4. The role of ICT-using services in labour productivity growth**




1. As a share of non-residential investment.
2. In 2003. The indicators range from 0(least restrictive) to 1 (most restrictive).

*Source*: OECD, Productivity Database and Conway *et al.* (2006b).

10. The small contribution to labour productivity from ICT-using services in Japan reflects, in part, the low level of investment. Indeed, investment in ICT accounted for only 14% of non-residential investment in Japan over the period 1995-2003, one of the lowest figures in the OECD area (Figure 4, Panel B). Moreover, ICT services account for only 2% of R&D spending in Japan. The level of investment in ICT-using services is sensitive to the degree of regulation; countries with stringent regulation tend to have lower levels of investment (Conway *et al.*, 2006b). In Japan, product market regulation in ICT-using sectors was the fourth highest in the OECD in 2003 (Panel C), suggesting scope for liberalising restrictions and thereby promoting investment and labour productivity. Easing overall product market regulation to the level of the least restrictive OECD country would have boosted annual productivity

growth by 0.7% in ICT-intensive sectors and 0.6% in other sectors over the period 1995 to 2003.[8] Such a gain would have significantly accelerated labour productivity growth from the 1.1% annual rate recorded over that period.

11. Another factor hindering the growth of the service sector is the legacy of an industrial policy that focused on exports and the manufacturing sector. The lower priority accorded to services reflected the perception that they are non-tradable and merely an appendage to manufacturing. The emphasis on manufacturing is also reflected in its dominant share of R&D spending, while the service sector accounted for only 12% of the total, compared to 43% in the United States and an OECD average of 25%. In addition to policies aimed at promoting manufacturing, excessive government assistance to small and medium-sized enterprises (SMEs) has damped competitive pressure in the non-manufacturing sector, which accounts for 90% of SMEs. There are 14 special government programmes for SMEs, including tax breaks and subsidies, while the regulatory framework provides preferential treatment and entry barriers in the service sector. According to the OECD's product market regulation index, the level of restrictiveness in Japan in the sub-category "barriers to competition", which includes entry barriers and anti-trust exemptions, lagged behind top performers in the OECD in 2003.

**Polices to promote higher productivity in the service sector**

12. A number of studies show that relaxing the strictness of regulations, promoting competition and lowering barriers to trade and foreign direct investment (FDI) have increased the level and rate of growth of productivity by stimulating business investment and promoting innovation and technological catch-up (Nicoletti and Scarpetta, 2005). According to a study by the Japanese government, regulatory reform in the service sector had a particularly strong impact on productivity: a 10% decline in the index measuring the stringency of regulation in the non-manufacturing sector (see below) boosted total factor productivity (TFP) growth by 0.2 percentage point, an impact 1.4 times greater than a similar easing of regulations in all industries (Cabinet Office, 2006).

13. Recognising the importance of services for the overall performance of the Japanese economy, the government has introduced a number of policy initiatives. *First*, it has launched policies to accelerate the development of the service sector (Box 1). *Second*, it has taken steps to level the playing field by harmonising the tax treatment of the service sector with that of the manufacturing sector, including accelerated depreciation on facility investment and reduced acquisition taxes on real estate. The government has also encouraged M&As between manufacturing and service firms by granting the same preferential tax treatment given to M&As within sectors. *Third*, it has accelerated privatisation and the outsourcing of public services through the market testing initiative (see below). Given the diversity of service activities, this sector is affected by a wide range of government policies. This section will focus on the scope for further progress in the key priorities of regulatory reform, competition policy and international competition, which have an important impact on service sector productivity. Labour market flexibility, which is essential to facilitate adjustment in the service sector, is discussed in Chapter 6 of the 2008 *OECD Economic Survey of Japan*.[9]

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8. This estimate is based on a model that makes the increase in productivity growth a function of the gap with the front-running country (Conway *et al.*, 2006b).

9. The 2005 OECD Ministerial (OECD, 2005a) also stressed the importance of improving education and training and upgrading innovation policies (see the 2006 *OECD Economic Survey of Japan*) to develop the service sector.

**Box 1. Government initiatives to boost productivity in the service sector**

The "New Industry Development Strategy 2005" selected seven priority areas for development, including four service sectors; business services, software contents, health/welfare and environment/energy. The Ministry of Economy, Trade and Industry (METI) has drawn up detailed action plans for the priority areas. In July 2006, METI announced another programme to develop the service industry as part of a comprehensive initiative, entitled the "New Strategy for Economic Growth". This programme selected six priority areas for development; health/welfare, childcare, tourism, business services, software contents and distribution/logistics. The specific target was to increase their market size by 70 trillion yen (14% of GDP) by 2015, based on a detailed action plan, entitled "Toward Innovation and Productivity Improvement in Service Industries", that focuses on the following priorities:

- Adopting a scientific and engineering approach and utilising information technology.
- Building a framework to provide information to enhance consumer credibility.
- Improving quality assurance and measures to support recognition, while encouraging standardisation.
- Developing human resources.
- Facilitating entry into the service sector.
- Encouraging expansion into foreign markets.
- Revitalising regional economies through service industries.
- Improving the statistical infrastructure to evaluate the current situation.

These plans were followed by the "Program for Enhancing Growth Potential" presented by the Council on Economic and Fiscal Policy (CEFP) in 2007. Its goal is to boost productivity growth, as measured by value-added per worker, by 50% for all industries over five years. Achieving this objective requires raising the annual productivity growth rate in the service sector, which averaged 1.6% over the past decade, to 2.4% by 2011. The action plan includes:

- Fostering Japan's growth potential through the development of human capital, supporting job placement and raising the competitiveness of SMEs.
- Pursing service innovation through reform of the government-controlled service market, promoting innovation in IT and improving regional growth potential.
- Expanding the growth frontier by focusing on areas with high potential, reforming the university system and promoting the diversification of investment.

In addition, the "SME Productivity Improvement Project" was included in "Basic Policies 2007". This project aims at enhancing productivity of SMEs through IT utilisation, corporate revitalisation and the promotion of business start-ups. Major policy tools include providing financial support and R&D assistance and developing human resources.

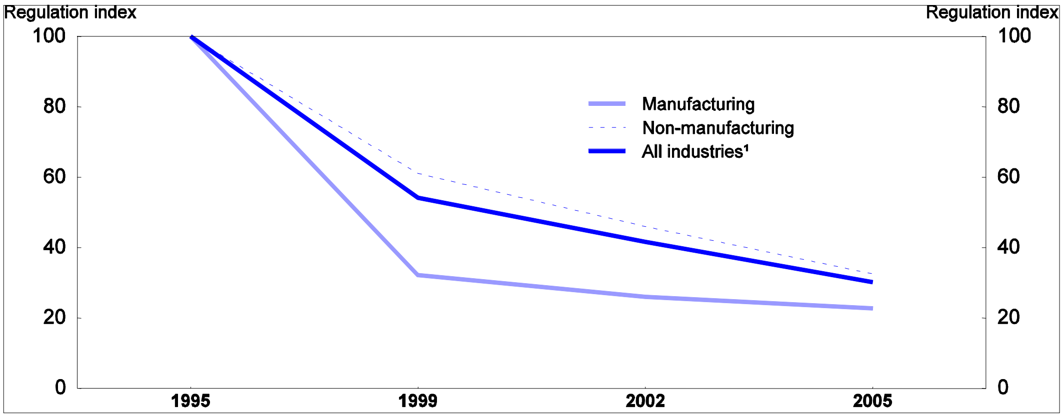
However, government policies targeted at services raise some concerns. *First,* the action plans of the three initiatives (two by METI and one by the CEFP) contain many similarities. It is, therefore, important to ensure the integration of the plans and avoid any overlap, which would potentially undermine their effectiveness and encourage redundant spending. *Second*, additional government intervention to protect SMEs, on top of the broad array of programmes already in place, might further distort resource allocation. For example, the "SME fund" to promote investment in SMEs, which was included in the action plan "Toward Innovation and Productivity Improvement in Service Industries" and the financial support under the "SME Productivity Improvement Project", need to be reconsidered.

***Pursuing regulatory reform***

14. Reforming the regulatory framework, including restrictions on entry and operations, is the key to promoting competition and investment. In addition to the policy measures specifically targeted at the service sector (Box 1), other reforms have been undertaken as part of Japan's policy of regulatory reform. According to the government, more than 6 000 regulatory reform measures have been implemented during the past decade. These measures helped to reduce the government's regulation index, which reflects the overall strength of regulations, from 100 for all industries in 1995 to 30 in 2005 (Figure 5).[10] The weighted averages by sector indicate a larger fall for the manufacturing sector, although the non-manufacturing sector has been catching up since 1999. However, as noted below, the impact of reforms on consumer surplus has been larger in non-manufacturing, reflecting its lower level of productivity and the greater stringency of regulation.

**Figure 5. Overall progress in regulatory reform in Japan**

1995=100




1. The "All industries" index is a weighted sum of the manufacturing and non-manufacturing indices, based on value added.

*Source*: Cabinet Office (2006) and OECD calculations.

15. The total economic benefits of regulatory reform, measured by the increase in consumer surplus, are estimated at 17.6 trillion yen (3.5% of GDP) between 1995 and 2005 (Table 4). The largest benefits were achieved in service industries that have experienced significant deregulation since 2000, notably electricity, trucking and telecommunications. Each of these industries recorded large price declines and sharp increases in demand. For example, electricity prices fell by 39%, while consumption rose by 19%. The large consumer surplus gain in telecommunications is due to a twenty-fold increase in the use of mobile telephones accompanied by a 61% drop in the price.

*Regulatory Reform Programme*

16. Japan's regulatory reform policies have been presented annually since 2001 in the three-year Programmes for Regulatory Reform based on detailed reports and actions plans from the Council for the Promotion of Regulatory Reform. In June 2007, the Cabinet decided on a new Regulatory Reform

10. The index is calculated based on both the stringency of a regulation and its administrative classification. For example, a general prohibition receives a weight of 10 000, compared to 10 for a notification requirement. There are four administrative classifications, ranging from law (a weight of four) to a public notice (a weight of one). The series for all industries shown in Figure 5 is a weighted sum of the manufacturing and non-manufacturing indices, based on value added.

Programme, focusing on 15 priority areas, including a number of services, such as education, IT, distribution and energy (Table 5). The new three-year programme calls for upgrading public administration, in part by improving the "Public Comment Procedure", the "No-Action Letter" scheme and "Regulatory Impact Analysis" (Box 2). Such a focus is appropriate, as some studies have found a significant correlation between the degree of burden imposed by administrative regulations[11] and the acceleration of catch-up in multi-factor productivity growth (Nicoletti and Scarpetta, 2003). Administrative regulations in the OECD area tend to be concentrated in certain non-manufacturing industries, such as public utilities, telecommunications, financial intermediation, business services and the retail sector. Indeed, the stringency of administrative regulations in Japan was higher than in the top performers in the OECD in 2003.

**Box 2. Regulatory reform in public administration**

The transparency of administrative measures is essential to establishing a stable and accessible regulatory environment that promotes competition. However, the opacity and unpredictability of public administration has been cited as one of the major obstacles to doing business in Japan. For example, Keidanren (representing the Japanese corporate sector), the European Union and the United States have voiced concerns about the continued prevalence of administrative guidance, both written and oral, and about the absence of efficient reviews of administrative decisions (OECD, 2004b). In light of these concerns, the 2007 Council for the Promotion of Regulatory Reform chose "evaluating and improving government regulations, including ministerial decree orders, administrative notification and guidelines" as one of its priority areas in 2007. In addition, several tools to increase the transparency and predictability of public administration have undergone major changes to make them more effective.

*First,* the "Public Comment Procedure" introduced in 1999 requires central government entities to give advance public notice of proposed regulations in order to provide opportunities for public comment and to take those comments into account in preparing the final regulations. The system was strengthened in 2006 by incorporating it into the Administrative Procedure Act, expanding its coverage[1] and establishing a standardised minimum comment period of 30 days. However, further steps are needed to make the public comment procedure an integral part of the regulatory process. In particular, it is important to strictly enforce the minimum comment period, given that about one-half of public comment periods before FY 2005 fell short of 30 days. In addition, the public should be able to comment on draft laws in their entirety rather than on excerpts or summaries. The coverage of the public comment procedure, which is applied on a discretionary basis to internal orders, communication notes, administrative guidance and negotiations for international agreements, needs to be expanded further.

*Second,* the "No-Action Letter" system allows a business entity with concerns about the interpretation of regulations, or about whether its proposed business plan would require a license or official approval, to seek advance clarification from the regulator. This system was introduced in 2001 in response to the lack of transparency and predictability in the implementation and enforcement of regulations. However, there were only 11 no-action letters as of FY 2006. The government made several reforms in FY 2004 and FY 2007 to encourage more active use of the system, such as expanding its coverage and enhancing the confidentiality of both the requests and the responses. To further improve the system, the government should strengthen the role of no-action letters by incorporating their use into the Administrative Procedure Act, thus making them legally binding on the issuing administrative body, while also making the letter public to create an easily accessible data base of no-action letters. Moreover, its scope should be expanded to include local government regulations. In addition, the limit on who is eligible to use the system needs to be relaxed further.

*Third*, Regulatory Impact Analysis (RIA) was introduced in 2004 on a trial basis to carry out objective assessments of the impact of regulatory measures. In 2007, RIAs were made mandatory for all regulations incorporated in laws and cabinet orders. The RIAs need to become an integral part of the regulation-making process by closely monitoring whether regulations actually reflect the outcome of the relevant RIAs, making public the results of RIAs and extending its coverage whenever possible.

1. However, a number of activities, including advisory council reports and recommendations and the development of bills that are to be considered by the Diet, are excluded.

11. Administrative regulations include reporting, application procedures and burdens on business start-ups that stem from both economy-wide and sector-specific requirements.

**Table 4. Benefits of regulatory reform**

Gains in consumer surplus in trillion yen

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Electricity | 0.2 | 0.7 | 0.1 | 0.6 | 0.0 | 0.3 | 0.1 | 0.6 | 0.2 | 1.0 | 1.8 | 5.7 |
| Trucks | 0.6 | 0.7 | -0.1 | 0.3 | 0.8 | 0.4 | 0.4 | -0.2 | -0.1 | 0.2 | 0.2 | 3.1 |
| Telecommunications | 0.3 | 0.4 | 0.6 | 0.4 | 0.3 | 0.2 | 0.3 | 0.2 | 0.1 | 0.0 | 0.0 | 2.7 |
| Petroleum products | 0.6 | 0.6 | 0.3 | 0.3 | 0.3 | -0.2 | 0.0 | 0.4 | -0.1 | -0.2 | 0.2 | 2.1 |
| Car registration and inspection system | 0.2 | 0.2 | 0.1 | 0.1 | 0.0 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.9 |
| Rice | 0.0 | 0.1 | 0.1 | 0.1 | 0.0 | 0.1 | 0.1 | 0.0 | -0.3 | 0.1 | 0.3 | 0.6 |
| Liquor sales | 0.1 | 0.1 | -0.1 | 0.1 | 0.1 | 0.1 | 0.0 | 0.2 | -0.1 | 0.0 | 0.0 | 0.6 |
| Railways | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.0 | 0.1 | 0.1 | 0.2 | 0.0 | 0.5 |
| Consignment fee for stock transactions | 0.0 | 0.0 | 0.1 | 0.0 | 0.1 | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.5 |
| Urban gas | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.0 | 0.1 | 0.0 | 0.1 | 0.1 | 0.5 |
| Damage insurance | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.1 | 0.3 |
| Cosmetics and pharmaceuticals | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 |
| Domestic airline | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | -0.1 | -0.1 | 0.0 | 0.1 |
| Taxi | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Total | 2.0 | 2.9 | 1.2 | 2.0 | 1.6 | 1.4 | 1.1 | 1.5 | -0.2 | 1.3 | 2.7 | 17.6 |

*Source:* Cabinet Office (2006).

**Table 5. The three-year Regulatory Reform Programme in 2007**

| Priority areas | Major issues |
|---|---|
| 1. Improving the horizontal regulatory framework | Improving public administration, including ministerial orders and administrative guidelines<br>Encouraging the effective use of the Regulatory Impact Analysis and No-Action Letter schemes |
| 2. Improving public services | Upgrading the operation of independent public corporations |
| 3. Education and research | Expanding choice for schools and establishing a performance evaluation system for teaching staff and schools |
| 4. Information technology, energy and transport | Reforming the governance structure of NHK and softening the principle of prohibiting concentration in the media<br>In electricity, pursuing accounting separation and encouraging transactions in the Wholesale Power Exchange<br>Liberalising international air traffic and expanding capacity in the Tokyo metropolitan area by allowing international flights at Haneda |
| 5. Housing and land | Creating highly efficient cities<br>Realising a safe and secure living environment |
| 6. Welfare, childcare and long-term care | Creating a childcare environment that responds well to the needs of families and facilitating the use of childcare leave<br>Actively implementing the law for "Supporting measures to promote the nurturing of the next generation" |
| 7. Medical | Allowing on-line applications for the receipt of medical services<br>Facilitating the use of generic medicines<br>Encouraging greater co-operation between doctors and medical assistants, such as nurses and medical technicians |
| 8. Living environment and distribution | Improving the regulation of wastes to promote recycling |
| 9. International co-operation | Improving procedures for exports and imports through ports<br>Strengthening the monitoring of foreigners after their entry in Japan |
| 10. Standardisation, law and certificates | Reforming commercial and civil laws governing interest rates<br>Strengthening the disclosure of information to increase the quality of professional service providers |
| 11. Competition policy and finance | Reviewing the firewall regulation between banking and securities<br>Reforming the framework for co-operative financial institutions |
| 12. Agriculture, fishery and forest | Reviewing the agricultural land system<br>Supporting the system of providing nutrition information in fish products<br>Improving the system for indicating the type of rice |
| 13. Revitalising regional economies | Promoting voluntary transport service by non-profit organisations<br>Supporting the location of companies in regional areas<br>Allowing outdoor advertisement to support firms in regional areas |
| 14. Labour | Reforming the regulation on dispatched workers |
| 15. Employment and hiring | Relaxing the eligibility requirement on the academic background needed to be licensed as a hairdresser<br>Reviewing raising the age ceiling for the exam to become central government officials |

*Source:* Council for the Promotion of Regulatory Reform.

*Special zones for structural reform*

18. The programme for "Special Zones for Structural Reform" began in 2002; it marked the start of a fundamentally new approach in Japan, based on local initiatives to advance nationwide regulatory reform. The special zone approach allows geographically limited areas to act as a testing ground for reforms that can be later introduced at the national level, while helping to revitalise regional economies through deregulation. All interested parties, such as local governments, private firms and citizens, are allowed to submit regulatory reform proposals, which are then reviewed by a committee of cabinet ministers chaired by the prime minister ("the Headquarters for the Promotion of Special Zones"). As of the end of 2006, 581 reform measures had been accepted, of which 211 were implemented in 963 special zones and 370 introduced on a nationwide basis (Table 6). Proposals implemented in special zones are reviewed, after one year or so, by an Evaluation Committee composed of experts from the private sector, including academia. This Committee assesses whether specific regulatory reforms should be: *i)* implemented nationwide; *ii)* continued in the special zone only; or *iii)* discontinued. Of the 83 special zone reforms considered by the Committee, 69 were expanded nationwide. An additional 51 special zone reforms were approved for nationwide use by the responsible ministry. The extension of 120 measures initially accepted for special zones to nationwide use has reduced the number of special zones to around 400.

**Table 6. The special zone initiative**

**A. Reforms proposed and implemented**

| | Total number of proposals | Total number of reforms implemented | *Of which:* those implemented in special zones | *Of which:* those implemented nationwide |
|---|---|---|---|---|
| 2002 | 426 | 204 | 93 | 111 |
| 2003 | 1 269 | 222 | 83 | 139 |
| 2004 | 642 | 80 | 18 | 62 |
| 2005 | 539 | 41 | 12 | 29 |
| 2006 | 643 | 34 | 5 | 29 |
| Total | 3 519 | 581 | 211 | 370 |

**B. Special zones by the responsible ministry (2002-2006)**

| Ministry or agency | Accepted in special zones | Accepted nationwide | Total |
|---|---|---|---|
| National Public Safety Commission | 4 | 4 | 8 |
| National Personnel Authority | 3 | 0 | 3 |
| Financial Services Agency | 2 | 11 | 13 |
| Ministry of Internal Affairs and Communications | 13 | 44 | 57 |
| Ministry of Justice | 15 | 20 | 35 |
| Ministry of Foreign Affairs | 2 | 10 | 12 |
| Ministry of Finance | 7 | 19 | 26 |
| Ministry of Education, Culture, Sports, Science and Technology | 36 | 36 | 72 |
| Ministry of Health, Labour and Welfare | 35 | 92 | 127 |
| Ministry of Agriculture, Forestry and Fisheries | 10 | 20 | 30 |
| Ministry of Economy, Trade and Industry | 54 | 48 | 102 |
| Ministry of Land, Infrastructure and Transport | 20 | 56 | 76 |
| Ministry of the Environment | 9 | 8 | 17 |
| Cabinet Office | 1 | 1 | 2 |
| Ministry of Defence | 0 | 1 | 1 |
| Total | 211 | 370 | 581 |

*Source:* Office for the Promotion of Special Zones for Structural Reform.

19. The special zones are intended to play a strong role in reforming key industries, such as healthcare and education as well as distribution, research and development and agriculture, where the progress in implementing regulatory reforms is slowed by special interests. Indeed, most special zones are related to areas covered by the Ministry of Health, Labour and Welfare, reflecting a growing demand for higher quality social services, followed by METI and the Ministry of Land, Infrastructure and Transport (Table 6, Panel B). In 2007, the special zone initiative was extended through 2012, with new incentives added to encourage local governments to participate more actively. For example, local governments will retain exclusive use of the special zone reforms for a longer time period before they are extended nationwide.

20. The success of this programme depends on the creativity and knowledge of local authorities and private entities in identifying and removing obstacles to growth and circumventing vested interests that have blocked reforms at the national level. Despite the government's continued commitment to developing special zones, momentum is slowing; the number of proposals fell from 1 269 in 2003 to 643 in 2006, while the number of reform proposals accepted declined from 222 to 34 over the same period. To some extent, the decrease was inevitable as easier reforms were implemented first. However, it is also due to diminishing interest by local governments and private participants. One reason is that reforms may not go far enough to make them attractive. For example, although the management of hospitals by for-profit corporations was allowed in the special zones in 2004, only one for-profit hospital has been opened thus far, partly due to remaining regulations, such as the rule limiting their services to non-insured treatments.

21. Perhaps a more important drawback from the perspective of local governments is the focus of the special zone plan on nationwide reform. Not surprisingly, local governments prefer that reforms be limited to special zones for an extended period of time, as expanding the coverage of the measures nationwide diminishes their impact on the local economy. The recent decision to allow local governments to retain special measures for a longer period of time is intended to encourage them to submit more special zone proposals. However, if the fundamental goal is to advance nationwide regulatory reform, measures accepted in special zones should be implemented nationwide as quickly as possible. To accomplish that goal, a maximum time period for reforms in special zones should be set in order to limit any distortions stemming from the uneven application of regulations across the country. In sum, the special zone initiative should place more emphasis on improving the nationwide regulatory framework rather than on promoting regional development. This orientation would be facilitated by changing the organisational structure, under which the same chief secretary is responsible for both the special zones and regional development policies. Moreover, organisational links between the special zone initiative and the Regulatory Reform Programme should be strengthened. Finally, it is important that the establishment and evaluation of special zones be carried out in a transparent manner.

***Upgrading competition policy***

22. In recent years, the Japanese Fair Trade Commission (JFTC) has increased its efforts to combat anti-competitive practices that stem in part from the legacy of government guidance of investment and industry-wide co-ordination that was permitted by numerous exemptions from the Antimonopoly Act (AMA). The JFTC's role was further enhanced by the 2005 revision of the AMA, which strengthened its enforcement power and increased the penalties for anticompetitive activities.[12] *First*, the surcharge rate on large manufacturing enterprises was increased from 6% to 10% of firms' sales of the affected product for up to three years for violations such as price fixing and output restrictions.[13] The surcharge rate for large

12. Under the current system, the JFTC can impose administrative measures, such as a cease and desist order and/or a surcharge payment order, and pursue criminal accusations against serious violations.

13. The surcharge rate can be boosted to 15% for frequent offenders or reduced to 8% for firms that end violations one month before the start of an investigation.

enterprises in retail and wholesale industries also increased from 2% to 3% and from 1% to 2%, respectively. *Second*, the JFTC was granted stronger criminal investigative power -- compulsory search and seizure based on a warrant issued by a judge -- which should improve its capacity to investigate cases that may call for criminal penalties. Previously, search and seizure to obtain evidence was only possible with the consent of the firm being investigated or by referring the case to the prosecutor. *Third*, a leniency programme was introduced in 2006. For firms confessing before the start of a JFTC investigation, it provides 100% immunity from surcharges for the first applicant in addition to immunity from criminal accusation, a 50% reduction for the second applicant, and 30% for the third applicant. Once the investigation is launched, a 30% reduction is granted. In both cases, the maximum number of firms eligible for leniency is three. Since the introduction of the leniency programme, there have been 105 applicants as of the end of FY 2006, primarily in cases of cartels and bid-rigging in the construction industry. *Fourth*, the "recommendation system" was abolished to facilitate administrative measures. In proceedings for cease and desist orders, respondents are now provided an opportunity to be heard before the introduction of administrative measures. Finally, the 2005 revision of the AMA required the government to examine the surcharge system and the procedure for cease and desist orders and take measures to improve them within two years.

23. The revision of the AMA resulted in stronger actions against violations of the competition law (Table 7). The total amount of surcharges jumped from 3.9 billion yen in FY 2003 to 18.9 billion yen in FY 2005, despite a slight decline in the number of cases to 20 (Panel C). The JFTC has been engaged in a strong effort against bid-rigging, which accounted for six of 13 legal measures in FY 2006. In addition, four criminal cases have been filed by the JFTC since the 2005 revision, compared to just one between FY 2000 and FY 2004. The increased enforcement activity partly reflects the enhanced resources available for enforcing competition policy. Indeed, the JFTC's budget grew 6.6% between FY 2004 and FY 2006 in a context of falling government spending in nominal terms, while the number of staff increased from 672 to 737, reflecting a commitment to strengthen competition policy.

24. However, there is still a need to strengthen the legal framework and enforcement of competition policy in Japan. Indeed, Japan ranked only 21st in terms of both the legal framework and enforcement in 2003 according to the OECD indicator (Hoj, 2007). In particular, legal measures by the JFTC in response to M&As have been rare, with only one merger formally rejected in more than 35 years. Moreover, the JFTC has taken no legal actions regarding M&As since 2000, even though nearly 100 mergers per year were reported to the JFTC during the period 2003-05.[14]

25. A number of measures are needed to strengthen the legal framework and enforcement of competition policy. *First*, the deterrent effect of surcharges and criminal penalties is still inadequate and they need to be raised further. According to estimates by the JFTC, the average rate of illegal profits from cartels was 16.5% of sales and, in 90% of the cases, it was 8% or more.[15] International comparisons also suggest that the surcharge rate in Japan is still low.[16] Furthermore, limiting the maximum period of

14. The small number of legal actions reflects the use of prior consultations by prospective merging companies with the JFTC on their merger plans before the statutory notification. For example, there were two cases of prior consultation in 2005 in which the JFTC pointed out that the proposed merger would have been harmful to competition, leading to the withdrawal of the merger plans.

15. See JFTC (2004). The study was based on the cartel cases it handled between 1992 and 2003 and bid-rigging cases between 1996 and 2003.

16. In most OECD countries, including the United Kingdom, Germany, France, Sweden, Austria and Spain, financial sanctions can be as high as 10% of total firm turnover, not just of the commerce affected, and there is no time limit in applying the sanctions, except in a few countries, such as the United Kingdom. Moreover, financial sanctions can be up to two times the gain in the United States and up to three times the gain in New Zealand.

turnover used in calculating surcharges to three years significantly restricts the deterrent effect. Instead, surcharges should be applied to sales during the full period during which violations occurred. In addition, criminal penalties should be increased and applied more frequently in order to strengthen the deterrent effect. Indeed, there has been no case in which a representative of a firm guilty of violating the AMA was subject to criminal punishment.[17] The highest possible fine, 500 million yen ($5 million), is substantially lower than fines imposed in many other major jurisdictions (OECD, 2004b). Unfair trade practices are subject to only cease and desist orders.[18] Given the prevalence of unfair trade practices in the retail sector, the JFTC issued orders to prohibit certain practices by large-scale retailers (see below). In addition, "private monopoly of exclusionary type"[19] is also subject to only cease and desist orders. The JFTC has proposed that this practice should be subject to surcharges. Strengthened sanctions would also make the leniency programme an even more effective tool. At the same time, increasing the number of firms allowed to benefit from the leniency programmes from the current number of three per violation of the AMA may facilitate its use.

26. *Second*, reducing explicit exemptions from the AMA that are aimed at achieving other policy goals is a prerequisite for the active enforcement of competition policy. Although the number of exemptions has been reduced from 89 in 1996 to 21, the exemptions cover a wide range of areas such as insurance, the liquor business, hair cutting, agricultural co-operatives, air transport (international and domestic) and maritime transport. These exemptions are contained in 15 laws, including the AMA. For example, SMEs in personal services such as hair cutting benefit from an exemption that permits agreements to prevent "excess competition" and similar agreements are allowed in the liquor business. In particular, the lower sanctions imposed on SMEs for anti-competitive behaviour should be lifted unless there is a clear rationale. For example, SMEs are subject to less than half of the surcharge rate imposed on large firms.[20] In addition, the AMA explicitly allows SMEs to form cartels aimed at providing mutual aid for their members. Consequently, measures to enforce the competition law against SME co-operatives have been very rare. Although co-ordination among smaller firms could in theory improve efficiency, such exemptions may reduce competitive pressures.

27. *Third*, the role of trade associations should be limited to norm setting, information sharing and provision of administrative information. Japan has a large number of such associations.[21] When the activities of the trade associations interfere with the operation of firms, there is a risk that they will curb competitive forces. For example, the Japanese Habour Transport Association significantly influences the business operations of firms in this sector (see below).

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17. Between 1990 and 2004, there were only seven criminal cases. While six resulted in fines, prison sentences were always suspended. As a result, no one has ever gone to jail in Japan for violating the AMA (OECD, 2004b).

18. Unfair trade practices accounted for 17.3% of violations of the AMA subject to legal measures between 2000 and 2006, the second highest share after bid-rigging at 69.2%.

19. "Private monopoly of exclusionary type" is an attempt to exclude competitors from the market individually or in collaboration with other firms through unfairly low and discriminatory prices or to monopolise the market by obstructing business activities of new entrants.

20. The surcharge rate for SMEs is 4% in manufacturing, 1.2% in retail and 1% in wholesale compared to 10%, 3% and 2%, respectively, for large firms. The government's rationale for lower rates is that margins are usually smaller for SMEs.

21. At the national level, there are about 3 100 trade associations, compared to around 2 100 in the United States (2004 *OECD Economic Survey of Japan*).

**Table 7. JFTC enforcement activity**

| Fiscal year | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|
| A. Cases resolved | 71 | 79 | 103 | 114 | 104 | 75 | 98 |
| Legal measures | 18 | 38 | 37 | 25 | 35 | 19 | 13 |
| Recommendations or cease and desist orders | 18 | 37 | 37 | 25 | 35 | 19 | 12 |
| Surcharge payment orders[1] | 0 | 1 | 0 | 0 | 0 | 0 | 1 |
| Others | 53 | 41 | 66 | 88 | 69 | 54 | 83 |
| Warnings | 17 | 15 | 17 | 13 | 9 | 7 | 9 |
| Cautions | 36 | 26 | 49 | 75 | 60 | 47 | 74 |
| Criminal accusations | 0 | 0 | 0 | 1 | 0 | 2 | 2 |
| B. Cases in which legal measures were taken | 18 | 38 | 37 | 25 | 35 | 19 | 13 |
| Private monopolisation | 0 | 0 | 0 | 1 | 2 | 0 | 0 |
| Cartels | 12 | 36 | 33 | 17 | 24 | 17 | 9 |
| Price cartels | 1 | 3 | 2 | 3 | 2 | 4 | 3 |
| Bid-rigging | 10 | 33 | 30 | 14 | 22 | 13 | 6 |
| Other types of cartels | 1 | 0 | 1 | 0 | 0 | 0 | 0 |
| Unfair trading practices[2] | 6 | 2 | 3 | 7 | 8 | 2 | 4 |
| Others | 0 | 0 | 1 | 0 | 1 | 0 | 0 |
| C. Surcharge payment orders | | | | | | | |
| Number of cases | 16 | 15 | 37 | 24 | 26 | 20 | 13 |
| Surcharge amount (billion yen) | 8.5 | 2.2 | 4.3 | 3.9 | 11.2 | 18.9 | 9.3 |
| D. Cases newly initiated | 69 | 90 | 111 | 121 | 101 | 88 | 141 |
| E. Hearings initiated | 8 | 44 | 30 | 77 | 27 | 19 | 16 |

1. Cases in which surcharge payment orders were given without a recommendation or cease and desist order.
2. Includes mainly resale price restrictions, other restrictive exclusionary dealings and abuse of dominant bargaining power.

*Source*: Japan Fair Trade Commission.

28. *Fourth*, it is important to ensure the neutrality and independence of hearing procedures for firms appealing cease and desist orders or surcharge payment orders. Such hearings are presided by the JFTC commissioners or by independent hearing examiners.[22] Relying more on hearing examiners would help ensure fairness and build confidence in the JFTC. In this regard, the JFTC should look to the private sector to recruit more hearing examiners with necessary expertise and experience. Moreover, the full hearing process, which can take two years or more, needs to be resolved more quickly, especially for time sensitive matters.

***Strengthening international competition***

29. The globalisation of services has been driven by technological advances such as the development of broadband networks and the growing scope for digitalisation, supported by regulatory reform and trade liberalisation. Indeed, the proportion of jobs in the service sector that can be outsourced was estimated to be as high as 20% in OECD countries in 2003 (OECD, 2005a). However, competitive pressure from international trade and FDI in the service sector is surprisingly weak in Japan. Its trade in services remains under-developed compared to other OECD countries; Japan had the lowest import penetration rate for services in 2003 (Figure 6)[23] and the lowest growth rate of service imports between 1997 and 2005. Consequently, trade in services as a share of GDP is relatively low in Japan (Panel B). Regarding inward FDI, the share of foreign affiliates in total service turnover in Japan was also the lowest among countries surveyed (Panel C), reflecting a low level of FDI in services. In wholesale and retail trade, an area of low productivity growth in Japan, the share of turnover of foreign affiliates in Japan was the lowest in the OECD area (see below). Moreover, the share of service turnover in the total turnover of foreign affiliates is the lowest in the OECD at 40% (Panel D). In most OECD countries, in contrast, services account for more than half of the total turnover of foreign affiliates. As a result, the turnover generated by Japan's outward investment in the service sector was nine times higher than that from its inward investment, the largest difference in the OECD area (OECD, 2005b).

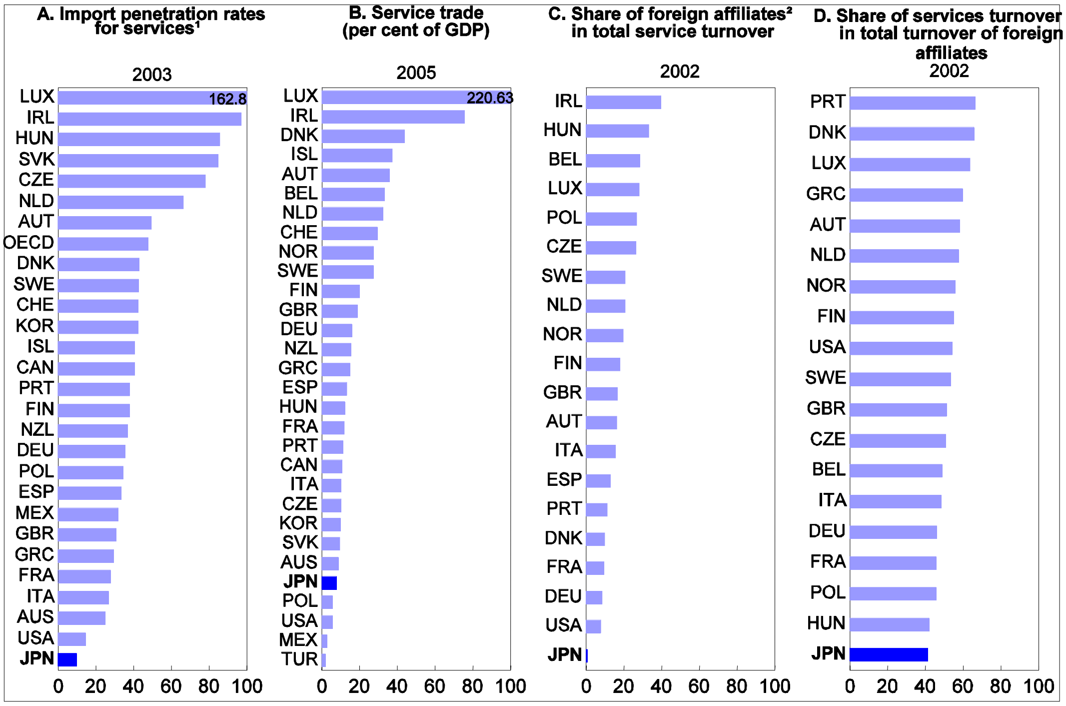
30. Given the low presence of foreign affiliates in services, the scope for increasing FDI in Japan's service sector appears large. The limited number of foreign affiliates in Japan's service sector have reported a stronger performance than domestic firms: their labour productivity was 1.8 times higher than the national average during the period 1997 to 2000 (Figure 7),[24] and they accounted for a third of total productivity growth between 1995 and 2001 (Panel B). However, the absolute size of the contribution was small, reflecting the limited role of foreign affiliates. Increasing the presence of foreign affiliates to a level in line with the OECD average would thus have a significant impact on overall productivity, given the large gap in productivity between domestic and foreign-affiliated firms.

22. Most hearings are entrusted to a hearing examiner in the General Secretariat. The number of hearing examiners increased from five to seven in 2006, four of whom are lawyers. As of December 2005, the JFTC had 138 pending hearing procedures that concerned alleged violations of the AMA (29), surcharge payment orders (103) and allegations of violations of the Premiums and Representations Act (6).

23. The low figure for Japan is partly due to the large size of the Japanese economy, given the inverse relationship between import penetration and the size of an economy. Nevertheless, the import penetration figure for Japan is exceptionally low, even after controlling for the size of the economy.

24. The higher productivity of foreign affiliates may reflect the fact that they tend to concentrate in business lines with higher productivity. However, FDI in services in Japan is rather evenly distributed across the entire sector. At the end of 2001, finance and insurance accounted for 20% of the 13.2 trillion yen of FDI accumulated in the service sector, followed by retail and wholesale trade (15%), business services (11%) and communications (9%). The even distribution between sectors suggests that the higher average productivity of foreign affiliates cannot be attributed to concentration in just a few sectors.

**Figure 6. International competition in the service sector**

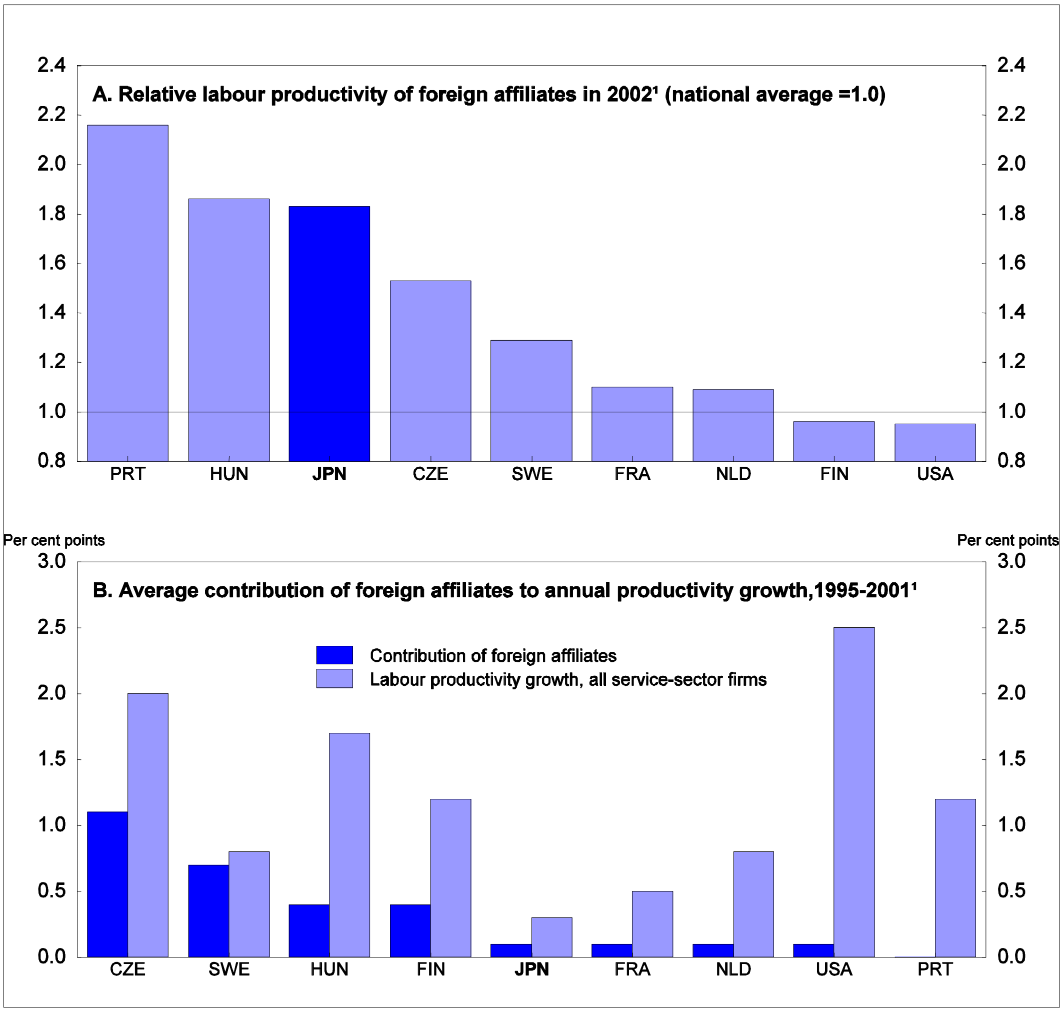



1. As a per cent of domestic demand.
2. Majority-owned affiliates under foreign control.

*Source*: OECD (2005b), *Economic Globalisation Indicators,* OECD, Paris, and Service Trade Database, 2007.

31. The low penetration of foreign affiliates reflects explicit FDI restrictions and product market regulations. Explicit restrictions are higher than the OECD average in telecoms (due to regulations on fixed lines) and transport (due to regulations on air travel), according to the OECD's indicator of FDI regulatory restrictiveness (Golub and Koyama, 2006). According to another index measuring the degree of protection from inward FDI in the service sector, Japan was found to be the most protective among OECD countries (Francois *et al*., 2007). As for product market regulations, they tend to have a larger negative impact on foreign players, who are not familiar with the regulatory environment in Japan. Given the small presence of foreign affiliates in the service sector and the large potential contribution to labour productivity, Japan should further open up its services market to global competition through trade liberalisation, including unilateral measures and both multilateral and bilateral agreements, and encourage FDI in the service sector by lifting explicit restrictions and relaxing product market regulations. It is important that trade liberalisation in services and regulatory reform go hand in hand. Trade liberalisation alone could increase international market concentration, while lowering entry barriers through regulatory reform would tend to reduce such concentration. In trade agreements, harmonisation or mutual recognition of licences, standards and qualification requirements would substantially enhance market integration by significantly reducing trade costs. Indeed, trade costs as a percentage of delivered service prices in Japan were estimated at 14.4%, one of the highest in the OECD area (Francois *et al*., 2007). Moreover, a country's rating on the indicator "communication and simplification of rules and procedures" was found to have a significant impact on trade. Countries with a poor rating on this index had reduced exports and imports of services, as well as low levels of inward FDI in services and outward FDI in business services. Therefore, enforceable horizontal rules on transparency are likely to help stimulate trade and FDI in services (OECD, 2007a).

**Figure 7. Contribution of foreign affiliates in the service sector in OECD countries**




1. See the source for exact years.

*Source*: OECD (2005b), *Economic Globalisation Indicators*, OECD, Paris.

## Selected issues at the sectoral level

32. This section focuses on specific regulatory issues in major service industries that are characterised by either low productivity or high growth potential. Retail and transport are industries with low productivity while public services and business services are increasingly important in the context of population ageing and globalisation.

### *Retail distribution*

33. Labour productivity growth in the retail sector in Japan has been one of the lowest in the OECD since 1990 due to a lack of competition stemming from regulations, especially on large stores, weak application of the competition law and the prevalence of unfair trade practices, notably vertical restraints.[25]

25. In response to the prevalence of unfair trade practices in retailing, the JFTC issued "Designation of Specific Unfair Trade Practices by Large-scale Retailers Relating to Trade with Suppliers" in 2005. It prohibits large-scale retailers from returning goods without justification, unduly imposing *ex post* price

The retail sector is characterised by an exceptionally large number of small stores and a corresponding lack of large stores. Indeed, Japan had 100 stores per 10 000 inhabitants compared to 43 in the United Kingdom and an average of 73 in the European Union (Table 8). Food supermarkets averaged 832 $m^2$ in area in 1999, roughly a fifth the size of the typical supermarket in the United States (Flath, 2002). In other OECD countries with more than 100 stores per 10 000 inhabitants, the average number of employees per store was about half that in Japan, suggesting a low level of labour productivity in Japan. The large number of small stores in Japan is partially explained by a relatively low rate of car ownership in the past and small houses, which favour shopping in local stores despite higher prices. However, it also reflects the legacy of the "Large-scale Retail Store Law", which strictly controlled the establishment of stores in an effort to balance supply and demand.[26] In practice, this law gave considerable power to existing retailers in setting the conditions under which large stores could be opened.

**Table 8. Key structural features of the retail distribution sector**

2002-03

| Country | Outlet density[1] | Employees per store |
|---|---|---|
| Austria | 52 | 7.5 |
| Belgium | 74 | 4.0 |
| Czech Republic | 137 | 3.0 |
| Denmark | 45 | 8.4 |
| Finland | 44 | 5.7 |
| France | 70 | 4.1 |
| Germany | 30 | 9.9 |
| Hungary | 114 | 3.0 |
| Ireland | 47 | 8.7 |
| Italy | 124 | 2.5 |
| Luxembourg | 60 | 6.6 |
| Netherlands | 49 | 8.9 |
| Norway | 65 | 6.3 |
| Poland | 113 | 3.0 |
| Portugal | 138 | 2.6 |
| Slovak Republic | 9 | 15.0 |
| Spain | 125 | 3.1 |
| Sweden | 64 | 4.5 |
| United Kingdom | 43 | 15.4 |
| European Union | 73 | 4.4 |
| **Japan** | **100** | **6.1** |

1. Number of stores per 10 000 inhabitants.

*Source:* Ministry of Economics, Trade and Industry, *Census of Commerce* and OECD (2007b).

34. The Large-scale Retail Store Law was replaced in 2000 by the "Large-scale Retail Store Location Law" (LSRSL), which is aimed at protecting the local living environment. Consequently, it shifts the responsibility for regulating large stores from the central government to the municipalities, while expanding the coverage of the law by lowering the threshold to stores of more than 1 000 $m^2$. In addition, the objective of balancing supply and demand was eliminated. Under the new law, a firm that wishes to open a large store begins by notifying the local government and holding a public hearing to explain its

reductions, assigning work tasks to employees of suppliers and requiring suppliers to provide economic benefits.

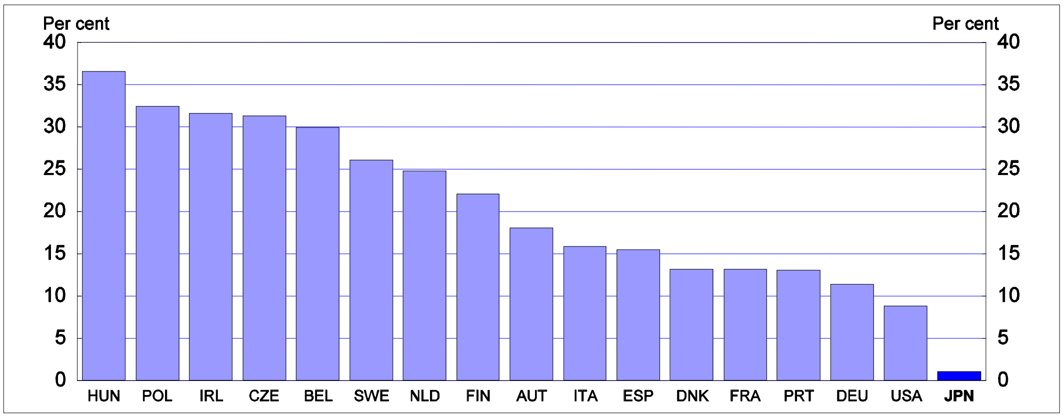
26. The law applied to two types of stores. Type I was stores larger than 3 000 $m^2$ (6 000 $m^2$ in large cities), which had to apply to the Ministry of International Trade and Industry. Type II was stores between 500 $m^2$ and 3 000 $m^2$, which applied to local governments.

plans. The local government reviews the plan and considers the comments of local residents and interest groups from the viewpoint of whether the new store would have an adverse effect on the local living environment. The process usually lasts about four to eight months if the local government is satisfied with the plan. Otherwise, it makes a "presentation of views"[27] and the company proposing the new store is required to submit a "voluntary co-ordination plan" taking into account those views. Since the law came into effect, there have been about 4 000 filings, with a "presentation of views" by the local government in 448 cases. In this situation, the process can take up to one year and the firms must delay construction until they have complied with the views of the local government. If the local government finds that its views are not fully reflected in the co-ordination plan submitted by the firm, it publicly issues "recommendations" to pressure the firm to conform to the local government's wishes. However, this has occurred only once so far. The fact that there has been only one case of public "recommendations" out of 4 000 filings suggests that it is practically impossible to open a store without fully complying with the views of local governments.

35. A key concern is the uncertainty and opacity of the procedure for opening large stores. The requirement to protect the local living environment is a vague and subjective standard for judging applications, which *de facto* relies on the discretionary decisions of local governments. Large store applicants thus still face a high degree of uncertainty. For example, some local authorities have imposed vague and subjective conditions, notably on the issue of parking space and traffic noise, which differ from the minimum requirements set by the central government.[28] Such uncertainty puts foreign retailers in a disadvantageous position relative to domestic firms, as they are new to the market and have less experience and fewer contacts at the local level. This helps to explain the 1% share of foreign affiliates in total turnover in wholesale and retail trade, an extremely low level compared to other OECD countries (Figure 8).

**Figure 8. Turnover of foreign affiliates as a share of wholesale and retail trade**

ISIC 50 to 52 in 2002¹




1. 2001 for Austria, Finland, France, Germany, Italy, Japan, the Netherlands and Portugal; 2000 for Sweden and 1999 for Denmark.

*Source*: OECD (2005b), *Economic Globalisation Indicators*, OECD, Paris.

27. Issues related to traffic congestion and securing sufficient parking space accounted for two-thirds of the comments from local governments, followed by noise and waste issues.

28. Local governments' "presentation of views" have included vague conditions such as: *i)* "The store opener must show evidence that the parking lot can accommodate the cars of customers to the store and should take additional measures if it cannot provide such evidence"; and *ii)* "As some parking lots are far from the store, some traffic congestion and accidents are expected. Therefore, the store opener must reconsider the location of those parking lots to avoid such problems."

36. Another concern is regulations on construction, such as the building permit system and environmental impact assessments in major cities, which overlap with the LSRSL in controlling the establishment of large stores. The lack of co-ordination and the overlap among these regulations further complicates the application procedure for opening large stores. For example, the objective of environmental impact assessments is to "maintain the local living environment", the same objective as the LSRSL. Furthermore, in 2006, the City Planning Law was revised to introduce stricter zoning regulations on facilities larger than 10 000 $m^2$, including stores, in order to limit suburbanisation and revitalise central urban areas. Under the revised law, developers of large facilities must go through several procedures that involve the local authorities, shops and residents in the initial planning process. The strengthened City Planning Law thus has the potential to act as an entry barrier to large-scale stores, distorting competition and offering considerable advantages and rents to established retailers.

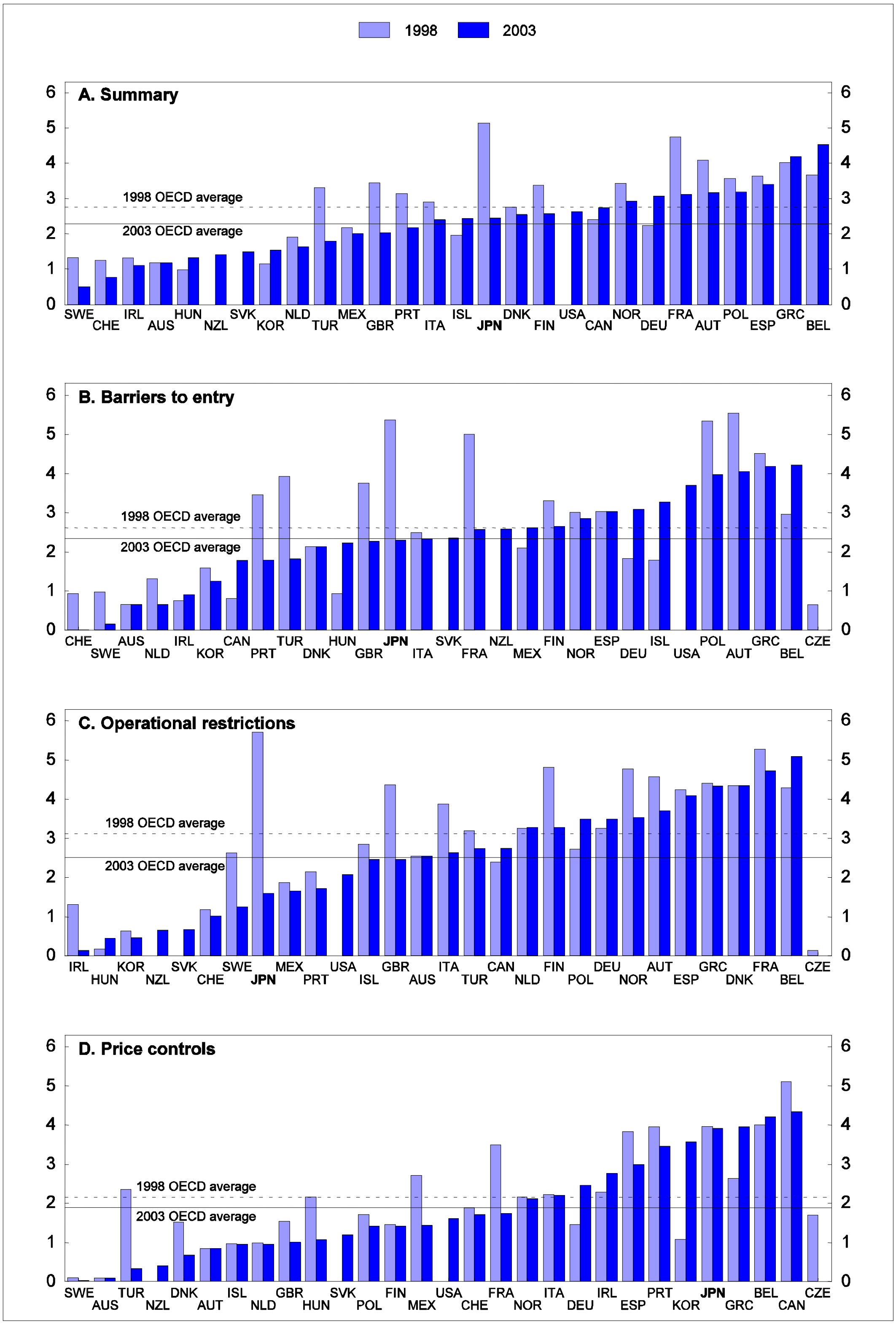
37. The regulations on large stores appear to have become more binding in recent years, as the proportion of sales by department stores and general merchandise stores subject to the LSRSL (or its predecessor) fell from 21% of total sales in 1997 to 16% in 2004. Moreover, their share of the total number of shops also declined from 13.1% to 11.7% over the same period, although this partly reflects the popularity of convenience stores in recent years. The small number of large-scale outlets has been identified as a key factor behind the low level of productivity in the retail sector (Aoki *et al*., 2000). Research shows that regulations to protect small shops from competition from large-scale outlets tend to increase incumbents' market power and price margins, pushing up retail prices. At the same time, such regulations fail to maintain employment, while discouraging investment and modernisation (Bertrand and Kramarz, 2002 and McGuckin *et al*., 2005). According to another study, easing restrictions on outlet size, opening hours and product selection increases both overall sales and employment (Nicolletti and Scarpetta, 2003). The OECD's product market regulatory indicators in retail distribution show that the degree of restrictiveness in Japan fell significantly from 1998, when it was the highest among member countries, to the OECD average in 2003, reflecting the repeal of the "Large-scale Retail Store Law" (Figure 9). However, Japan still lags behind the top performers, leaving scope for further liberalisation, particularly in the sub-category of "price control". Moreover, the lack of transparency concerning the application of the LSRSL and the subjective nature of the criteria used by local governments in the review process are not fully reflected in the product market indicator, which therefore does not fully capture the actual degree of restrictiveness. Improving productivity of the retail sector requires a relaxation of large-store regulation, more transparency in its application and strong enforcement of the competition law by the JFTC.

***The energy sector: electricity and gas***

38. Electricity is generated primarily by ten private "General Electricity Utilities" (GEUs) that have integrated generation, transmission, distribution and retail supply and enjoy near monopoly status within their respective regions.[29] The generation of electricity by the GEUs is supplemented by two wholesale electricity utilities and numerous in-house power producers, such as steel makers and chemical companies. The high electricity price in Japan relative to other OECD countries at the end of the last decade (Figure 10) was a major impetus driving deregulation to strengthen competitive pressures.

29. The GEUs establish the tariffs as well as supply terms and conditions for the captive consumers, although any price increases are subject to authorisation by METI and price cuts require only notification.

**Figure 9. OECD indicators of regulation in retail distribution[1]**




1. The indicators range from 0 (least restrictive) to 6 (most restrictive). OECD is simple average.

*Source*: Conway *et al.* (2006a).

39. The 2000 revision of the Electricity Utilities Law allowed free supplier choice for large customers using more than 2 000 kW, resulting in the liberalisation of a quarter of the retail market. The threshold was further cut to 500 kW in 2004 and 50 kW in 2005, increasing consumer choice to 63% of the retail market. Prices in the liberalised market can be freely negotiated between consumers and suppliers. A proposal for full liberalisation, covering all customers including households, is now under consideration. The 2000 reform also allows new entrants – "Power Producers & Suppliers" (PPS) – in the liberalised sector following notification of METI. Third-party access (TPA) to transmission networks was opened to all suppliers, with the tariffs set by the owners of the transmission network in accordance with the ministerial ordinance of METI. In addition, the "pancaking" system[30] was abolished in 2005 to promote inter-regional sales of electricity. A neutral organisation, the Electric Power System Council of Japan (ESCJ), which includes incumbent market players and new entrants, was established to handle electricity transmission and distribution issues. Moreover, the Wholesale Power Exchange for trading excess electricity was established in 2005, thus reducing the reliance of new entrants on bilateral contracts for supply. Finally, one of the two wholesale electric utilities was privatised in 2003.

40. Reform in the electricity market has been significant. Japan's regulation index in this sector fell by 72% between 1995 and 2005 (Figure 11, Panel A), while the OECD measure (Panel B) also showed improvement. The impact of liberalisation was significant, reducing the price of electricity by 16% in the industrial sector and 11% in the household sector between 1999 and 2005, in contrast to rising prices in other major countries (Figure 10).[31] As noted above (Table 4), electricity showed the largest increase in consumer surplus of any sector in Japan, with a gain of 5.7 trillion yen between 1995 and 2005.

41. While liberalisation has narrowed the gap with other OECD countries, the electricity price (excluding taxes) in Japan was the fourth highest for both the industrial and household sectors in 2006 (Figure 12). High electricity prices in Japan are partially a result of the capital costs for generation and the costs of transmission, distribution and fuel, particularly for natural gas. In addition, electricity prices are boosted by high land costs, the remote location of nuclear power stations,[32] Japan's mountainous terrain, high technical standards for equipment and strict safety regulations on construction and maintenance to withstand earthquakes and typhoons.

42. While special factors partially explain high electricity prices, additional reform is needed to reduce prices toward the OECD average. The OECD's indicator of product market regulation ranked Japan below the OECD average in 1995 and above it in 2003, suggesting that the pace of liberalisation in Japan has lagged behind that in other member countries (Figure 11, Panel B). The key problem is weak competition, which makes it difficult for new entrants to gain market share. Indeed, the share of new entrants (the PPS) in the liberalised sector was only 2% in 2006.[33] Weak competition reflects a high degree of vertical integration,[34] resulting in high costs to use the network for new entrants, in addition to the

30. Under the "pancaking" system, power suppliers were obliged to pay tariffs to all network owners on the way from its power plant to the final consumer.

31. Stronger competition also narrowed the price differences between GEUs. The maximum difference among GEUs shank from 3.55 yen kWh to 1.41 yen kWh between FY 1994 and FY 2005.

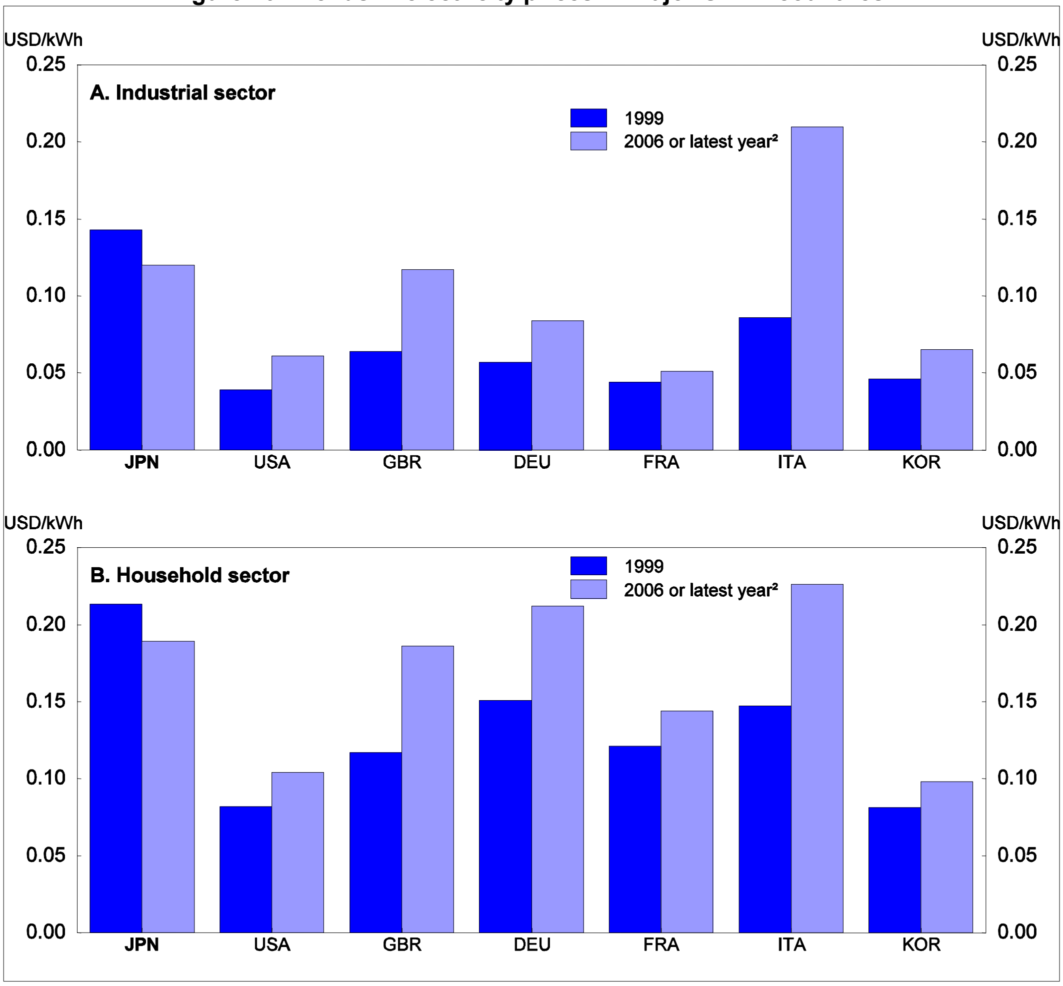
32. Nuclear power plants in Japan are usually located in remote areas due to lower land prices, as well as public concern to building them near urban areas, given the risk of nuclear accidents, thus adding to transmission costs (Beder, 2005).

33. Some customers avoid PPS because of concern about their ability to provide a reliable supply, given that they lack backup capacity in case of emergencies.

34. The OECD indicator of vertical integration in the electricity sector in 2003 was 6.0, the most restrictive score possible, compared to the OECD average of 2.0.

burden associated with strict "balancing requirements".[35] Indeed, Japan has the worst score among OECD countries according to the OECD's indicator of network policies, which measures legal restrictions on entry, the degree of vertical integration and the independence of sectoral regulators (Figure 13). To facilitate competition in the electricity market, unbundling is crucial to prevent vertically-integrated incumbents from impeding the functioning of the market through cross-subsidisation and discrimination in network access (Gönenç *et al*., 2001). Accounting separation and information firewalls were introduced in 2003 in Japan and enforced from 2005. However, numerous studies argue that management and accounting unbundling is not sufficient and that legal separation is necessary (Newbery, 2002a and 2002b and Pollitt, 2007). If market liberalisation is to be extended to smaller consumers, unbundling of the retailing and distribution activities of the GEUs will become a more urgent issue. Meanwhile, it is essential to ensure the independence of the ESCJ, which sets the rules for transmission network access and arbitration, from dominant market participants, interest groups and the government. It is important that large market incumbents do not have more power within the ESCJ than new entrants.

**Figure 10. Trends in electricity prices in major OECD countries[1]**

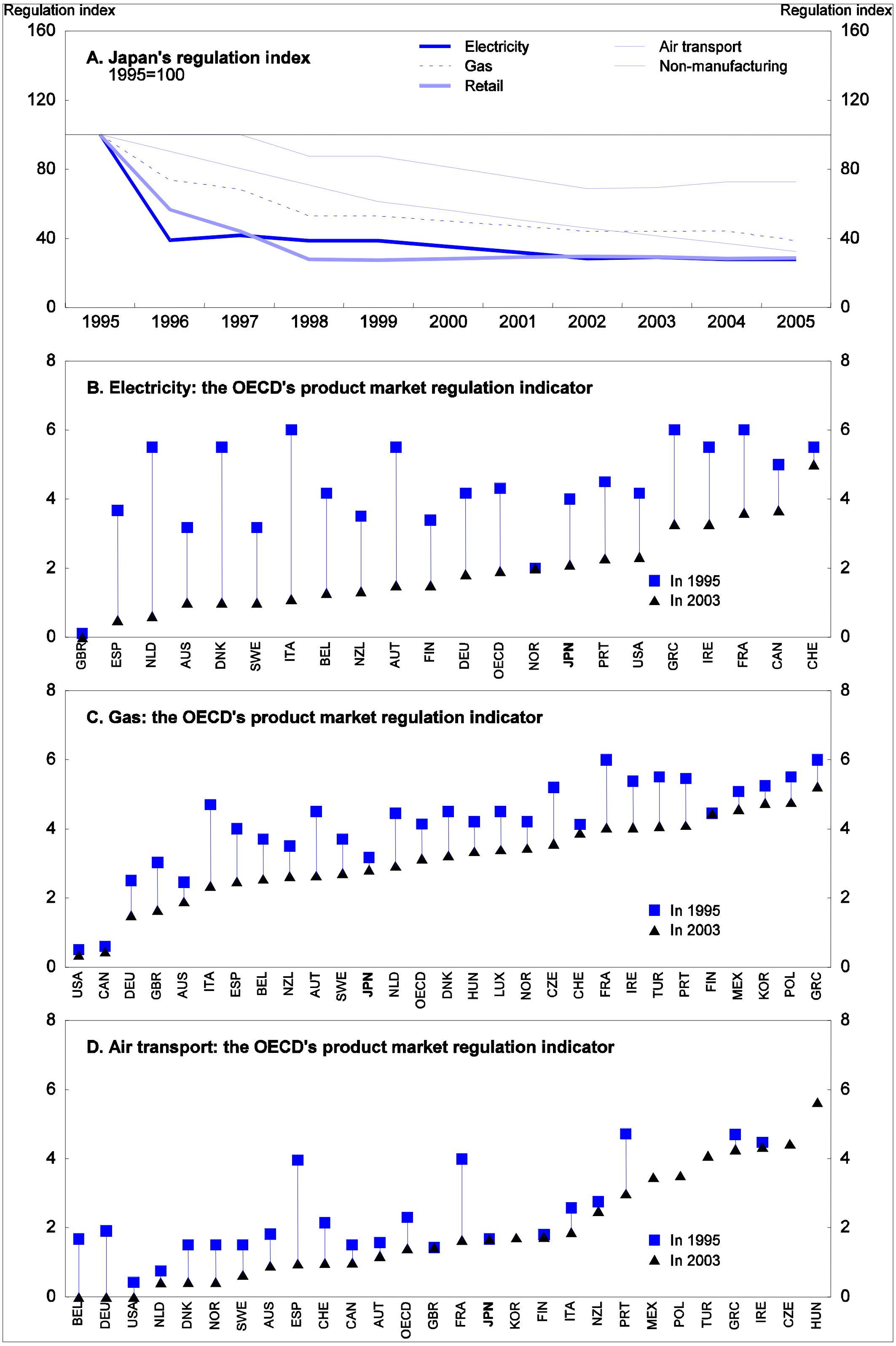



1. Including taxes, except for the United States.
2. 2005 for Japan and Germany.

*Source*: OECD/IEA, *Energy Prices and Taxes*, 1Q2007, OECD, Paris.

35. The PPS are required to maintain balance between demand and supply in every 30-minute period to ensure reliable supply. Any shortage of supply above 3% by the PPS is filled by large incumbents (GEUs), at a higher fee.

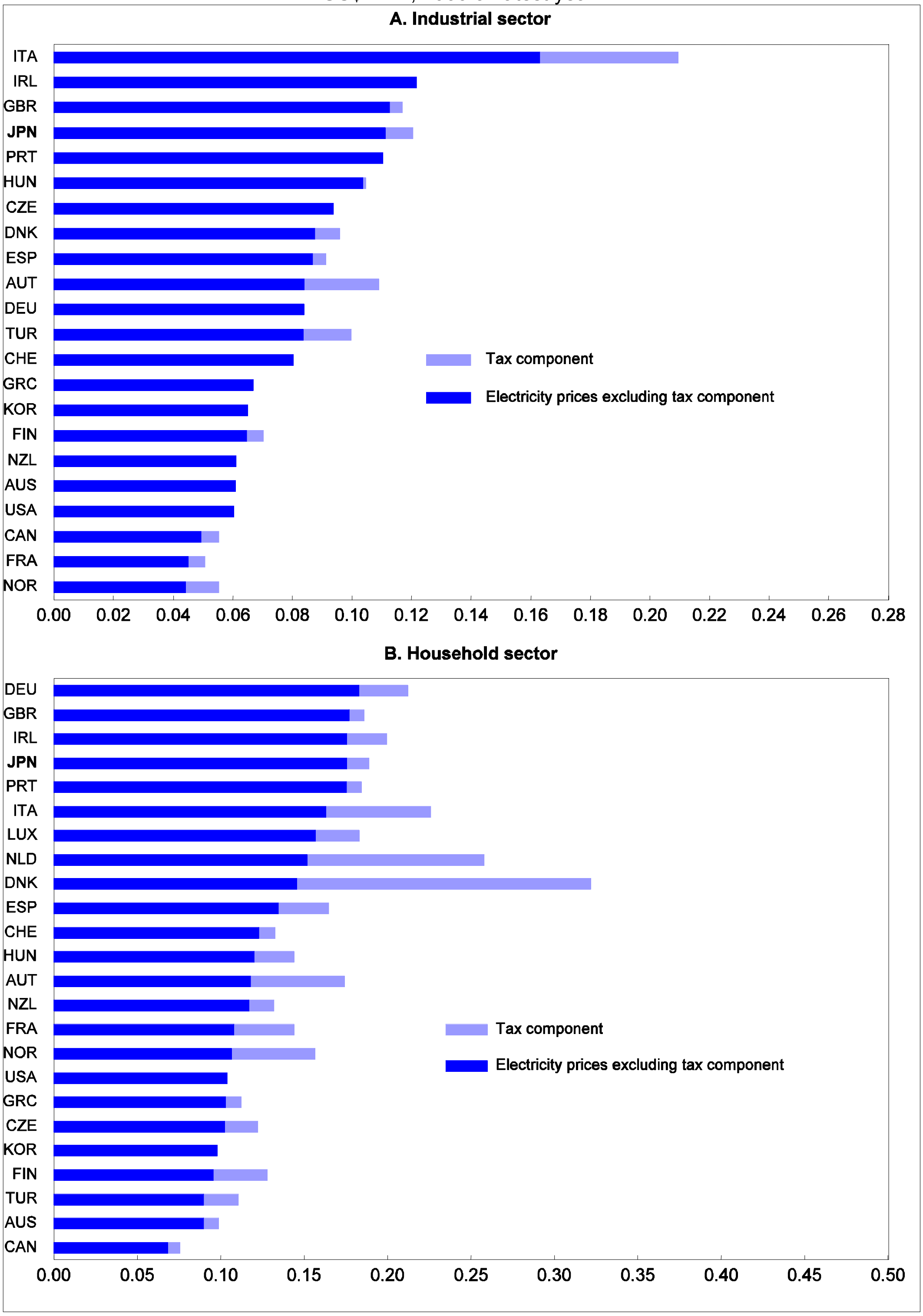
**Figure 11. Regulatory reform in key service industries**




*Source*: Cabinet Office (2006) and Conway *et al.* (2006a).

**Figure 12. Electricity prices in OECD countries**

US$/kWh, 2006 or latest year[1]

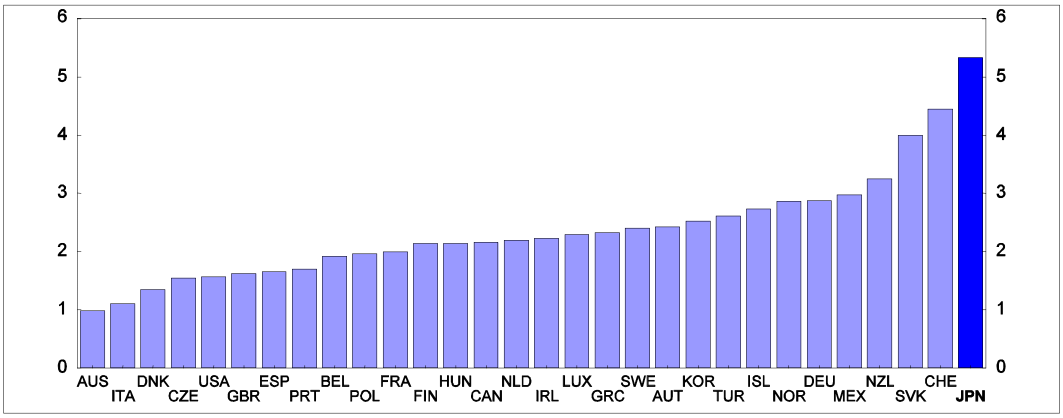



1. Countries are ranked in order of prices excluding the tax component. For the United States, the price excludes taxes, while for Korea, no tax information is available. For some OECD countries (Ireland, Portugal, Czech Republic, Germany, Switzerland, Greece, New Zealand and Australia), taxes on electricity are zero for the industrial sector. See the source for the specific year.

*Source*: OECD/IEA, *Energy Prices and Taxes*, 1Q2007, OECD, Paris.

**Figure 13. The OECD indicator of network policies**

0 to 6 scale from most to least favourable to competition[1]




1. This indicator measures network access and the independence of sector regulators.

*Source*: Hoj *et al*. (2007).

43. As market liberalisation increases the scope for trade across Japan, it is important to expand transmission networks and open access to interconnection capacity, which is a prerequisite for effective market integration.[36] In the past, interconnection capacity was determined on the basis of self-sufficiency in each region without consideration for third-party access, thus leading to low interconnection capacity between regions, even in the same frequency area. In this regard, adopting a capacity auctioning mechanism, as in European countries, would be an attractive option to make transmission capacity available to all users. In sum, in promoting competition in the electricity market, METI should continue to develop an appropriate pro-competition framework in collaboration with the JFTC[37] to avoid the abuse of market positions by GEUs, while ensuring fairness and transparency in network access. Such a strategy would be promoted by the creation of a single independent sectoral regulator, as is the case in most OECD countries.

44. In parallel with the reform of the electricity sector, Japan has introduced significant changes in the gas sector, which is characterised by many, mostly private, vertically-integrated regional companies with little interconnection capacity between regions. The 2003 revision of the Gas Utilities Law included several initiatives to strengthen competition. Most importantly, large industrial consumers with annual usage of more than 0.5 million $m^3$ were allowed to choose suppliers freely, and the threshold was further reduced to 0.1 million $m^3$ in 2007, thus including most commercial users. As a result, the liberalised sector accounts for 60% of total sales, boosting the number of consumers free to choose their supplier by three times between 2004 and 2007. Moreover, rules and procedures for TPA to pipeline and Liquefied Natural Gas (LNG) terminals were established and non-discriminatory access was increased through accounting separation, information firewalls and a prohibition against discrimination. On the other hand, to stimulate investment in pipelines, new capacity will be exempted from the TPA obligation or will be allowed a higher rate of return in their TPA tariff for a limited time period.

36. This should include expanding the capacity of frequency converters needed for the exchange of electricity between different frequency areas. The GEUs serving the northern part of Japan deliver electricity at a frequency of 50 Hz, while western Japan uses 60 Hz.

37. In order to promote competition in the electricity market, METI and JFTC published "Guidelines for Proper Electric Power Trade" in 1999. In addition, the JFTC published "Issues Concerning the Electricity Market and Competition Policy" in June 2006.

45. These reforms reduced Japan's regulation index in the gas sector by 61% (Figure 11, Panel A) and kept the OECD's indicator of the stringency of regulation below the average (Panel C).[38] Reforms encouraged greater competition, which allowed new entrants in the liberalised sector to increase their market share from 2% in 2001 to 7.6% in 2004. Intensified competition resulted in a 36% fall in prices and a 19% rise in consumption between 1995 and 2005, boosting consumer surplus by 0.5 trillion yen (Table 4).

46. However, given the dominance of incumbents with large bargaining power, additional measures are needed to encourage competition. One key is the establishment of an independent regulator, as found in the gas sectors of other OECD countries, such as the United States, the United Kingdom, Germany and Italy, prior to the effective unbundling of vertically-integrated gas utilities. The expansion of an inter-connected pipeline network is another important task. In addition, TPA to pipelines and LNG terminals should be closely monitored to ensure that it does not act as an entry barrier to new suppliers. The client notification requirement, under which gas suppliers are obliged to notify METI when they acquire a client from another gas company's supply area, is unnecessary. Similar problems in other countries are dealt with through licenses to distributors, stipulating transparent and equal conditions for all players.

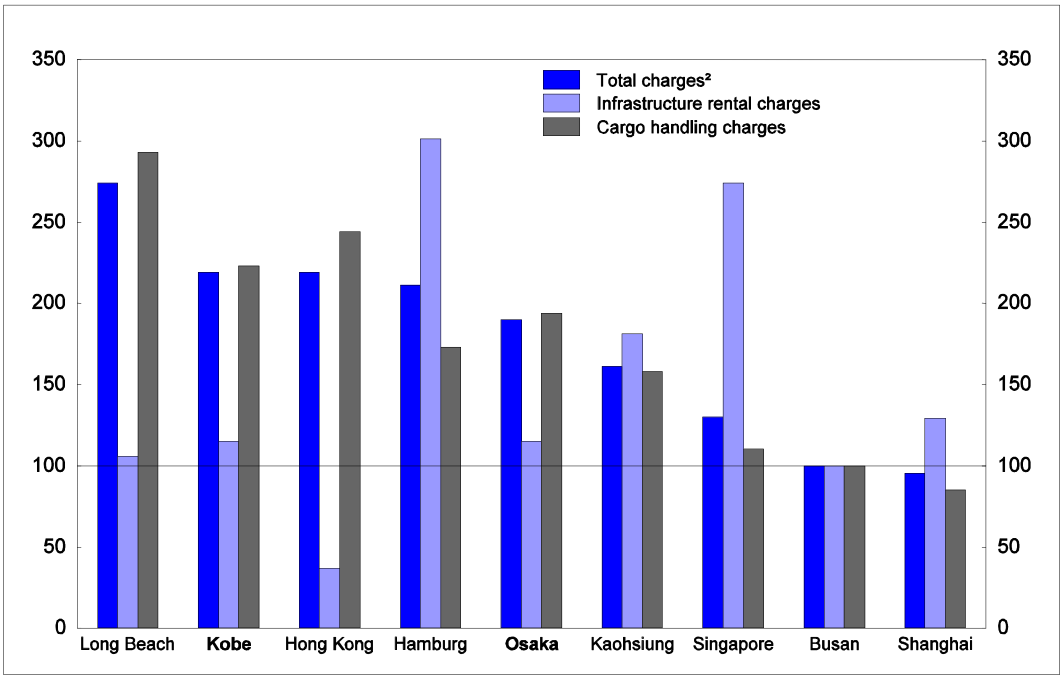
***The transport sector: harbours and air transport***

47. Harbour charges are high in Japan (Figure 14). Although the rental cost of infrastructure that is administratively determined by local governments was not far out of line with other ports, the cost of cargo handling, tugging and pilotage by private providers is much higher than in other countries (Table 9). The government introduced reforms for nine major ports in 2000, including the removal of the "demand and supply adjustment scheme", which required potential new entrants to prove that there was surplus demand. The licensing system for entering and leaving the industry was changed to a permission system, which is less strict and allows less room for discretion, and the permission requirement for setting prices was replaced by a prior notification system. These reform measures were expanded to all ports by 2006. Furthermore, the government launched a "Super Hub-Port Initiative" in 2004 aimed at reducing costs and providing services comparable to other major ports in Asia by 2010 through better management and economies of scale. The initiative included specific targets, such as cutting costs by 30% and reducing lead time from three days to one day, the level of Singapore. Ports designated as super-hub ports have been given priority in government support.[39]

38. Japan's overall ranking in the gas sector reflects a good performance (relatively low scores) for the public ownership and market structure sub-categories. However, the sub-categories for vertical integration and entry barriers (6.0 and 4.3, respectively) are relatively restrictive, as they are well above the OECD averages (3.5 and 2.4, respectively).

39. Thus far, the government has designated six harbours in three areas as super-hub ports: Osaka and Kobe in the Hanshin area, Tokyo and Yokohama in the Keihin area and Nagoya and Yokkaichi in the Isewan area. Government support includes no-interest loans to private-sector firms to build or improve infrastructure. While total government investment in harbours has remained steady at around 135 billion yen since FY 2004, the proportion allocated to the super-hub ports rose from 27% to 59% in FY 2007.

**Figure 14. International comparison of harbour charges**
Index with Busan port = 100 in 2000[1]




1. Based on charges for ships with capacity of 4 000 TEU.
2. Includes pilotage and tugging charges.

*Source*: Kim *et al.* (2000).

**Table 9. Comparison of major service charges in international ports**[1]

In thousand yen

| | Singapore | Hong Kong | Kaohsiung | Busan | Tokyo |
|---|---|---|---|---|---|
| Tugging charge | 216 | 262 | 457 | 361 | 570 |
| Pilotage charge | 60 | 239 | 131 | 169 | 1044 |

1. Based on charges for a container ship of 50 thousand tonnes.

*Source*: Tokyo Metropolitan Harbor Bureau (1999).

48. Despite these reforms, prices remain high, partly reflecting the lack of competition within and among Japanese harbours (OECD, 2007c). Although the exemption from the competition law was abolished in the late 1990s, the Japanese Harbour Transport Association (JHTA) wields discretionary power over business operations through the "Prior Consultation" process between shipping companies and the labour unions of harbour service providers. The JHTA is an incorporated association under the regulatory authority of the Ministry of Land, Infrastructure and Transport (MLIT) that includes all major port service providers, except shipping lines. Although its participation is not mandatory, the JHTA usually assumes an intermediary role in the prior consultation process between labour unions and shipping companies whenever there are proposals that would cut jobs or adversely affect working conditions. In such cases, the JHTA consults with the relevant parties and issues recommendations that all parties are

effectively bound to respect. The shipping companies are thus required to obtain advance approval from the JHTA for even minor changes, such as the time of arrival, port or pier designation or substitution of vessels. While the Port Transport Business Law allows competitive bidding at confidential rates, the prior consultation process prevents such bidding for harbour services, including cargo-handling, thus raising the cost of doing business (European Business Council in Japan, 2006).[40] The prior consultation process and the role of the JHTA should thus be reformed to promote greater competition in the harbour industry.

49. Such anti-competitive practices are further compounded by entry regulations. When the "demand and supply adjustment scheme" was abolished in 2000, the regulation setting the minimum number of workers was revised. Specifically, existing and new firms must have employment that is 50% higher than before 2000 (for the same scale of operations). This regulation makes it difficult for new entrants to gain market share based on higher efficiency and lower costs. The number of harbour business firms fell from 1 019 to 953 between FY 1999 and FY 2005 despite the liberalisation of entry barriers in 2000, in part reflecting depressed economic conditions and mergers between existing firms. No foreign companies have established terminal operations in Japan.

50. Another reason for high harbour charges is the additional fees for cargo-handling during weekends and at night, which is as high as 60% to 120% in Tokyo port, compared to 0% to 50% in other major ports in Asia. As a result of the high charges, Japanese ports are losing business to major ports in Korea, China and Singapore.[41] Liberalising port services has been found to be very effective in lowering service charges. One study (Fink *et al.,* 2002) estimates that it could reduce prices by an average of 9%, while ending co-operative working agreements and price-fixing arrangements could lower prices by another 25%. In sum, the government should strengthen competitive pressure in the harbour industry, putting a priority on reforming the prior consultation process, actively pursuing deregulation and adopting a more pro-active competition policy. In addition, privatising harbours would boost competition, leading to higher productivity and lower cargo handling costs.[42]

51. There has also been some regulatory reform in the air transport industry. The permission requirement for changing airfares was relaxed to a prior notification system and the government abolished the demand and supply adjustment scheme in 2000, while the licensing requirement to enter and leave the industry was changed to a permission system. Nevertheless, the OECD indicator of entry barriers in air transport was more than twice as restrictive as the OECD average in 2003. Overall, progress has been relatively modest compared to the electricity and gas sectors, with only a 27% fall in Japan's regulatory index between 1995 and 2005 (Figure 11, Panel A). As for the OECD indicator, there has been no change for air transport since 1995, in contrast to the large drop in the OECD average (Panel D). Given the limited

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40. The prior consultation system involving JHTA lacks transparency and effectively gives the JHTA and its members the power to prevent shipping lines from seeking competitive bids for waterfront services (European Business Council in Japan, 2006). The European Union also requested Japan to review the role of the JHTA to encourage competition in the harbour transport business in Japan (European Union, 2006).

41. In terms of the volume of containers handled, Tokyo fell from 16th in the world in 1994 to 22nd in 2004, while Kobe dropped from 6th to 36th and Yokohama from 10th to 27th, according to the Containerisation International Yearbook (Informa UK Limited, 2004). In addition, the transhipment ratio, a major indicator of the international competitiveness of harbours, declined from 20% to 12% for Yokohama between 1990 and 2006, in contrast to an increase from 6% to 43% in Busan over the same period (Jung, 2007).

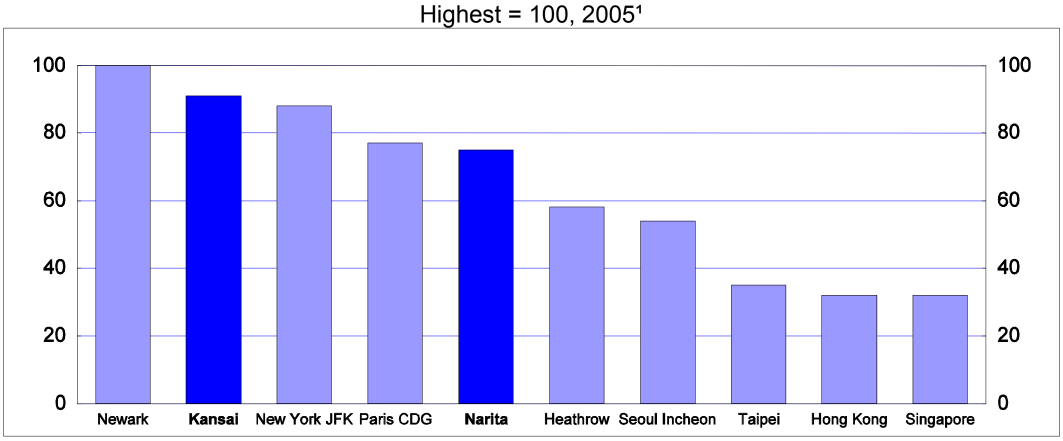
42. The World Trade Organisation report (2004) on the experiences of South American countries in liberalising and privatising port services shows that deregulation and participation of the private sector, including foreign capital, has led to higher productivity and lower cargo-handling costs. It also found that the key to success is the coherence between liberalisation and privatisation measures and other economic policies, such as competition between ports, investment in infrastructure and the flexibility of the labour markets.

progress, consumer surplus gains during the decade to 2005 were small (Table 4). The Japanese business sector has complained about the high charges in airports, as well as ports (Keidanren, 2000).

52. To strengthen its international competitiveness, Narita airport, which serves the Tokyo region, reduced its landing charge by about 20% in 2005, compensating by cutting costs through improving outsourcing activities and increasing non-aeronautical revenue. Nevertheless, charges at Narita and Kansai, the second largest airport in Japan, are still among the highest in the world, in part due to high landing charges (Figure 15).[43] In addition, overall operational costs per passenger in Japanese airports are the highest among major airports surveyed, according to the Transport Research Laboratory. The high price for airport services in Japan fundamentally reflects the monopolistic powers of airports in the context of a serious shortage of landing slots, particularly at Narita. Despite the opening of a third major international airport in central Japan in 2005, airport capacity appears inadequate to meet rising traffic. Capacity is limited by the rules set by MLIT that impose strict hourly and daily limits on airport slot numbers.[44] In addition, capacity utilisation is limited by the slot allocation mechanism, which is based on the grandfather principle - granting slots to incumbent operators based on their past usage.[45] The slot allocation scheme needs to be more transparent and to fully utilise airport capacity. Increasing capacity is all the more important as it is a prerequisite for fully realising the benefits of further liberalising air transport services, particularly in the context of the worldwide trend toward liberalisation of this sector.[46]

**Figure 15. International comparison of landing and departure charges**

Highest = 100, 2005[1]




1. Based on eight different aircraft types.

*Source*: Transport Research Laboratory (2005).

43. Before the 2005 reduction, the landing charge at Narita airport was 948 000 yen per aircraft (based on a Boeing 747-400 aircraft) and 825 000 yen at Kansai airport. In contrast, landing charges were only 180 000 yen in Singapore, 283 000 yen in Incheon and 377 000 yen in Hong Kong, China. In 2002, the IATA requested that Narita reduce its landing charge. The 20% reduction in 2005 still leaves landing charges in Japan well above other major airports in Asia.

44. Airport slots are the scheduled time of arrival or departure available for allocation for an aircraft movement at a specific time or date. According to the Japanese authorities, the hourly and daily limits on slot numbers are intended to limit noise pollution for surrounding areas and ensure safety.

45. It leads to the inefficient use of slots due to overbidding, late hand-back of slots and babysitting of slots – maintaining a slot with the smallest aircraft possible in order to preserve its claim for the future (NERA, 2004).

46. The liberalisation of Japan's air transport sector is being advanced by the "Asian Open Skies"strategy, which was described in the *Economic and Fiscal Reform 2007*, and in the "Asian Gateway Initiative".

53. Improving the mechanism for allocating landing slots is also essential to reduce entry barriers to potential new airlines. The current slot allocation mechanism, in line with IATA guidelines, reserves a pool of slots for new entrants. However, the mechanism does not sufficiently encourage entry as it is based on the grandfather principle. This approach prevents the provision of slots to airlines that value them most and acts as a barrier to changing service patterns. Introducing market mechanisms, such as secondary trading, auction of slots and higher posted prices, would increase the degree of competition by removing important entry barriers for low-cost and competing long-haul services. A carefully-designed market mechanism is important to realise the full benefits of reform in the air transport sector. Finally, competition policy should be strictly enforced in the airline industry, which has two major players.

54. Another barrier to competition is restrictive airfare pricing and ticket distribution mechanisms for international travel. The prices of tickets sold by airlines directly to consumers are restricted by MLIT, in principle, with a minimum floor set at 30% of the IATA price,[47] which does not reflect actual market prices. Consequently, the ability of airlines to offer competitive fares to and from Japan directly to consumers is limited, making them sell through licensed travel agencies, which account for most of their sales.[48] This restriction is particularly disadvantageous to foreign airlines as it is difficult for them to set up their own travel agencies in Japan (like Japanese airlines do) due to the lack of scale economies. The restriction on setting international airfares should be removed and airlines should be allowed to sell tickets directly to consumers at market prices. The recent government plan to eliminate the restriction will be beneficial.

55. The government should focus on reducing high landing and departure charges and operating costs of airports through deregulation and measures to increase capacity. Although Narita was corporatised in 2004, it remains 100% government-owned. It should be privatised, while ensuring a good governance structure and appropriate regulation through the introduction of an independent regulatory body. This should be combined with active enforcement of competition policy, given the natural monopoly status of airports. To expand airport capacity, allowing international routes to use regional airports is one option. For example, Haneda Airport, which is closer to Tokyo than Narita Airport, could handle international traffic.[49] Perhaps even more important is improving the slot allocation mechanism at major airports to increase effective capacity.

***Business services***

56. The business services sector – which includes activities such as accounting, legal services, consulting, R&D, marketing and advertising – has been growing rapidly in most OECD countries in the context of increased outsourcing and the growing importance of knowledge-intensive service activities, such as R&D and software development. Rapid advances in information technology and the liberalisation of trade and investment in services has increased international competition in business services. Enhanced productivity in business services creates positive spillovers on other industries, enabling firms to focus on their core activities. In Japan, the business services sector expanded at an average annual rate of 3% between 1990 and 2003, boosting its share of GDP from 12% to 15%, while its share of employment

47. These refer to the Instant Purchase Excursion Fares (PEX), as defined by IATA.

48. Furthermore, IATA full economy fares (Y2) are considered as the minimum level for business class fares in an attempt to ensure consistency between service and fare levels.

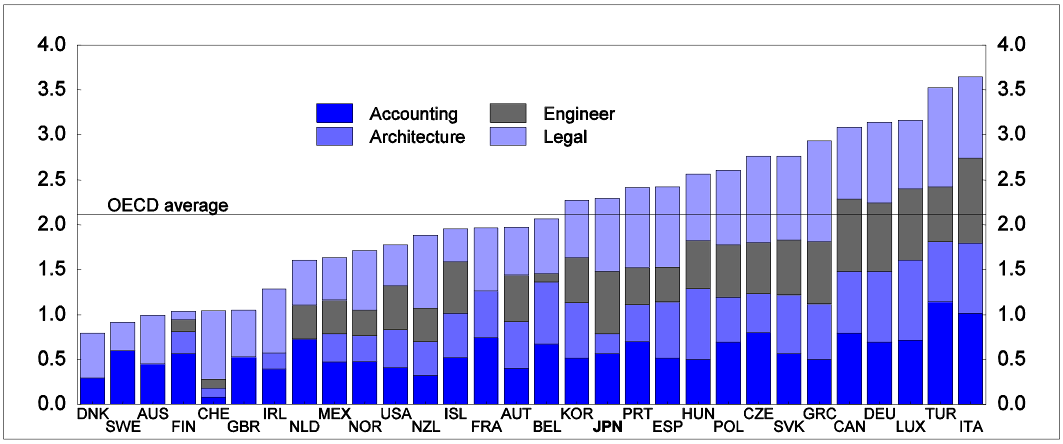
49. Haneda Airport has handled little international traffic since 1978, when its international traffic was taken over by Narita Airport, based on an agreement between the central government and the prefectures. In addition, the shared use of Yokota Air Force Base for commercial domestic flights and military flights would free up slots at Haneda for international flights.

increased from 5% to 6%. This reflected high productivity growth in business services, averaging 4% during 1996-2001, one of the highest rates in the OECD area (OECD, 2007a).

57. However, there is scope for further improvement in the regulatory framework as competition in business services has long been weak compared to other sectors in Japan. Weak competition is a result of pervasive regulations, such as mandatory membership in professional associations, recommended fixed prices by professional associations, the exclusive exercise of certain activities and restrictions on advertising and business structures (OECD, 2000). According to the OECD's indicator, the stringency of product market regulation in Japan in professional services - accounting, architecture, engineering and legal services (which account for the major share of the business service category) – ranks a little above the OECD average (Figure 16). As for the openness of business services to inflows of FDI, Japan was more open than the OECD average, although it lags significantly behind top performers in 2006.[50] There has been progress, notably in the legal services market, which was opened to FDI in 2005. This reform is expected to significantly increase competitive pressures and enhance the quality of service in Japan, which has a relatively low number of lawyers.[51] Given the importance of business services and the potential scope for improvement, the government has implemented various strategies to develop this sector, including it as one of six priority sectors in the recent initiative for the service industry (Box 1). The key policy measures include developing human resources by setting skill standards for each individual sector, improving infrastructure to facilitate outsourcing through IT and expanding the scope of outsourcing by the public sector (see below).

**Figure 16. Regulations in professional services**

In 2003




*Source*: Conway *et al.* (2006b).

58. As in other areas, there is a negative correlation between the strictness of product market regulations and productivity growth in business services in the OECD area (OECD, 2007a). The government should thus strengthen competitive pressures by liberalising restrictive regulations governing professional services to enhance output growth. Pervasive regulations in professional services are ostensibly intended to improve service quality and prevent market failure arising from information

50. The OECD's FDI restrictiveness index for Japan for business services was 0.063, compared to 0.017 in the United Kingdom, 0.038 in the United States and an average of 0.152 in the OECD area. The index ranges from 0 to 1, with 0 the least restrictive (Golub and Koyama, 2006).

51. The number of lawyers per 100 thousand population was 17 in Japan in 2005, compared to 154 in Germany (2004), 195 in the United Kingdom (2004) and 352 in the United States (2002) (Lee *et al.*, 2007).

asymmetries and transaction costs. However, there is little empirical evidence to suggest that the regulations imposed on business services in many countries actually improve consumer welfare. Instead, such restrictions have been correlated with higher prices and less innovation (Nguyen-Hong, 2000 and Patterson *et al.*, 2003). For example, the annual target on the number of applicants allowed to pass the bar exam in Japan – around 1 500 in 2006[52] – should be replaced by criteria based on the qualifications needed to be a competent lawyer. Attempts to liberalise restrictions on business services in Japan have been frustrated by the "regulatory conduct doctrine", which exempts anti-competitive behaviour if it is required by regulation (Hoj, 2007). Additionally, the business services market should be opened further to FDI, while expanding the recognition of professional certificates acquired overseas. Finally, OECD principles for high-quality regulation of professional services should be applied:

- Exclusive rights should not be granted where there are other mechanisms available to address market failure directly.
- Entrance requirements for a profession should not be disproportionate to the skills necessary to perform the services competently.
- Regulation should focus on the need to protect small consumers.
- Restrictions on competition between members of a profession should be eliminated while encouraging competition between professional associations.
- Professional associations should not be granted exclusive jurisdiction and should be subject to independent scrutiny in making decisions about entrance requirements, mutual recognition and the boundary of their exclusive rights.

59. Another priority is to establish an efficient reporting system for intellectual and intangible assets, which are particularly important to business services. Accurate reporting of firms' intangible assets increases their valuations in financial markets, thus facilitating outside funding and the establishment of such firms. This promotes efficient resource allocation and helps to ensure a positive effect of ICT investment on productivity growth. According to one study (Fukao and Miyagawa, 2007), the relatively low level of investment in intangible assets in Japan limits the impact of ICT investment on productivity growth.[53] In addition, setting common industry-wide standards would increase market transparency and competition, thus enabling service providers to realise economies of scale. Finally, the intellectual property rights regime should carefully balance incentives to innovate with adequate access to and sharing of knowledge.

***Public services***

60. Public services, such as health and education, have been provided in a non-market environment with limited use of the price mechanism and competition, while relying to a large extent on public funding to promote equity and to ensure national minimum standards. In contrast to the overall decline in regulation in the non-manufacturing sector, there has been limited progress in reducing regulations in health and education, despite some improvement in the early 2000s (Figure 17). Moreover, the regulation index for other public services has increased since 1995. Such "government-driven markets" have failed to respond adequately to the changing needs of consumers, resulting in low efficiency and poor service

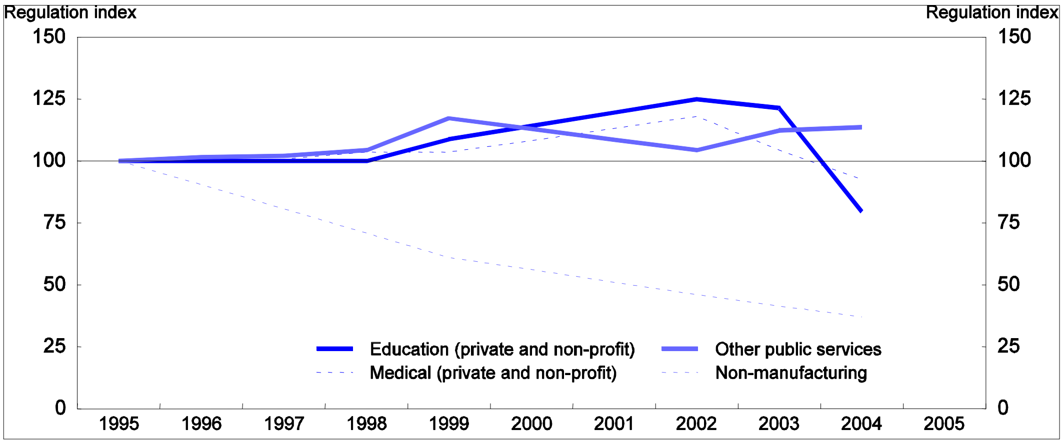
52. The annual target has been steadily increased from around 500 in 1990 to 1 000 in 2000 and is planned to increase further to 3 000 by 2010 following the introduction of law schools.

53. The share of intangible investment in GDP was estimated at 7.8% in Japan (1995-2002) compared to 10.9% in the United Kingdom (2004) and 11.7% in the United States (1998-2000).

quality. The government's Council on Economic and Fiscal Policy called for "innovation of government-driven markets, especially in the fields characterised by low productivity and failure to satisfy consumers' potential needs".[54] To overcome these problems, as well as to limit government expenditure, the authorities have implemented several initiatives, such as special zones and market testing, to introduce market principles in public services.

**Figure 17. Regulatory reform in public services**

1995 = 100




*Source*: Cabinet Office (2006).

61. The regulation that restricts entry in the education and health sectors to firms that are considered to be "non-profit" has been abolished in some special zones. Under the special zone initiative, 22 private schools for profit, including seven universities, were established by April 2007, but there has been no decision on whether to expand this reform nationwide, partly reflecting problems in the administration of some of these establishments. As for hospitals, only one for-profit institution has been established in a special zone, partly reflecting remaining regulatory barriers. In particular, the incentive to establish for-profit hospitals is limited by a regulation that restricts their activities to advanced medical treatment not covered by National Health Insurance, thus preventing competition with existing hospitals. With only one for-profit hospital in operation, the evaluation of this reform for possible nationwide implementation is difficult. The success of the special zone initiative in the area of public services depends on the removal of the obstacles imposed on the operation of private schools and hospitals for profit so that an adequate number of zones can be established, as well as on the benefits resulting from the operation of for-profit schools and hospitals.

62. Another important initiative is the market testing project, which aims at increasing the efficiency of public services through competitive tendering. Under this scheme, services eligible for market testing are decided by the Cabinet at least once a year. Private companies then bid for contracts to provide those services and the relevant ministry decides the winner of the bidding process. Evaluation of performance takes place three to five years later. The transparency, fairness and neutrality of the process are to be ensured by a third-party watch dog in the Cabinet Office, the "Supervisory commission for public/private

54. See the CEFP statement, "Program for Enhancing Growth Potential" (April 2007). In the paper prepared by the private members of the Council, it stated that "there are inevitable cases where the government has to be involved (healthcare and education) and hence this requires that regulations remain. However, such excuses do not justify a situation where the choice of consumers is narrowed, where consumers have to stand in line for these services due to supply shortages, or where those prices are expensive."

and private/private competitive tendering", which is composed of private-sector experts. Eight pilot projects were implemented in 2005 in three areas – job placement activities, social insurance and prison services. In the evaluation of the market-testing initiative at the end of FY 2006, the monitoring committee gave a C to one ministry (an average grade), while the other 11 ministries received a grade of D for poor performances. The scheme was further expanded to seven areas in 2007.[55] The neutrality and independence of the third-party watch dog is a key to the success of this initiative. In addition, while market testing is mandatory for the central government in the seven areas, it is only optional for local governments, even though they provide some of those public services as well. Public services provided by local governments need to be subject to market testing whenever possible.

63. Finally, another important reform aimed at increasing the efficiency of the public sector is the privatisation of Japan Post. In October 2007, the government launched the long-awaited privatisation of Japan Post, the largest financial institution in the world with assets of more than 300 trillion yen (60% of GDP and about one-fifth of total household assets) and 240 000 employees (Box 3).

**Box 3. The privatisation of Japan Post and financial-sector reform**

Japan Post was split into four companies in October 2007, plus a holding company, with all shares initially held by the government, as announced in the 2004 plan.

- The Postal Delivery Service became the **Japan Post Service**, which provides correspondence delivery, packaging and storage services. In addition, it will enter the "international special delivery business", competing with private firms such as FedEx and UPS.
- The Post Office Network became the **Japan Post Network** and offers a wide range of services, including the sale of life and damage insurance and real estate development. However, the new company is required to maintain the existing local network of 24 000 branches to provide services for those living in rural areas, thus making it difficult to increase efficiency through restructuring.
- The Postal Savings System became the **Japan Post Bank** (Yucho Bank) and the Postal Life Insurance System became the **Japan Post Insurance** (Kampo Insurance). Both institutions will be treated as private financial institutions subject to supervision by the Financial Supervisory Agency (FSA), with their initial business scope limited to that under the Japan Post. They need to obtain approval from both the FSA and the Ministry of Internal Affairs and Communications to enter new business areas that they are considering, such as housing loans, credit cards and health insurance.

The two financial companies will be listed on the stock market by the early 2010s and are to be completely privatised by 2017. The holding company will also be listed and will sell shares to private investors. However, even in 2017, the government will hold at least a third of the shares of the holding company, which will in turn hold all of the shares of the Japan Post Service and the Japan Post Network. The privatisation is expected to bring about a number of benefits. *First*, it will increase efficiency by improving resource allocation. Indeed, the investment yield from Postal Savings in 2006 was just 1.2% due to the concentration on investment in government bonds, which accounted for around 60% of assets. The privatisation is expected to diversify the asset portfolio by including more high-yielding financial products, including equities, thereby encouraging the flow of funds toward more productive private areas. *Second*, it will develop private financial institutions by ending the preferential treatment of Japan Post. Previously, the insurance payments and savings accounts of Postal Savings and Postal Insurance were guaranteed by the government and both were exempt from major taxes, such as the corporate income tax, and some financial regulations. *Third*, it will provide better service at a lower cost for consumers by increasing efficiency.

55. The seven areas are: 1) statistical research; 2) registration of real estate and corporations; 3) social insurance agencies; 4) job placement activities; 5) independent administrative organisations; 6) local government operations; and 7) collection of fees for public services, such as national health insurance.

However, there are some concerns, particularly on the part of private firms worried about unequal competition with Japan Post as it expands its business operations using its nationwide network, while the government holds all of its shares and allows some preferential treatment. Indeed, the Japan Post Service will receive special treatment for customs clearance and ground transport. Moreover, there is also potential risk that profitable activities, for example the Japan Post Service, with its monopolistic status in correspondence delivery service, may cross-subsidise other businesses or companies during the transitional period before full privatisation. Lastly, the entry of Japan Post in the private lending market, which is already saturated in the context of weak demand from the corporate sector, runs the risk of crowding out existing private players.

The key to the successful privatisation of Japan Post is to foster a business environment conducive to efficiency gains while ensuring a level playing field with private financial institutions. This requires eliminating the remaining preferential treatment for the new companies and privatising them as quickly as possible to minimise distortions during the transitional period. Meanwhile, the independence and neutrality of the government committee overseeing the privatisation process, which provides opinions on allowing the new companies to enter new business lines, must be ensured to avoid conflicts of interest arising while the government still holds all of the shares of the four companies and the holding company. In addition, competition policy should be strictly enforced in areas where these companies are operating.

While the privatisation of Japan Post is a positive step, other measures are necessary to develop Japan's financial markets, which is an important priority to achieve sustainable growth in the context of a globally integrated financial market and an ageing society. The FSA announced a plan in December 2007 to strengthen financial markets by promoting competition and improving the regulatory environment. Concrete action plans to achieve those objectives included:

- Diversifying the range of financial products traded in the exchanges to include various types of derivatives and Exchange-Traded Funds.
- Constructing a tax system that facilitates the shift of resources from savings to investment.
- Easing the firewall regulation in financial companies to maximise the synergy effect between the banking and securities business. This is to be accomplished by lifting the ban on interlocking officers and relaxing the restrictions on sharing information about corporate customers.
- Broadening the scope of business allowed for banking and insurance companies.
- Enhancing the transparency and predictability of financial regulation and supervision through the extensive use of the "No-Action Letter" scheme (see above).
- Developing human resources specialised in finance, law and accounting by supporting specialised graduate schools and encouraging the inflow of foreign experts.

## Conclusion

64. Given its large role in the economy, the service sector is the key to achieving faster economic growth. Accelerating productivity growth in services requires strengthening competition and making Japan more open to international trade and FDI inflows. A summary of specific recommendations to achieve these objectives is presented in Box 4. While enhanced productivity in the service sector benefits consumers and improves overall economic performance, structural changes also incur adjustment costs. However, such costs should not prevent reforms to create more open and competitive service markets.

**Box 4. Summary of recommendations**

**Strengthen the competition framework in general**

- Pursue a more pro-active competition policy in the service sector, raising its importance relative to the industry-specific policy objectives pursued by line ministries.
- Increase the transparency and predictability of public administration, notably by enhancing the effectiveness of "Public Comment Procedures", "No-Action Letters" and "Regulatory Impact Analysis".
- Use competition laws more actively to prevent anti-competitive activities by trade associations.
- Further strengthen penalties, such as surcharges and fines for violations of the AMA, to a level that would provide sufficient deterrent effects.
- Reduce the number of explicit exemptions from the AMA, while ending preferential treatment for SMEs, except when necessary to correct clear market failures.
- Ensure the neutrality and independence of the JFTC's hearing procedure while continuing to upgrade the capability of the JFTC in terms of human resources and budgets.
- Strengthen international competition by promoting inward FDI through the elimination of restrictions on FDI and product market regulations that discourage inflows of investment.
- Facilitate trade in services by reducing trade barriers.

**Accelerate regulatory reform**

- Step up the pace of regulatory reform in the service sector, particularly in ICT-using areas.
- Improve the special zone scheme by focusing its objective on nationwide regulatory reform, removing barriers to the effective implementation of reform measures in the zones and ensuring fair and independent evaluation of the measures to accelerate nationwide adoption of the reforms.
- Focus the government's development plans for the service sector on policies to strengthen competition, while avoiding preferential measures, particularly toward SMEs, that would result in distortions.
- Better co-ordinate government plans to develop the service sector so as to use resources efficiently.
- Remove obstacles discouraging investment in ICT and intangible assets, particularly in services.

**Remove restrictions in key service industries**

***The retail sector***

- Pursue further deregulation, in part by enhancing the transparency and predictability of the Large-scale Retail Store Location Law.
- Ensure that other laws, such as the City Planning Law, are not used as entry barriers for large stores.

***The energy sector***

- Establish single independent regulators to promote competition in both electricity and gas.
- Further expand the share of consumers allowed to freely choose their suppliers of electricity and gas.

- In the electricity sector, strengthen competitive pressure by expanding the interconnection capacity, facilitating the power exchange and removing remaining obstacles to the operations of new entrants.
- Actively pursue unbundling of vertically-integrated incumbents through formal separation, while ensuring the neutrality and independence of the Electric Power System Council of Japan.
- In the gas sector, strengthen competitive pressures by expanding the network capacity and removing remaining obstacles to the operations of new entrants.

***Transport***

- In the harbour industry, strengthen competitive pressure by improving the "Prior Consultation" process and relaxing entry barriers, such as the minimum requirement on employment.
- In the air transport industry, expand the capacity of airports, particularly in the Tokyo region, and increase their efficiency through privatisation.
- Introduce market mechanisms in the allocation of landing slots to fully utilise capacity and to reduce entry barriers.
- Allow airlines to sell tickets at competitive prices directly to consumers.

***Business services***

- Further deregulate professional services while preventing negative effects on competition from self-regulatory bodies.
- Encourage international competition through increased inflows of FDI and trade, while expanding the scope of mutual recognition of certificates acquired overseas.

***Public services***

- Actively use the special zone scheme to promote reforms in areas such as education and healthcare.
- Expand the use of market testing and ensure that it results in outsourcing of activities in which the private sector is more efficient.

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