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Product Market Competition
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ABSTRACT

PRODUCT MARKET COMPETITION AND ECONOMIC PERFORMANCE IN JAPAN

Empirical work shows that competition is important for promoting economic growth. However, in Japan the promotion of competition has long been compromised by ministerial guidance and exemptions from the competition law. Thus, the level and growth of productivity have been low in many domestically oriented sectors and consumer welfare has suffered under high prices and the slow introduction of new goods and services. This misallocation of resources contributes to explaining why the Japanese economy had difficulty in coming out of the quasi-stagnation of the past decade. Recognising that gains from more pro-competition policies are substantial, the Japanese government has now made the promotion of competitive markets a cornerstone of its economic policy. Reforms to promote product market competition in Japan should *inter alia* focus on strengthening the legal framework by increasing fines to a deterrent level and introducing cartel destabilising measures, such as a leniency programme. Combined with a reform of zoning laws, this should further new entry in the retail sector. In network industries, non-discriminatory third party access should be secured through forceful *ex ante* regulation, including the introduction of independent sector regulators and formal separation of activities. Other measures should include neutral financing of the net-cost of public service obligations. Privatisation and greater use of fair public procurement measures should promote competition as well as having beneficial fiscal effects.

Key words: Japan, anti-trust law, competition law, cartel, regulatory reform, productivity and growth, retail sector, network industries, energy, telecommunication, postal services, transportation, public procurement.

JEL codes: K21, L42, L43, Q18, L11, L16, L33, L43, L81, L87, L92, L93, L94, L95, L96, F13, O53, O57

RÉSUMÉ

CONCURRENCE SUR LES MARCHÉS DE PRODUITS ET PERFORMANCE ÉCONOMIQUE AU JAPON

Des études empiriques montrent que la concurrence est importante pour promouvoir la croissance économique. Mais au Japon, la stimulation de la concurrence a longtemps été compromise par des directives ministérielles et des exemptions au droit de la concurrence. Aussi, le niveau et le taux de croissance de la productivité ont été bas dans de nombreux secteurs tournés vers le marché intérieur, et le bien-être des consommateurs a souffert de prix élevés et d'une diffusion trop lente des nouveaux biens et services. Cette mauvaise allocation des ressources contribue à expliquer pourquoi l'économie japonaise n'est pas parvenue à sortir de la quasi-stagnation de la dernière décennie. Conscient que des politiques plus propices au jeu de la concurrence peuvent s'avérer très bénéfiques, le gouvernement japonais a fait de la promotion des marchés concurrentiels l'une des pièces maîtresses de sa politique économique. Les réformes visant à stimuler la concurrence sur les marchés de produits au Japon devraient entre autres s'attacher à renforcer le cadre juridique, en alourdissant les amendes pour les rendre dissuasives et en appliquant des mesures de déstabilisation des ententes, en particulier un programme de clémence. Conjuguée à une réforme des règlements de zonage, cette action devrait favoriser les entrées dans le secteur du détail. Dans les industries de réseau, l'accès non discriminatoire des tierces parties devrait être garanti par une réglementation *ex ante* coercitive, et notamment par la création d'organismes de réglementation sectoriels indépendants et par une séparation formelle des activités. Parmi les autres mesures, il convient de citer un financement neutre du coût net des obligations de service public. La privatisation et un recours accru à des procédures équitables en matière de marchés publics devraient promouvoir la concurrence tout en exerçant des effets bénéfiques sur le plan budgétaire.

Mots clés : Japon, réglementation anti-trust, droit de la concurrence, entente, réforme de la réglementation, productivité et croissance, secteur de détail, industries de réseau, énergie, télécommunications, services postaux, transports, marchés publics.

JEL codes : K21, L42, L43, Q18, L11, L16, L33, L43, L81, L87, L92, L93, L94, L95, L96, F13, O53, O57

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PRODUCT MARKET COMPETITION AND ECONOMIC PERFORMANCE IN JAPAN

By Jens Høj and Michael Wise¹

1. The OECD Growth Study and other empirical work have shown that the strength of competition in product markets is likely to play an important role in the process of economic growth. In Japan, policies promoting product market competition have long been compromised by ministerial guidance and explicit exemptions from the competition law. Intense competition is thus lacking in many domestic sectors. As a result, these sectors are characterised by comparatively high prices, weak innovative activity and low levels and growth of productivity. The current allocation of resources thus seems inefficient, partly explaining why the Japanese economy has failed to come out of its quasi-stagnation of the past decade. From a positive perspective, however, this means that potential gains from more pro-competition policies are probably quite large. To realise such gains, the Japanese government has made the promotion of competitive markets one of the cornerstones of its policy to promote economic growth. For example, the resources of the Fair Trade Commission have been increased, and greater impetus has been given to regulatory reforms. However, the legacies of past policies appear difficult to dismantle and progress has been uneven.

2. This paper begins with a short review of Japan's disappointing growth performance over the past decade and its possible links to weak competitive pressures. Attention is then turned to indicators of product market competition to gauge the strength of competitive pressures as well as the implications of barriers to trade and foreign direct investment. This is followed by an assessment of the general competition policy framework and its role in promoting competition. The paper then examines a number of sectors where regulatory policies can be expected to have particularly large impacts. The paper concludes with a set of policy recommendations.

Macroeconomic performance and indicators of competition

The economic performance has been weak over the past decade

3. Starting from a high level of GDP per capita, the economic performance of Japan over the past decade has been comparatively poor (Table 1). GDP growth has been less than half of the OECD average, with stagnant employment levels and a falling participation rate. There has also been a deceleration in multifactor productivity growth, which was essentially flat during the 1990s. While to a large extent this reflects the ongoing adjustment to the collapse of the speculative bubble in early 1990s, structural factors seem to be playing a role as well.

1. This paper was originally prepared for the *OECD Economic Survey of Japan 2003-2004* published in February 2004 under the authority of the Economic and Development Review Committee of the OECD. Jens Høj is an economist in the OECD's Economics Department and Michael Wise is a lawyer in the Competition Division in OECD's Directorate for Financial and Enterprise Affairs. They are indebted to Jørgen Elmeskov, Michael Feiner, Val Koromzay, Andrew Dean, Yutaka Imai, Randall Jones, Hideyuki Ibaragi, Marie Maher, Willi Leibfritz and other colleagues in the OECD Economics Department for useful comments. Special thanks to Brooke Malkin for excellent technical assistance and Nadine Dufour for assistance in preparing the document.

Table 1. Output, employment and productivity

	United States	Japan	Germany	France	Italy	United Kingdom	Canada	OECD	European Union
Average GDP growth: 1992-2002 of which:	3.2	1.1	1.4	1.9	1.5	2.6	3.2	2.6	2.0
Productivity	1.8	1.1	1.3	1.1	1.3	2.0	1.5	1.2	1.4
Employment	1.4	-0.1	0.1	0.8	0.2	0.6	1.7	1.4	0.6
of which:									
Unemployment ¹	0.1	-0.3	-0.2	-0.1	-0.1	0.3	0.3	-0.1	0.0
Labour force	1.3	0.3	0.3	0.7	0.2	0.3	1.4	1.4	0.6
Demographics, ² 1990-2001	1.2	0.7	0.2	0.7	0.1	0.2	1.3	1.7	0.8
Participation rates, ³ 1990-2001	0.0	-0.1	0.2	-0.1	0.0	0.0	0.0	-0.1	0.3
Labour productivity growth in selected industries: ⁴									
Total manufacturing	3.9	2.4	2.4	3.8	2.2	2.5	2.5	n.a.	n.a.
Electricity, gas and water supply	1.0	2.1	4.9	1.8	3.9	9.7	1.3	n.a.	n.a.
Construction	0.2	-3.0	0.0	-0.3	-0.1	2.5	0.2	n.a.	n.a.
Wholesale and retail trade, restaurants and hotels	3.8	0.9	-0.6	0.6	1.1	2.4	2.3	n.a.	n.a.
Transport, storage & communication	2.7	1.2	7.2	3.1	3.5	4.9	3.4	n.a.	n.a.
Memorandum items:									
MFP growth, ⁵ 1992-2001	1.1	0.1	0.6	0.6	0.8	1.2	1.2	n.a.	n.a.
GDP per hour worked, 2001	100.0	75.1	98.2	109.9	102.6	85.1	87.6	83.1	94.9

1. A positive sign indicates that unemployment has declined and contributed to higher output growth.

2. The contribution of demographics includes changes in the size and age composition of the working-age population.

3. Measures the effect from changes in age-specific participation rates.

4. 1991-2001, except for France, which is 1991-2000.

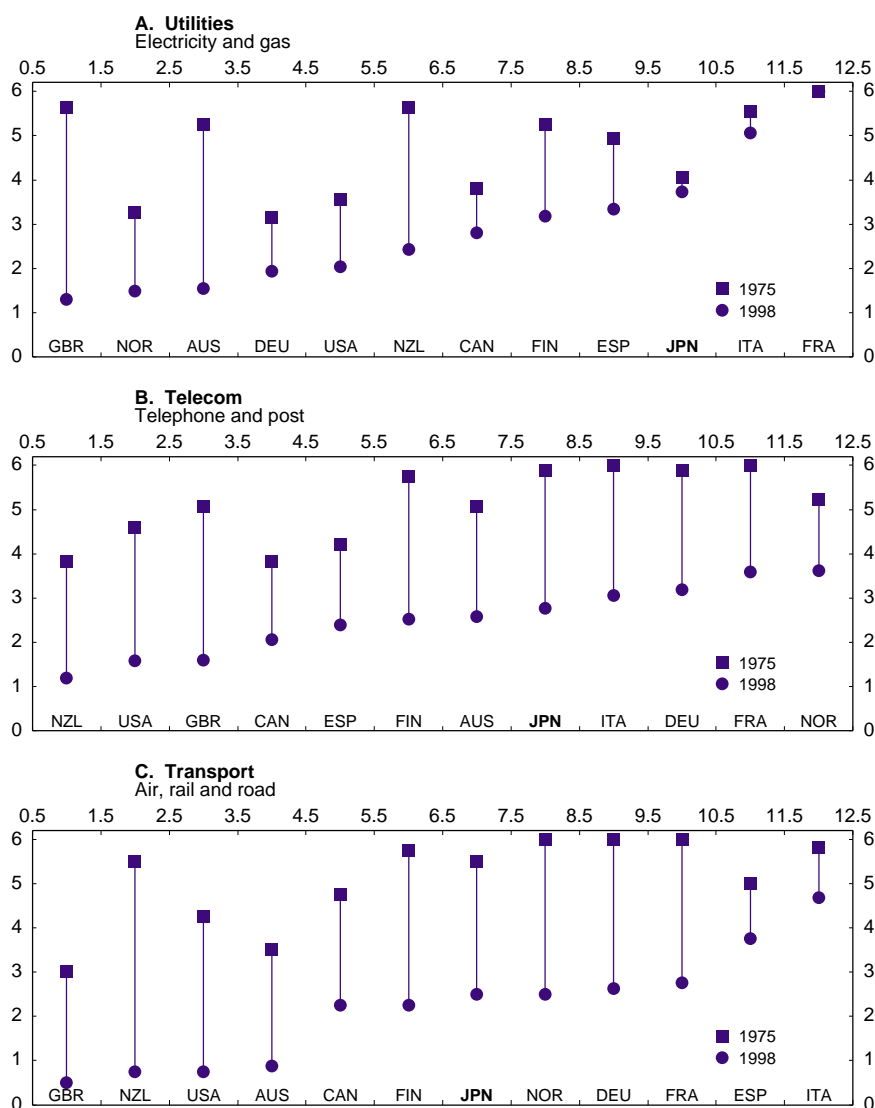
5. Total economy.

Source: OECD.

4. Although a number of large Japanese enterprises are among the world's most productive, the average level of productivity is well below that of most other OECD countries, indicating the dualistic nature of the economy. Productivity differentials have been maintained or even accentuated. With some exceptions -- notably in export-orientated manufacturing industries -- nearly all sectors have recorded lower productivity growth per worker than in other OECD countries, especially in those oriented towards the domestic market. In particular, the construction sector, which has benefited from generous government spending on infrastructure, had negative labour productivity growth, which is unusual among OECD countries (Table 1). The protected food manufacturing sector had basically no productivity growth in contrast to quite rapid expansions in other countries. The broad category of transport, storage and communication had markedly lower productivity growth than in other countries over the past decade, partly reflecting entry problems in some segments of the transport sector, although this was partially offset by an acceleration in the late-1990s of the liberalisation process in the telecommunication sector (OECD, 2001c).² On the other hand, a relatively rapid expansion of productivity in the distribution sector reflects changes in market structures as competitive pressures have increased. The direct links between liberalisation and productivity are not always easy to draw, but relatively less comprehensive regulatory reform in some sectors, especially utilities, may be one explanatory factor (Figure 1).

2. The markedly faster productivity growth in the telecommunication sector in the latter part of the 1990s reflects sharply falling prices (OECD, 2001a).

Figure 1. Progress in liberalisation of service sectors in OECD countries¹



1. In each year and sector, the indicators have a 0-6 scale ranging from least to most restrictive of competition. They cover public ownership, barriers to entry, market structure, vertical integration and price controls. See Nicoletti and Scarpetta (2003) for details.

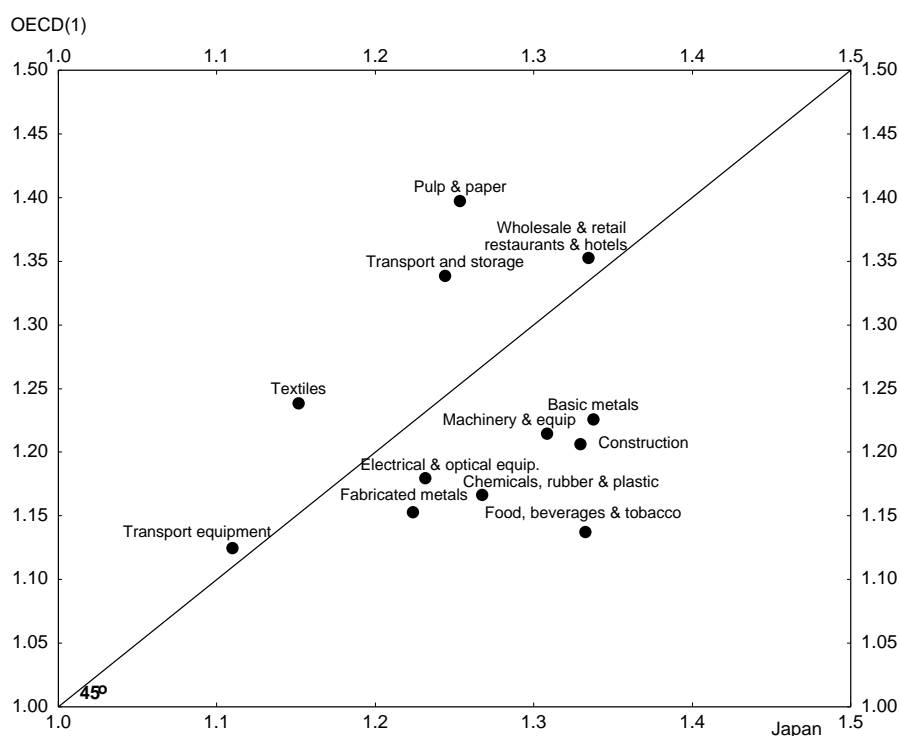
Source: OECD Regulatory Database.

A range of indicators point to a lack of competition

5. Measuring the strength of competition is not straightforward, but it is useful to survey available indicators that may, individually or in combination, convey some information on the strength of competitive forces in the economy. The evidence from such an exercise suggests weak competitive pressures. It is noticeable that sectors with competitive domestic markets also tend to be successful in export markets.

6. Estimates of *concentration* show contradictory patterns. At a relatively aggregated level, concentration is not particularly high in Japan, according to OECD estimates. On the other hand, concentration ratios at a more disaggregated level tend to be relatively high in a number of sectors, probably reflecting the legacy of an industrial policy geared on economies of scale effects (Ariga *et al.*, 1999). Moreover, there are some indications of an increase in the three-firm concentration ratio over the 1990s, and of relatively high degrees of market-share stability. These findings suggest limited rivalry in product markets, which is also supported by relatively high *mark-ups* (Figure 2). OECD work demonstrates that mark-ups are high in many industries, despite the tendency for them to decrease -- unlike in other countries -- in the 1990s. Compared with other OECD countries, mark-ups are significantly higher in such sectors as food and beverages and, to a lesser extent, metal processing and machinery and equipment.³ In addition, mark-ups in the service sector, particularly in construction and utilities, are internationally high. However, mark-ups are an incomplete indicator of competitive pressures, because rent arising from market power may be partly or largely absorbed in wages or other cost elements. In this respect, price level comparisons may also be important indicators.

Figure 2. **Industry-level mark-ups in Japan and other OECD countries**
From 1981 to the latest available year



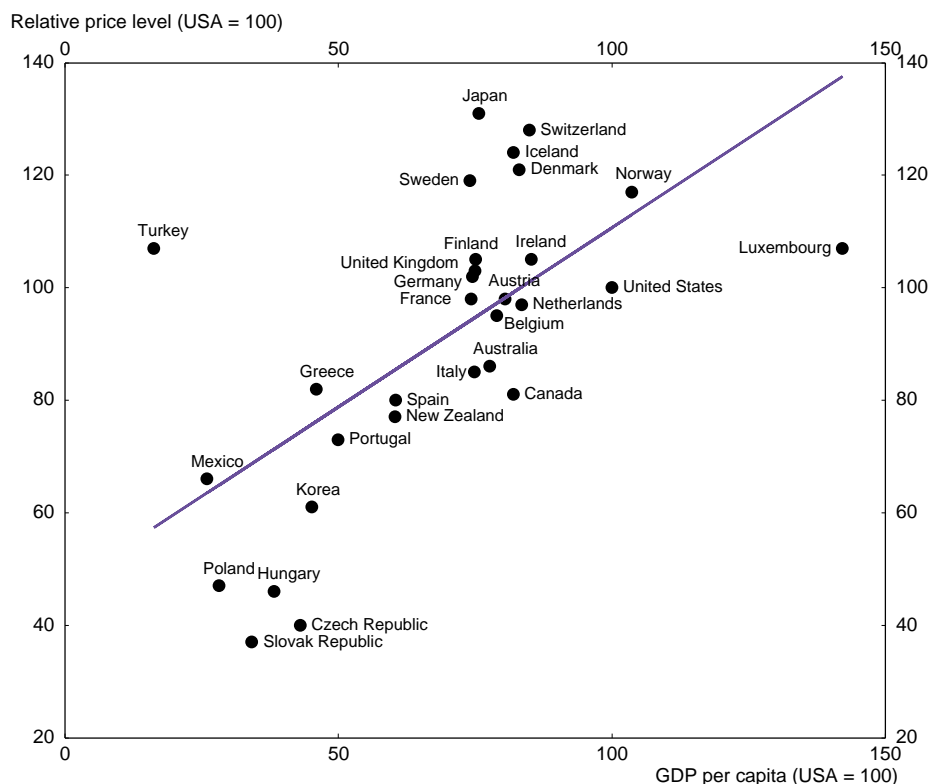
1. Average of Austria, Belgium, Canada, Finland, France, Germany, Italy, Netherlands, United Kingdom and United States. OECD estimates based on the Roeger method.

Source: OECD, STAN database.

3. These results are confirmed by OECD (2002a) and Ariga *et al.* (1999).

7. The overall *price* level has remained relatively high (Figure 3). Direct comparisons between the price levels in the early and late 1990s are imprecise due to definitional changes, but suggest that the relative difference with prices in the OECD has not changed much, although there has been some narrowing of the differentials for a number of privately produced services.⁴ This may be the result of increasing rivalry in depressed markets or the reduction of regulatory barriers in growing markets. When controlling for income per capita, average prices are about 40 per cent higher than expected.

Figure 3. **International comparison of prices**
Real incomes and relative prices, 2001 in purchasing parities



Source: OECD, Purchasing Power Parities.

8. With respect to *import penetration* and *inward FDI*, the Japanese economy is surprisingly closed, even when controlling for transportation costs and per capita income (Figure 4). The increase in the overall import-to-GDP ratio in volume terms has been smaller than in other OECD countries. Moreover, the import share for the manufacturing industry is well-below that of all other OECD countries. A further break-down by industry type reveals a particularly low import penetration ratio for industries with high

4. Comparing prices across countries is complicated by exchange rate movements. Using purchasing power parity (PPP) equilibrium exchange rates is a way to avoid being misled by short-term fluctuation in actual exchange rates. On the other hand, the current exchange rate for the yen has been over-valued against its PPP equilibrium rate for almost two decades. In 2002, it was about 20 per cent higher. An additional issue is that the price effects of exchange rate movements vary depending on whether the goods in question are internationally traded. For example, an appreciation of the yen would *ceteris paribus* lower energy prices in Japan relative to other countries, while for a non-traded good, the price differential would increase.

9. R&D intensities, as well as for some low R&D spending sectors, such as food manufacturing (Table 2). In particular, import penetration in segmented industries with high R&D spending, such as pharmaceuticals, is very low, even though these industries are normally associated with a high degree of international rivalry. However, in some cases this may reflect intense domestic rivalry as in the case of cars, where Japan is also internationally very competitive. Foreign rivalry is also not forthcoming through FDI inflows: Japan has the lowest inward FDI position in the OECD area (Figure 5). This reflects, in part, the past decade's low growth performance, but also the barriers to entry facing foreign firms.

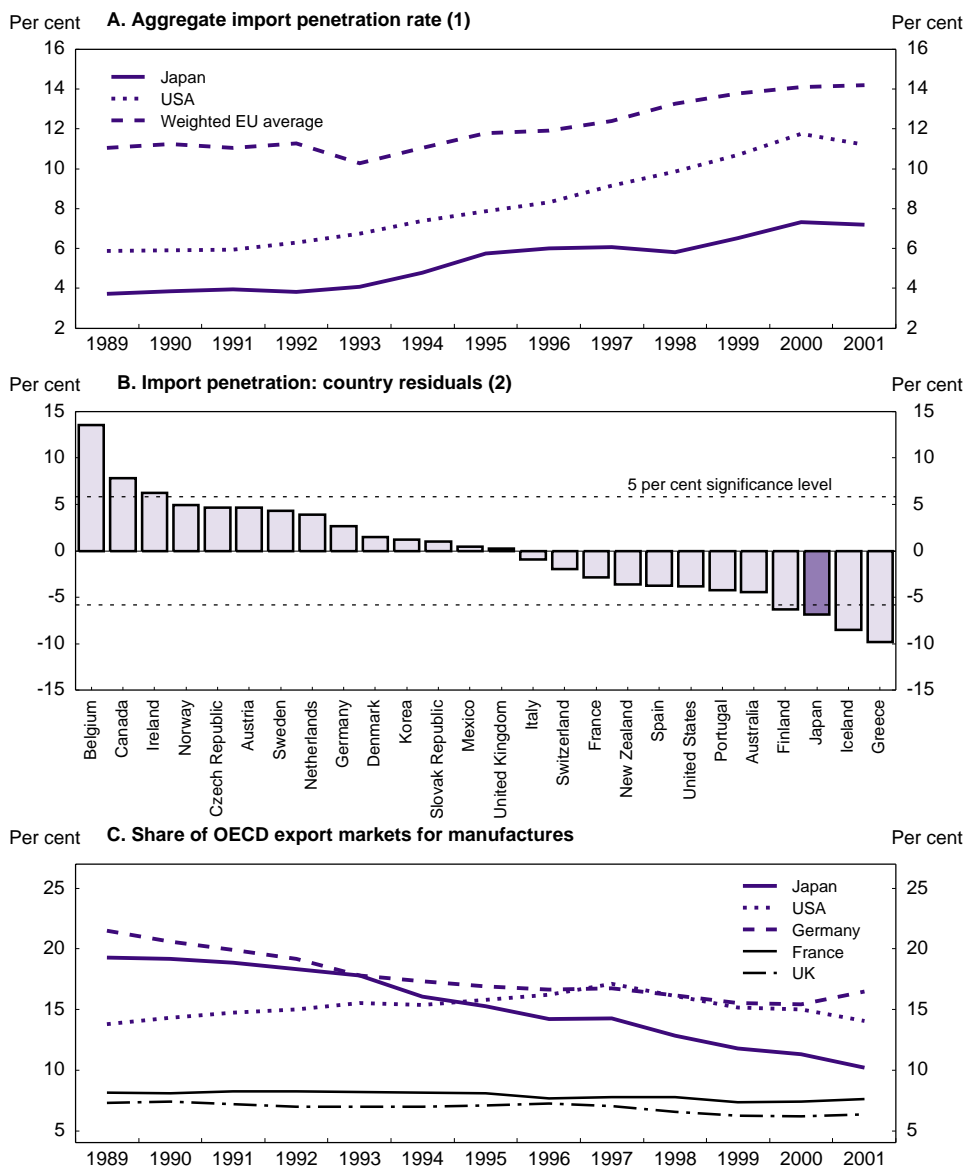
Table 2. **International comparison of import penetration by type of manufacturing industry**

	High R&D		Low R&D	
	Segmented	Fragmented	Segmented	Fragmented
Austria	51.9	42.6	27.9	29.5
Belgium	54.7	63.9	26.6	37.1
Czech Republic	43.3	41.3	25.8	25.7
Denmark	55.2	34.3	30.7	35.5
Finland	38.4	26.5	18.7	10.8
France	31.1	32.0	18.6	20.6
Germany	28.8	22.2	20.3	21.7
Italy	35.0	19.8	19.3	12.3
Netherlands	-	39.4	27.9	33.3
Spain	39.7	36.8	17.5	15.3
Sweden	34.9	30.0	25.2	17.8
United Kingdom	39.3	32.4	21.7	23.2
United States	26.4	22.7	10.2	14.4
Canada	44.2	55.9	21.0	22.9
Japan	8.0	7.2	8.4	8.7
Korea	20.0	38.5	14.4	13.7
Mexico	34.0	51.9	19.2	24.6
European average	39.9	34.1	22.3	22.9
OECD average	36.6	35.1	20.8	21.6

1. Segmented market structures are characterised by large firms and significant entry barriers associated with high costs, while fragmented market structures are characterised by small firms and low sunk costs and entry barriers.

Source: See Oliveira Martins, J., T. Price and N. Mulder (2003) "A taxonomy of market structure cluster", OECD Economics Department, mimeo.

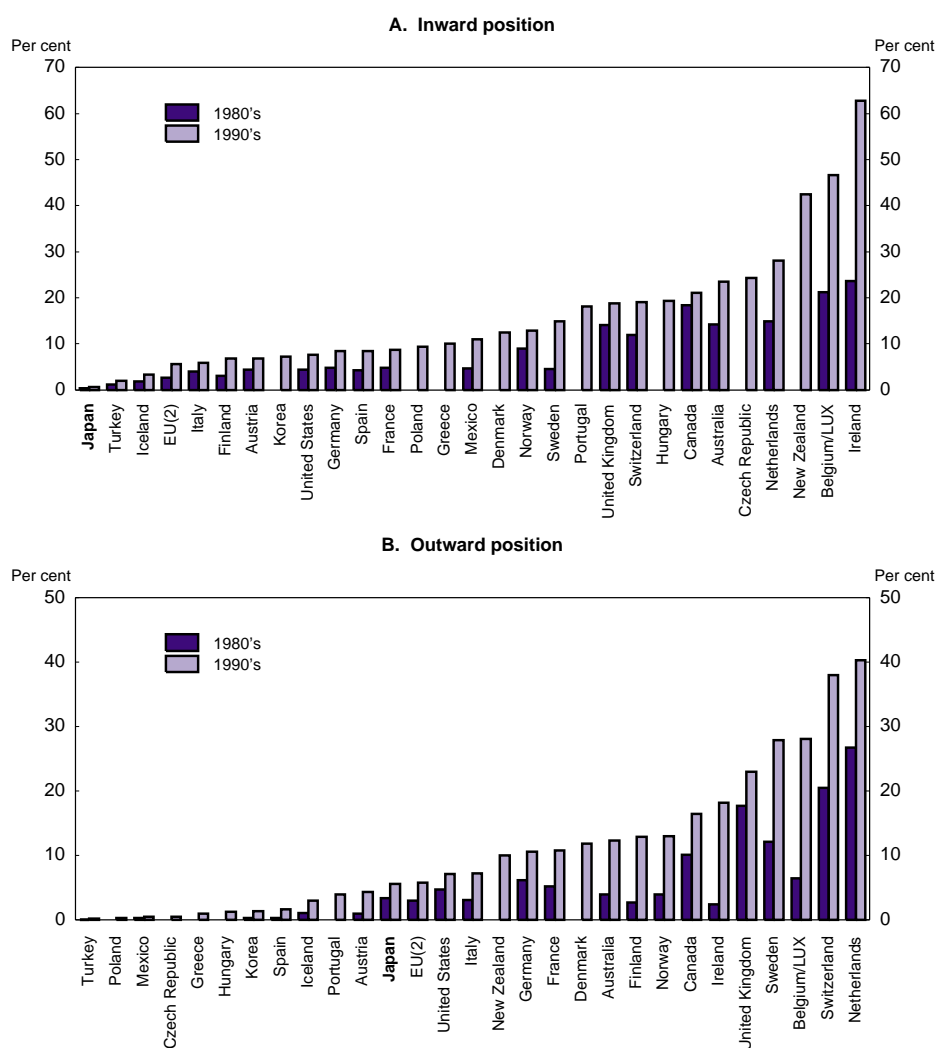
Figure 4. Indicators of market openness



1. Manufacturing imports relative to manufacturing imports plus GDP, excluding intra-EU trade.
2. Residuals after controlling for effects of country size, GDP per capita and transportation costs.

Source: OECD, Monthly Trade Statistics.

Figure 5. **FDI positions in OECD countries¹**
Per cent of GDP



1. Average values over the two periods. For countries where the FDI position data are not available, values of bilateral stocks reported by their OECD partners were summed to obtain an approximate measure of multilateral FDI stocks.

2. Excluding intra-EU investment.

Source: OECD.

10. Explicit trade barriers have been largely brought into line with those of other countries, but imports in some sectors are still hampered by differences in regulatory and administrative procedures.⁵ Such indirect barriers are difficult to quantify, but include factors such as the Japanese list of permitted food additives, which differs from the one agreed within the FAO/WHO Expert Committee on Food Additives, and differences in cosmetic standards.⁶ Empirical work on estimating the combined effects of all trade barriers and excluding unavoidable costs of international trade indicates that such barriers in Japan have pushed up average producer prices by nearly 60 per cent above the world level -- more than in other countries. Prices for food are particularly high.⁷ Interestingly, trade barriers were the lowest among major OECD countries in successful export industries, such as cars and office and computing equipment.

11. The low inward FDI position can be explained by explicit restrictions, such as ownership requirements, which remain relatively strict, although they are gradually declining (Figure 6). In addition, other features of the Japanese economy contribute to limiting inward FDI flows, including relatively high effective marginal and average taxation of inward FDI and the remaining restrictions against using foreign shares as compensation when purchasing Japanese shares.⁸ Administrative regulation tends to be concentrated in certain non-manufacturing industries, such as public utilities, telecommunication, financial intermediation, business services and the retail sector (Nicoletti *et al.*, 2003). Measures have recently been taken to encourage inward FDI.⁹ Recent OECD work indicates that more than half of the increase in inward FDI in Japan in the 1990s can be ascribed to an easing of explicit FDI restrictions and more pro-competitive product market regulation. Indeed, two sectors -- finance and insurance and telecom -- accounted for two-thirds of the rise in FDI inflows between 1990 and 2000.

12. The lack of competition in many domestic markets appears to have had a negative influence on Japanese exports as well. Starting from a very high base, the export market share of manufactured goods has declined by about 50 per cent over the past decade -- substantially more than in any other large OECD country. Only about half of this decline can be explained by the real appreciation of the yen. Examining the export structure in more detail shows that the fall in world export market shares has been broad-based with

5. Nicoletti *et al.* (2003) indicates that Japan has a relatively low average tariff and non-tariff barriers. Even in the relatively highly protected agro-food sector, applied tariffs are on average lower than in the EU, though higher than in the United States. However, tariff peaks for some important commodities, such as rice and dairy products, are much higher than in other places (Walkenhorst and Dihel, 2003). Taking into account the importance of different commodities, the producer support estimate (PSE) in Japan is considerably higher than in the EU and the United States (OECD, 2003). Domestic agricultural support as contained in the aggregate measurement of support (AMS) has been reduced to less than 20 per cent of the bound level.

6. Other OECD countries also have lists that differ from the FAO standard [EBC (2002) and European Commission (2002)].

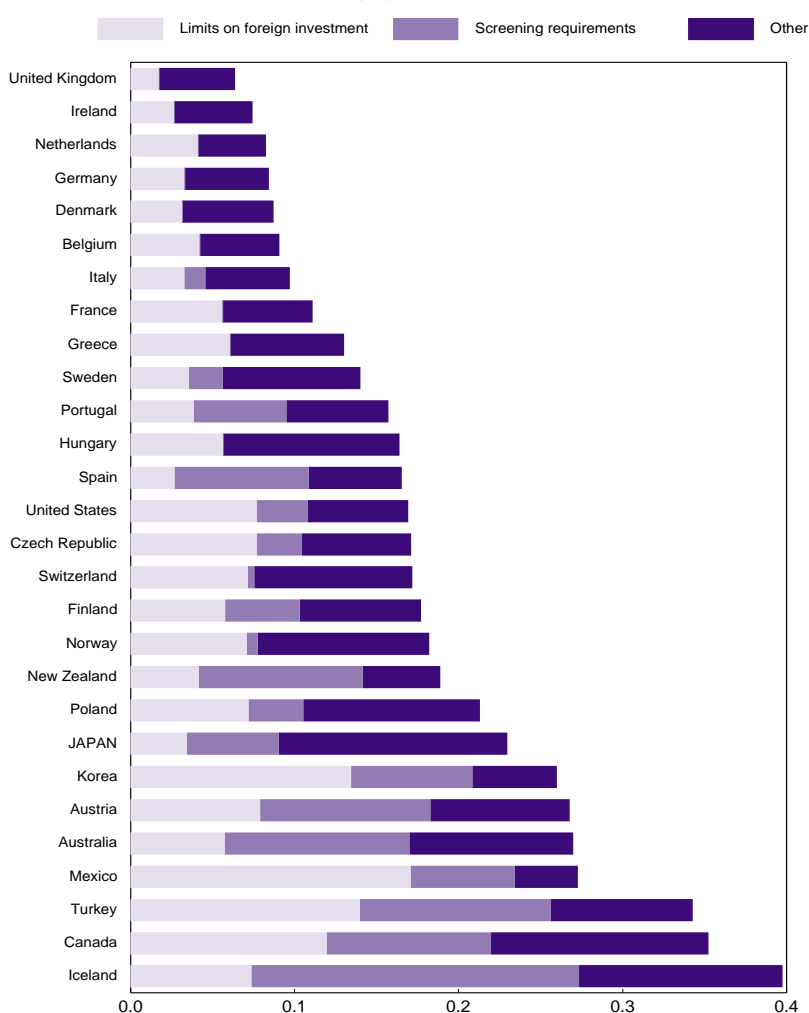
7. See Bradford (2003). It could be argued that the price differences reflect variations in market power, but the latter can only be maintained in the presence of trade barriers.

8. European Business Community in Japan (2002) also mentions non-transparent tax rules and benefit taxation, such as favourable taxation of stock options, which is not applied to foreign stocks. Other issues include the absence of tax relief for contributions to foreign pension plans and limited refunding of mandatory contributions paid to the public pension system upon leaving Japan.

9. To further promote inward FDI flows, a government committee proposed in its spring 2003 report specific measures to raise the attractiveness of Japan for foreign companies, such as the establishment of a streamlined support organisation for inward FDI with, for example, one-stop service centres to improve information flows and measures to satisfy foreigners' educational and medical needs, as well as to impose conditions for developing growth clusters. As a pilot project, five local areas have been selected to promote inward FDI mainly through public relation campaigns. On the other hand, support for outward FDI is mostly financial and is more generous and broader in scope than in other large OECD countries (Solis, 2003).

only about 10 per cent of Japan's export industries having increased market shares and almost none were in new and significant markets in terms of technology and size (Porter *et al.*, 2001). The diminishing ability to compete in important new markets has been related to non-competitive domestic markets, as this entails higher input costs for exporters as well as a smaller base for innovation in terms of goods and production processes (Sakakibara and Porter, 2001). Indeed, the notable Japanese export successes are concentrated in relatively few industries (such as cars), which are characterised by very competitive domestic markets. The outward FDI position is relatively high, reflecting the outsourcing of production to neighbouring countries. While this has also taken place in other OECD countries, the high cost of intermediate services (see below) has increased outsourcing incentives in Japan. Combining these trends indicates that as production has moved abroad there has been limited replacement via expansion of higher value-added goods and services through innovative efforts and growth of new sectors -- the very process that would make Japanese products less sensitive to price competition. The implication is that as Japan's highly innovative world leaders outsource production and foreign producers limit investment in Japan, the country is left with the less competitive and innovative sectors.

Figure 6. **Foreign direct investment restrictions¹**
By type



1. The indicator ranges from 0 (least restrictive) to 1 (most restrictive).

Source: OECD.

Enforcement of competition law is not strong enough

13. The lack of competitive pressures and disappointing performance of much of the domestic economy are consistent with the relatively low profile of competition policy and enforcement for most of the post-war period. The general competition law, the Antimonopoly Act (AMA), and the enforcement institution, the Fair Trade Commission (FTC), date from 1947. But for much of their history, central direction of investment and administrative guidance from ministries sanctioned industry-wide co-ordination and hundreds of exemptions from the AMA. Over the last decade, the FTC has become stronger and more active, but much still needs to be done.¹⁰ The FTC tends to focus its resources on selected areas and has recently targeted bid-rigging.

The scope and coverage of the law is fairly broad

14. Enforcement of the AMA's many tools has been strongly influenced by policy concerns about fair, as well as free, competition. The AMA's most basic antitrust rule, which prohibits "unreasonable restraints of trade" (Sec. 3), is used against horizontal price fixing and bid-rigging.¹¹ For nearly everything else, ranging from distribution restraints, discrimination and tying of products to refusals to deal and exclusion, the FTC uses the AMA's prohibition of "unfair practices" (Sec. 19). Here the burden of proof is lower, but the only sanction the FTC can impose is an order to correct the violation. The FTC mostly deals with abuse of dominance by treating large-firm abuses as "unfair practices."¹² This approach preserves enforcement resources for horizontal matters, but it may also be less effective at curbing monopolising practices than the prospects of fines or even divestiture that enforcers employ in Europe and the United States. Also, in practise, some of the FTC's interventions on dominant firm conduct seem tepid. In 1999, the FTC examined the airline industry, prompted by complaints about schedules targeted to undermine new entrants, as well as refusals to service their planes and discrimination in allocation of ground facilities. No action resulted, however, as the FTC "hoped that the three major airlines will exercise prudence... until the new airlines are able to compete equally with them." In other major jurisdictions, similar tactics by airlines have led to formal enforcement actions.

15. The most important limitation on the scope of the AMA is the system of exemptions for co-operative organisations of small and medium-sized enterprises (Sec. 22). The exemption depends upon compliance with AMA rules about the organisations' governance, and it does not extend to unfair practices or substantial restraints of competition that lead to "unjust" price increases. But enforcement against an SME co-operative for exceeding these statutory bounds is very rare.¹³ Although co-ordination among smaller enterprises could improve efficiency, a habit of overly-permissive exemption could reduce competitive pressure in what should be highly competitive settings. The number of exemptions has been reduced markedly (once there were over a thousand), and remaining ones are also common in most other

10. The Japanese Prime Minister Junichiro Koizumi stated in his general policy speech on 7 May 2001 that, "We will strengthen the structure of the Fair Trade Commission, which should serve as the guardian of the market, thereby establishing competition policies appropriate for the 21st century".

11. However, it may be relevant whether the restraint has been significant or whether it has had some actual effect. This factor makes enforcement more difficult in Japan than it is in jurisdictions with a true *per se* rule against horizontal price fixing. On the other hand, the rule prohibiting "unreasonable restraints" of trade is similar to the basic rule under the US Sherman Act.

12. Restructuring and divestiture of monopoly firms appear to be authorised, but this part of the law is never applied. Other means for regulating industry investment structures are vestiges of the AMA's recently-repealed ban against holding companies.

13. SMEs also benefit from an exemption that permits agreements to prevent "excess competition" in personal services such as hair cutting and from another that permits agreements in the liquor business.

jurisdictions. But repealing an exemption will not by itself change industry behaviour overnight. Harbour services provide an example, where the exemption was abolished in the late 1990s, but the industry association is still trying to control entry and police competition. Recognising the particular risks of anticompetitive activity by trade associations, the FTC has paid close attention to violations by these groups, applying a provision of the AMA that prohibits them from imposing any “substantial restraint on competition.” Members will be required to pay financial sanctions where the association has violated the law. In the past, some trade associations have received multiple cease-and-desist orders for repeated infringements (Box 1).

Box 1. Organisation and activities of trade associations in Japan

There are a relatively high number of well-organised trade associations in Japan. They are organised by industry, firm size and geographical location. At the broadest level, there are umbrella associations, encompassing whole industries at the national level, that provide industry information to member firms, secure contacts with ministries (often playing an active role in the formulation and dissemination of ministerial guidance) and facilitate the building of relationships between executives from other parts of the industry. Under the umbrella, industry branches are organised in core associations with an estimated 90 per cent of all firms within an industry affiliated to the relevant association. The legal status of the trade associations can either be voluntary, incorporated (recognised as legal entities and often used by national umbrella associations) or co-operative. The latter enjoys certain exemptions from the AMA and is an organisational form that is widespread in the distribution sector. Most of the incorporated associations have retired officials from the regulating ministry among their leading staff, as compared to about half in the case of voluntary associations. This staffing pattern may create problems of regulatory capture as the law mandating a two-year cooling-off period for retired officials (before they can be employed in an industry which they previously regulated) is not applied to non-profit organisations. In the mid-1990s, there were about 15 400 notified trade associations, of which nearly 14 per cent were incorporated. At the national level, there were about 3 100 trade associations, compared to about 2 100 in the United States. Their financial resources are substantial with an average annual budget of \$4 million per nation-wide association.

Political activities of the trade associations are usually left to the national umbrella associations, while economic regulation activities are normally pursued at the level of the core associations and co-operatives. In ranking their key functions, most associations consider the provision of administrative information and promoting friendship, often through social events among their members -- supposedly competing companies -- to be among their primary activities. Indeed, in the past the majority of cartel cases prosecuted by the FTC have involved trade associations. Most associations are organised around relatively narrowly defined activities, making interaction between competitors multi-levelled and frequent; one research project found that members of 37 associations had 1 100 employees meeting on a monthly basis. The formal points of interactions are the board meetings of the associations (consisting of directors from the leading companies), committees with middle to lower-level staff representatives from the member companies, and staff seconded to the associations. As the boards of directors have to keep minutes of their meetings, a number of the revealed price cartels have been organised at the committee level. This was the case of fee collusion in the Money Market Broker Association, where the actual fee-fixing agreement was reached in the “R&D” subcommittee (Schaeede, 2000).

16. The FTC issues guidelines in line with the AMA covering trade associations’ activities to specify where legal self-regulation ends and illegal activities begin, stipulating in particular that the trade associations are not allowed to restrict the functioning of the market nor individual firms’ business activities. However, the FTC must still rely on case-by-case judgements, as the trade associations’ primary and legal function is to establish rules and restrictions within their industry. In addition, some self-regulation came into force under ministerial guidance and with the ambiguous application of legal measures, there may be a risk that the associations are not aware of when their activities are in breach of the law. Furthermore, the role of the trade associations and their self-regulation has gained a larger role over the past years as ministerial guidance has been partially withdrawn and there has only been a relatively limited increase in the FTC’s resources. Insofar as such self-regulation is confined to norm setting and other information enhancing activities, they could have a pro-competitive impact. However, when the activities of the trade associations interfere with operational activities of the firms, there is a risk that they curb competitive forces, such as when the Harbour Transportation Association has to approve

change of service providers (see below). Only an active regulatory stance by the FTC, combined with the introduction of legal measures aimed specifically at breaking cartels, can curtail such anti-competitive activities.

17. The FTC can enforce the AMA in the newly deregulated network industries. The exemption for “inherent monopoly” was removed in 2000 in the context of the liberalisation of the electricity sector. But the *ex post* nature of AMA enforcement makes it poorly suited to dealing with competition issues in newly deregulated network industries, in which supporting entry usually requires *ex ante* oversight. In telecommunication, the FTC has issued guidelines jointly with the Ministry of Public Management, Home Affairs, and Posts and Telecommunications to clarify and to describe conduct that would violate both the AMA and the telecom law. Co-ordination with sectoral regulatory authorities is evidently informal and developing. For example, guidelines for the telecommunication sector call for mutual communication between the FTC and sectoral regulatory authorities but do not establish formal protocols or rules with respect to joint action, deferral to one or the other body in particular cases, or agreement between them on findings about market power. So far, the FTC has been cautious in applying the AMA to activities in the network industries. In 2000, and again in 2001, the FTC examined claims that the incumbent telecom firms were discriminating against entrants in the provision of ADSL facilities and services, but issued only a warning. At some point, the FTC may have to treat repeat offenders sternly enough to change their behaviour.

18. If a government entity is involved in anticompetitive conduct, it is difficult to correct it using the AMA, unless the activity is organised through a commercial enterprise. The difficulty is illustrated by the new law about public officials’ responsibility for bid-rigging. The FTC can order the procuring agency to investigate the situation, and can require the agency to take disciplinary action against the individual official involved and even to demand indemnity from the official (after the agency’s own investigation). However, the FTC has no power to issue a fine or other sanction against the agency or the official, and if the local government ignores the FTC’s requirement or order, the only consequence it faces is the embarrassment of bad publicity.¹⁴ The recent reform thus still falls short of giving the competition authority the legal power to correct problems associated with public procurement. More generally, there is no unified framework in place to supervise the public tendering process.

19. The AMA’s merger control rule prohibits mergers whose effect may be to restrain competition substantially in any particular field of trade. The FTC, however, virtually never issues a formal decision about a merger as its enforcement process relies on advance consultation and negotiated correction.¹⁵ When problems are worked out in advance and in a confidential manner, official public filings almost exclusively appear for mergers that the FTC approves. Keeping the parties’ plans confidential until they know that the FTC will approve them probably makes the enforcement process more efficient in terms of building mutual trust, minimising costs of publicity, and reducing the risk of publishing market sensitive information. The FTC has tried to adopt transparent guidelines and its reports have tried to explain the reasons for its decisions about major transactions that become public knowledge. These steps nevertheless fall short of revealing clearly how and whether the standards in the law and guidelines are applied to block mergers; indeed, it is unclear from this process if the FTC ever actually takes that step. The FTC has published its policies dealing with the informal consultation process, by setting a timeline for advising the parties whether a merger requires more serious investigation and possibly relief. It represents a significant step

14. The official might face prosecution, if the misconduct amounts to corruption.

15. There has only been one formal FTC decision rejecting a merger in more than 35 years. Only large mergers are subject to prior notification. After a size threshold was added to the AMA in 1998 (combined assets or turnover over 10 billion yen, and 1 billion yen for the acquired party), the number of mergers requiring prior FTC notification dropped by 90 per cent.

toward the two-phase process that is becoming standard in other major jurisdictions.¹⁶ The FTC devotes less attention to merger investigation than do enforcers in other jurisdictions, and the public reports of FTC action imply that it takes a more tolerant approach as well, accepting commitments or conditions that seem unlikely to provide significant assurance that competition problems from a merger will be corrected.¹⁷

Despite increased resources, the FTC's activities remain limited in scope

20. The FTC was created as an independent body by law, but the perception of its independence has been compromised by its position as an external organ of the Ministry of Public Management, Home Affairs, Posts and Telecommunications. This problem is further highlighted by the FTC's enforcement responsibilities in newly liberalised network industries, which are often regulated by the same ministry. Recently, the FTC has been moved back to a more clearly independent position, by making it an "extra-ministerial body" of the Cabinet Office. Historically, the FTC's five commissioners have been civil servants, although now two of them come from academia. Selecting commissioners from a wider range of backgrounds helps restore the perception of its independence. About 10 per cent of the staff come from other ministries, and many of them serve in rotating, temporary positions at the FTC. These personnel practices, which are also used in other parts of the government, have some advantages, such as facilitating exchanges of view, but relying too much on staff from other ministries could make it more difficult for the FTC to build up expertise and to demonstrate independence from the policy priorities of other parts of the government. The resources available for competition enforcement have steadily increased over the last decade. Even so, they may still be insufficient, in kind if not in amount, for dealing with an economy as large as Japan's. The FTC staff level for FY 2003 is 643, compared to 478 in 1991. Although the total is now exceeded only by the US antitrust enforcers and the EU (including both the staff of the European Commission and the Member country agencies), the FTC contends that it needs several hundred more people. More important than the number of staff is their expertise. The FTC now has only a few graduate-degree economists on its staff. For sophisticated economic analysis, including policy advocacy projects, it often must rely on outside experts. The FTC has begun trying to bring in experts with experience in law and economics by offering fixed-term contracts.

16. Another merger processing proposal pending in early 2003 would shorten the examination period for reviewing certain acquisitions under the Act for Special Measures on Industrial Revitalisation.

17. In a recent merger case, the FTC accepted the involved parties' pledge to admonish their staff to obey the law in the future.

21. The enforcement process seems informal, but some of that informality represents a realistic accommodation to the delays and costs of full proceedings. Most enforcement orders and financial sanctions are imposed through “recommendation” decisions, which are issued when the parties do not contest the FTC’s claims and proposed relief. If the respondent rejects the recommendation, the case goes to a hearing process, presided over by a hearing officer from the FTC (or even the FTC commissioners themselves) in order to separate the functions of prosecution and decision-making. The full hearing process typically takes too long -- two years or more -- for time-sensitive matters such as complaints about network access, so these must often be resolved with only a non-binding warning. To obtain criminal penalties (fines or imprisonment), the FTC must refer the case to the prosecutor’s office, initiating a process that would conclude with a decision by the court. That process can take many years. The FTC appears to have adequate means to obtain evidence for its own administrative hearing processes, including dawn raids. However, to obtain evidence for criminal prosecution the FTC must refer matters to the prosecutor, who subsequently needs a search warrant issued by a judge. It might be more efficient to use the criminal investigation process in the first instance. That would require changes in law, either to authorise FTC investigators to use these criminal process methods themselves or to involve the prosecutor’s office at an earlier stage of an investigation, before the FTC makes a formal referral.

22. In theory, a wide variety of sanctions, punishments, relief, and private lawsuits may be applied to competition law violations in Japan.¹⁸ There are no obvious conceptual or jurisprudential constraints on the use of strong sanctions. Yet in practice, although the law seems to threaten violators with heavy damages and even imprisonment, reluctance to impose severe sanctions means that deterrence is much weaker than would appear. Most enforcement matters are resolved with a non-coercive, non-binding “warning” or even just a “caution”. In the 1990s, the FTC resorted much more to stronger, more formal measures, especially in the area of serious horizontal violations, but their deterrent effect may still be inadequate. The most important remedial measure available to the FTC is a “surcharge” for violations such as price fixing, which is computed as a percentage of the firm’s sales of the affected product during the period of the restraint. When the surcharge system was first adopted, the surcharge rate of only 1.5 per cent looked like a cartel license fee. The current rate, which is 6 per cent of covered commerce -- but only 3 per cent for small and medium-sized enterprises and 1 per cent for retailers and wholesalers -- is still low compared to fines imposed in other major jurisdictions, where the amount of the fine can be tailored more closely to the party’s unlawful gains or its victims’ losses.¹⁹ Surcharges may nonetheless be a much more important deterrent in Japan than fines, which would typically be significantly smaller. Fines are criminal penalties, and thus they can only follow a conviction by a court. They only apply to restraints imposed by a trade association or in violation of Sec. 3. Even though the maximum possible fine was recently increased to 500 million yen for an organisation, such as a company, it remains much lower than similar fines in other major jurisdictions. The theoretical criminal penalties are of little practical importance. Fines of any magnitude, against companies or individuals, are almost never imposed, and prison sentences, which are even rarer, have always been suspended. No one has ever gone to jail for violating the AMA.

18. Experiences with private suits for damages have been disappointing. A new kind of private suit has been introduced, where consumers or businesses may seek an order to correct or prevent unfair practices by firms and restraints imposed by trade associations. Citizens can also bring actions to recover losses due to practices such as bid-rigging.

19. In other jurisdictions, actual fines are much larger, with the largest fine ever issued by the EU set at nearly 900 million euros (imposed on the vitamins cartel in 2001). Moreover, the maximum fine in the EU is considerably larger than in Japan, as it can reach 10 per cent of the previous year’s world-wide turnover.

23. The FTC has been considering whether to adopt a formal leniency program, offering lower sanctions to violators who come forward early, to make enforcement more effective. A necessary prerequisite for a leniency program is discretion about bringing an action or setting the sanction, so that the enforcer can be lenient in appropriate cases, for example, by reducing or forgoing surcharges. This would require changes in the law, because the surcharge is conceived now as a fixed administrative charge that the FTC cannot vary. Japan's criminal law does not usually countenance the use of leniency in this fashion, so that any leniency program would most likely be applied only in administrative proceedings. It might be necessary to create an administrative fine under the AMA. Another measure could be to offer leniency to an individual, such as by agreeing not to recommend prosecution or offering compensation for lost income, in order to obtain evidence about corporate violations. A draft law to protect such "whistleblowers" against retribution from their employers is under preparation.²⁰ However, these potentially important technical aspects of an effective leniency program are ultimately less important than the enforcement climate. The promise of leniency is an effective tool only if the threatened sanction that is avoided is substantial and credible. Recognising that the enforcement "stick" in Japan has been too fragile to deter anti-competitive conduct effectively, a working group is now engaged in a comprehensive review of the entire system of administrative and criminal remedies. The likely focus of attention will be the level of surcharges and the potential for adapting the surcharge system to a leniency program, rather than increasing the criminal penalties. The implications of supplements, such as private recoveries, should also be considered. Deterrence requires that the violator face a risk of having to pay, not just the amount of its gain, but a multiple of that amount, to correct for the difficulty of detecting the violation and taking action against it.

24. The FTC has concentrated its attention on the violations which cause great economic harm, namely horizontal cartels and bid-rigging. The most frequent target of enforcement action is bid-rigging in the construction industry with enforcement activity appearing to have peaked in 2001 (Table 3). Visible enforcement results may have slowed because these can also be the most difficult violations to detect and prove.²¹ Despite this high priority, though, and admitting the difficulty of the cases, the results have been meagre. For several years, the FTC has announced a crackdown on horizontal violations and a general policy of seeking criminal penalties against them (FTC, 2002). The FTC is now pursuing dozens of bid-rigging matters every year, but it appears that the prosecutor can only handle one case at a time, with the last filed case pending since 1999 (against 11 firms and nine individuals for rigging the bids to supply jet fuel to the Self-Defence Agency). Unless that capacity expands greatly, criminal penalties against horizontal cartels and bid-rigging cannot be applied credibly.

20. This issue was highlighted in a recent case in the food industry, where imported meat was re-labelled as domestically produced meat. A participating company revealed the scandal and received an order to stop operation for one week from the relevant ministry. Furthermore, the firm was considered as a "traitor" and boycotted by other firms, and eventually went bankrupt.

21. An econometric study of the FTC's enforcement instruments found that only targeted warnings about particular products had some effects on lowering mark-ups (Ariga, K. *et al.*, 1999).

Table 3. **FTC enforcement activity**

	1999	2000	2001	2002
Completed investigations	111	66	101	81
Caution	41	33	32	36
Warning	29	12	21	16
Formal measures (order or surcharge)	32	18	42	23
Bid-rigging	22	9	36	17
Other cartel	3	2	3	3
Unfair practices	5	5	3	3
Private monopolisation	0	1	0	0
Other	2	1	0	0
Trade association involved	2	1	0	0
Total surcharges imposed (billion yen)	18.4	9.2	3.8	2.7
Rescinded, for hearing (billion yen)	11.7	1.9	0.8	0.3
Criminal referrals to prosecutor	2	0	0	0
Hearings initiated	7	8	18	61
Decisions after hearings	4	31	5	7

Source: FTC Annual Reports to OECD; FTC Report to the Diet (2003).

25. The most common complaint received at the FTC is about excessive discounts in retailing, and the FTC is particularly vigilant against “unjust low price sales” (predatory pricing strategies).²² These issues, along with enforcing laws about misrepresentations and protection of subcontractors, occupy a considerable share of the FTC’s attention -- amounting to nearly 3 000 cases per year -- as measured by the number of actions taken, if not by time and resources.²³ Applying the Premiums and Representations law involves a degree of industry self-regulation through nearly a hundred fair trade associations and their fair trade codes. The FTC authorises and monitors these institutions and attends their annual meetings. Such self-regulation may alleviate information asymmetries – particularly important as Japanese consumer interests are poorly organised -- but the FTC’s active, but uneasy, participation may make a tough stance against horizontal agreements look like a reversal of policy. The surprisingly large number of FTC actions against price cutting would not inspire confidence in consumers that competition enforcement is promoting their interests, as they risk making the FTC appear to be complicit in practices that sustain comparatively high prices. Laws and institutions protecting consumers in Japan need to be strengthened. Giving that responsibility to the FTC could help to focus competition law enforcement on consumer interests, too.

22. Most of these cases are about sales below invoice price and are usually resolved by warnings. Most cases involve liquor sales -- in 2001, there were 2 500 cases in that sector alone -- and gas stations. In addition, the FTC still brings over 100 cases per year about “premiums”, as well as about 300 per year against other kinds of misleading advertising. The FTC’s strongest remedy against misrepresentations is an order. The criminal law about unfair competition is enforced by the police and prosecutor, and applies only to trademark or country of origin violations.

23. The assiduous attention to unfair competition from discounting in the liquor industry is oddly inconsistent with the toleration of European geographic terms in the marketing of Japanese-produced alcoholic beverages.

Regulatory policies at the sectoral level

26. Regulatory policies in domestic service sectors vary in scope. Retail distribution and professional services are inherently competitive sectors, but entry controls and self-regulation may hamper the development of competition. To increase competition in these areas, it is important to remove exemptions from the competition law and apply it forcefully. On the other hand, network industries have segments with “natural monopoly” where competition is difficult -- or even impossible -- to introduce, directing regulatory efforts to ensuring non-discriminatory access to networks for third parties and opening potentially competitive segments to competition. International experience has shown that the gains from regulatory reform in network industries are potentially very large, although to be realised careful attention must be paid to the design of such reforms.

Retail distribution

27. One of the reasons for the high price levels in Japan is -- despite corrections over the past decade -- a relatively inefficient retail distribution sector, which is further characterised by a number of what appears to be collusive practices by producers. To be sure, structural changes in the sector have increased its productivity over the past decade, reflecting an increase in the number of relatively large stores, the replacement of mom-and-pop shops with more vertically integrated franchise systems and a strong increase in discounters.²⁴ New entrants are primarily found in the non-food segment of the retail sector and are an important competitive force as they often purchase directly from producers, thereby bypassing the multi-layered distribution channel. This process frequently includes applying new information technology to control stocks, requiring producers to provide frequent delivery of relatively small amounts of goods (Maruyama, 2000). Moreover, new market opportunities opened up for discounters with the easing of licensing conditions for liquor and drug sales as well as the removal of the regulation that had permitted resale price maintenance for drugs, cosmetics and other products.

28. The productivity level in the sector remains, nevertheless, comparatively low with a relatively high outlet density and low number of employees per establishment (Table 4). Moreover, the sector's productivity has been estimated to be about half of the level in the United States (Aoki *et al.*, 2000). In the broader distribution sector (including wholesale), the productivity level is lower than in most other countries. Despite liberalisation of entry and declining land prices, which induced a reduction in the share of small shops from 68 to 58 per cent of all establishments during the 1990s, the prevalence of large stores remains relatively low, even compared to Europe.²⁵ The shortage of large-scale outlets due largely to insufficient deregulation at local levels has been identified as a key factor behind the low levels of productivity in the retail sector (Aoki *et al.*, 2000).

24. Official data may not fully cover new entrants as the Census survey is only published every three years and may thus underestimate the sector's productivity increases.

25. In the large-store segment, it is only recently that a few foreign companies have entered the Japanese market, although franchises entered much earlier. For example, the 7-Eleven franchise came to Japan in 1973 and subsequent strong growth made it considerably larger than in the United States. The American parent was bought by the Japanese licensee in 1995 and subsequently revived it through the implementation of marketing strategies developed in Japan, focusing on such factors as cleanliness, freshness of products and improved stock management (Sparks, 2000).

Table 4. Key structural features of the retail distribution sector, 2000

	Outlet density ¹	Employees per enterprise	Wholesale and retail distribution, total value added per employed person	Non-specialised stores ²
				Share of total output in real distribution (per cent)
Austria	43	7.7	90	20
Belgium	80	3.5	114	35
Denmark	47	8.1	79	39
Finland	46	5.0	82	44
France	64	4.2	87	37
Germany	35	9.0	75	23
Italy	130	2.2	101	31
Netherlands	54	8.5	81	
Portugal	150	2.5	66	31
Spain	133	2.8	71	32
Sweden	65	4.3	79	34
United Kingdom	36	14.2	68	43
European Union	71	6.3	83	35
Japan	111	5.7	74	16 ³

1. Number of enterprises per 10 000 inhabitants.

2. Includes large-format outlets such as hypermarkets and department stores.

3. Only share of large stores.

Source: Eurostat, New Cronos, Japan Statistics.

29. The Large-Scale Retail Location law²⁶ to regulate entry is applied to all stores with a retail space larger than 1 000m² -- an internationally low threshold -- inducing new entrants to establish relatively small supermarkets and discount stores. The law opens up the possibility for local incumbents to restrict entry by referring to environmental concerns (traffic congestion, waste collection, etc). Local governments have few incentives to exercise their appeal possibilities, partly reflecting local competitors' political clout. Furthermore, certain trading practices by producers may restrict competition and reduce productivity in distribution (Box 2). Thus, to improve the retail sector's productivity requires both a further relaxation of the large-store regulation and a strong regulatory stance by the FTC to remove anti-competitive practices.

26. The full name of the law is the Law Concerning the Measures by Large-Scale Retail Stores for Preservation of the Living Environment.

Box 2. Potentially-harmful trading practices

Certain trading practices, which are often embodied in the self-regulation issued by trade associations of producers, give them a set of tools to hamper competition by direct price setting, determining the allocation of retail outlets and restricting new entry. These include the “standard price system”, rebates, return of unsold goods, and vertical affiliations from producers to retailers. The *standard price system* can take the form of (often binding) suggested retail prices, resale price maintenance or after-sales price adjustment, where final transaction prices are only settled when the product is sold on the retail market.¹ The *rebate systems* are dependent, in some cases, on the volume sold or share of turnover, which creates incentives for retailers to carry only one brand or product, restricting entry opportunities for other producers. Similar problems arise with the practice of *return of unsold goods* at no costs. Some of these practices were established during earlier exemptions from the AMA. In general, they are illegal if involving coercion, which the FTC typically has had problems in proving.

Other trading practices may restrict competition in distribution by establishing discriminatory practices and are often linked to trade associations’ self-regulation. These include boycotts, vertical non-price constraints (such as customers, geographical, or advertising restrictions, etc), tie-in sales (forcing the purchase of other products) and reciprocal and exclusive dealings (excluding third parties). The actual anti-competitiveness of these measures is generally difficult to demonstrate, as coercion and a certain degree of market power have to be present (Schaede, 2000). This type of self-regulation can, when combined with the Premiums and Representations Act and the FTC’s own traditional policy priority of supporting fair, as well as free, competition, lead to some curious outcomes. Reportedly, a soft drink producer in the early-1990s wanted to under-cut the soft drink industry’s rules to promote its product against well-established brands. The producer asked its distributors to undercut the price-related agreements of the industry association, of which the producer was not a member. The association complained to the FTC that the producer was undermining the industry’s self-regulation. Schaede (2000) reports that the FTC’s observations were interpreted as meaning that even non-members are bound by the rules that the industry developed, effectively leading a non-member to abide with self-regulation. According to the FTC, non-members cannot be bound by associations’ self-regulation.

1. The system is stable with specialised and exclusive links between firms, whereby if profits are squeezed too much in one link of the system, then that part can impose switching costs on the other links by withdrawing.

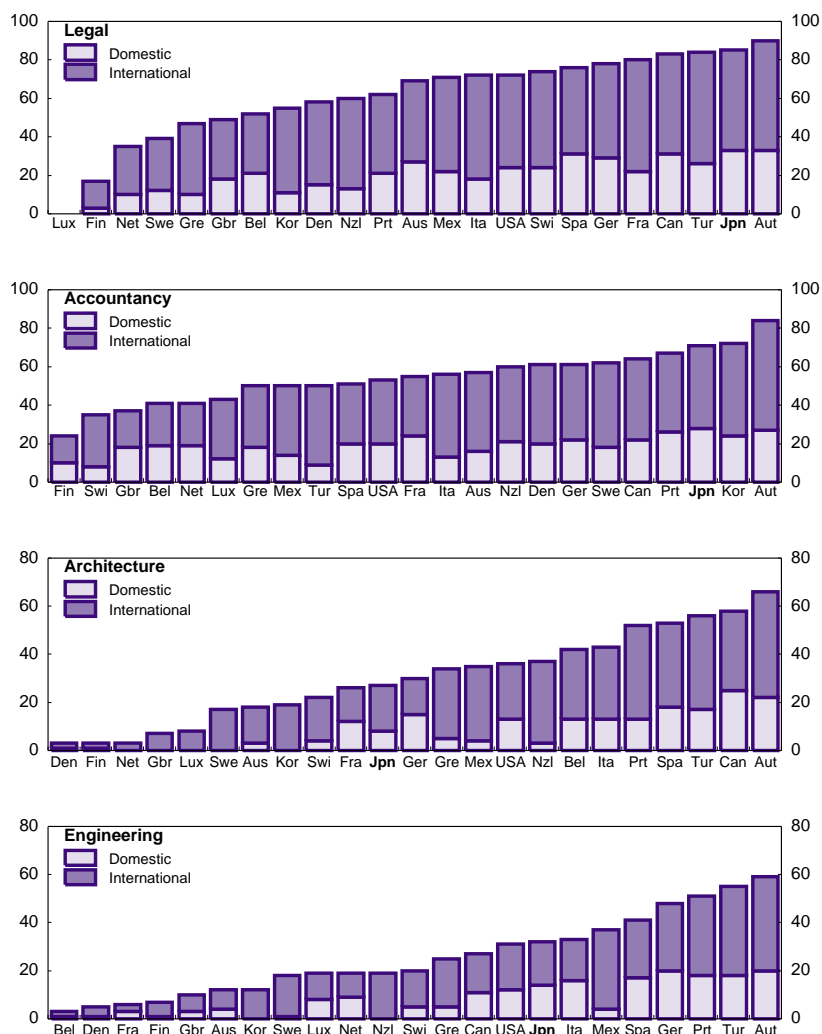
Professional services

30. Self-regulation in *professional services* is relatively common in OECD countries as a means to alleviate information asymmetries, to protect consumers and ensure high quality services. However, self-regulation may also hamper competition’s role in ensuring efficiency. In Japan, membership in self-regulating professional associations is compulsory for eight professional services, including lawyers and accountants.²⁷ The regulation in the latter two services used to be among the most restrictive among OECD countries (Figure 7). However, measures are being taken to ease regulations of professional services. The compulsory stipulation of standard fees in the associations’ rules is in the process of being removed, which should help make fees more responsive to market developments. This is further reinforced by the expected removal of the remaining regulation restricting advertising, which continues to be relatively widespread in many other OECD countries. Nevertheless, other elements of self-regulation may continue to hinder competition in these services, such as the very high qualification requirements in the exams to become lawyers (equivalent to the Anglo-Saxon bar examination) and certified accountants, leaving Japan with a very low supply of both.²⁸ Recent measures aim at expanding the number of graduates through easing requirements and to establish law schools (supplementing universities’ law departments) but these are unlikely to improve the situation significantly in the short and medium term.

27. The self-regulating professional services comprise certified public accountants, administrative scriveners, lawyers, judicial scriveners, land and house investigators, licensed tax accountants, public consultants on social and labour insurance, and patent attorneys.

28. For example, relative to the population there are five times more lawyers in France and ten times more accountants in the United States than in Japan (OECD, 2002b). The situation is further compounded by the barriers placed on foreign lawyers trying to establish businesses in Japan.

Figure 7. Regulations of professions: restrictiveness indices for OECD countries¹



1. Country order ranked by restrictiveness of legal services regulation.
Source: Nguyen-Hong (2000).

Network industries

31. Liberalisation of network industries has become internationally widespread over the past decade, generally inducing substantial price reductions. There are examples of less successful reforms or outright failures, although these are mostly related to design problems of deregulation rather than liberalisation *per se*. In Japan too, network industries have been deregulated but remain less open to competition than in many other countries. The regulatory framework, reflecting the traditional prescriptive stance, used to be geared towards such issues as supply-demand balancing in the energy sectors and securing universal service provision. Recently, however, the policy stance has begun to change towards introducing competition.

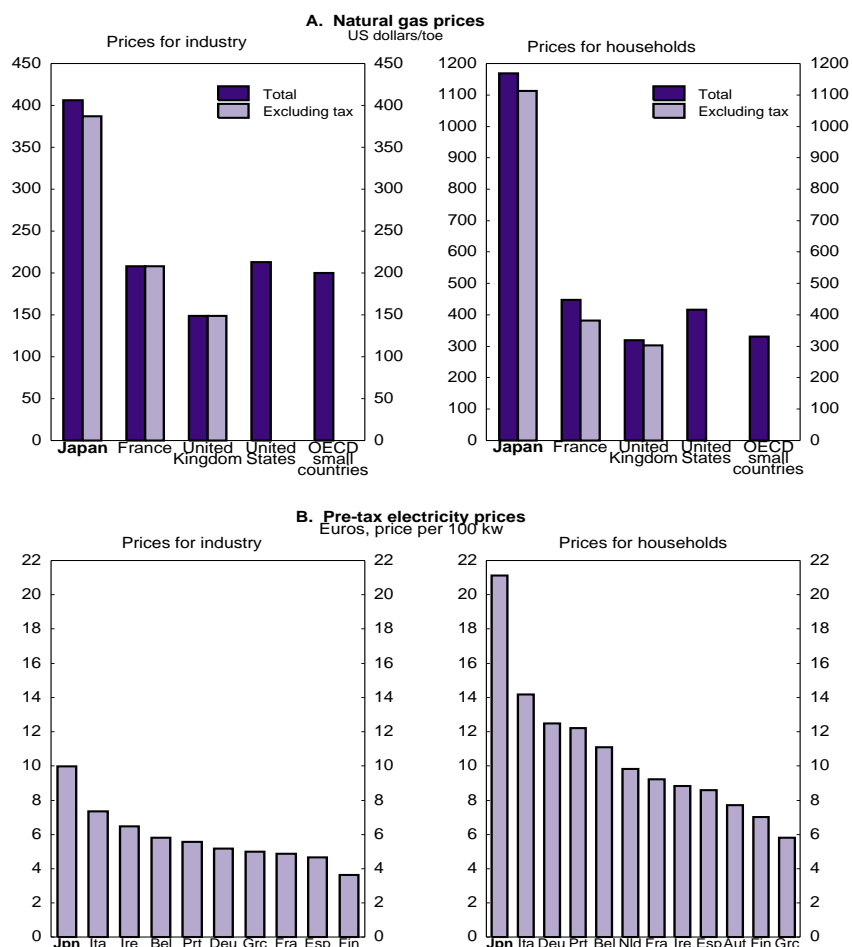
The energy sectors

32. Parts of the energy markets have already been successfully deregulated with the liberalisation of oil imports in 1996. This led to a collapse of an implicit import cartel. Over the following 3½ years, pre-tax retail prices were reduced by more than one-third despite roughly unchanged crude oil prices.²⁹ The electricity and natural gas sectors are in the process of being opened up. Free supplier choice for very large business consumers is already allowed, and this option is being gradually extended to smaller business consumers by 2005 (electricity) and 2007 (gas). Discussion for full liberalisation will start in April 2007 based on the experience to that date. Presently, there are no concrete plans to extend the opening to household consumers. The Ministry of Economy, Trade and Industry (METI) continues to be the regulator (approving tariff increases on the basis of rate of return regulation and with a notification requirement for price decreases in place since early 2000) and is responsible for securing energy supplies as well as for technical and safety regulations, including setting standards for lowering CO₂ emissions. The economic gains from achieving fully competitive energy markets are likely to be large as energy prices in Japan are considerably higher than those prevailing in other countries (Figure 8). Part of the high energy prices are explained by very prescriptive regulation that sets internationally high standards.³⁰

29. The Temporary Law on the Import of Specific Oil Products was abolished in March 1996, which removed a regulation that only allowed oil refining firms located in Japan to import gasoline, kerosene and diesel oil (Nagaoka and Kimura, 1999). Another example of successful deregulation in the energy area was the decision to allow self-service in petrol stations in the mid-1990s.

30. For example, maintenance regulation requires that natural gas turbines are completely disassembled for inspection every 30 months -- a regulation not duplicated elsewhere and not recommended by the manufacturers. Maintenance regulation for nuclear power is also more restrictive than in other countries. Additional factors increasing energy prices include internationally high construction standards even when compared with other countries affected by seismic activity, as well as time consuming land purchasing procedures and multi-layered permit collection processes at several level of government (IEA, 2003).

Figure 8. Energy prices in an international perspective



Source: OECD, Energy Prices & Taxes, 2002, Eurostat and OECD calculations.

33. A characteristic of the *electricity market* is that, in response to high electricity prices, on-site generation (so-called auto-generation) in the manufacturing industry covers about a third of the sector’s demand. On the other hand, liberalisation has so far only led to a limited number of new entrants and no direct competition between existing utilities has developed.³¹ This is partly because market structures are not promoting competition as the industry is dominated by ten vertically integrated utilities of generation, transmission, distribution and retail supply, which each enjoy near monopoly status within their respective electricity regions. This status arises from the limited converter capacity between the two frequency areas and the restricted interconnection capacities both within and between electricity regions.³² This has led to an extensive use of “pancaking” -- adding charges on top of each other -- by the incumbent, a practice that the government has taken measures to stop.

31. As with most newly liberalised markets in other countries, new entrants have been subjected to a number of discriminatory practises, including problems of accessing supply, high access tariffs, lack of dispute settlement mechanisms and rigid balancing rules. In addition, new entrants face problems such as regulatory uncertainty, ineffective unbundling and a lack of independent transmission system operators.

32. The northern part of Japan is served by electricity at a frequency of 50 Hz as compared with the 60 Hz used in the western part of the country. Moreover, interconnection was historically only established for security of supply reasons as each utility was required to be self-supplied within its supply area. Moreover, most of the existing transmission capacity is reserved for the utilities (IEA, 2003).

34. The March 2000 amendment to the Electricity Utility Industry Law allowed free supplier choice for high-voltage customers and regulated third-party access, where the utilities determine the access tariffs on the basis of METI regulations. The tariffs have to be notified to METI. Nevertheless, new entry has been prevented by high third-party access charges, amounting to more than a quarter of retail prices -- a higher share than can be observed in more competitive electricity markets.³³ This approach contrasts with a system of independent transmission system operators in charge of setting access tariffs -- an approach that is considered to be a prerequisite for the development of competition in most other OECD countries. An amendment to the electricity law with the purpose of increasing competition was passed by the Diet in June 2003. The amendment covers regulation for transmission, balancing, system access and operation. Moreover, measures to ensure accounting unbundling of vertically integrated utilities will be obligatory from April 2005 to secure the prohibition of cross-subsidies and prevent discriminatory treatment of new entrants. A "neutral transmission system organisation" -- with representation of all market participants -- will be established with many of the responsibilities of an independent network operator, such as implementing system operation, transmission and distribution rules.³⁴ Moreover, a spot electricity market for day-ahead delivery and forward contracts will be established, although the success of this measure obviously depends on developing interconnection.

35. Recent international experience has revealed the need for carefully formulated reforms, pointing to the benefits of a step-wise approach. At the same time, to realise all the benefits of reform, it is important that reforms are implemented within a well-defined time framework. Reforms in the electricity sector must be multi-faceted in order to bring about markedly lower prices. Installing market structures to promote competition requires the effective separation of presently vertically integrated utilities to avoid cross-subsidisation of competitive activities with profits obtained in monopolistic market segments. The government aims at achieving this through accounting unbundling between generation and distribution, while not excluding formal separation if fair and effective competition does not emerge. However, international experience indicates that accounting separation has not sufficed as it contains a large judgemental element and is difficult to verify because of asymmetric information, suggesting a need for legal or ownership unbundling. Similarly, separation of retailing and distribution activities must be introduced if small customers are to enjoy the benefits of liberalisation. It should be noted that problems of instability of supply and insufficient network capacity experienced in countries with formal separation were due more to defects in regulatory frameworks than the nature of separation. In addition, it would be desirable to create an independent -- financially as well as politically -- sector regulator in ensuring non-discriminatory access to the electricity network by potential entrants (such as auto-generators in the manufacturing industry). However, this would require an expansion of the present interconnection capacity, pointing to some need for additional infrastructure investments. Existing owners of the network have little incentive to undertake such an expansion, as enabling new entry would only increase competitive pressures. Thus, part of the strategy to install structures to promote competition should be to collect networks in a separate company. The emergence of a competitive electricity market would enhance incentives to better exploit existing generation capacity, inducing companies to increase the use of pricing

33. An element of competition has been introduced in electricity generation, where the incumbents must allow independent power producers to participate in a tendering for ten-year contracts. Such contracts have delivered electricity prices 10 to 40 per cent below the tenders' maximum upper limit.

34. Current balancing rules constitute an entry barrier because of potentially high cost. The rules require new entrants to balance supply and demand in every 30-minute slot with a maximum tolerance of 3 per cent. In case of a shortfall, the incumbents are allowed to charge 1½ times the normal price for supplying the additional energy. Surpluses above 3 per cent are not compensated for by the incumbents. In case of more prolonged imbalances, the new entrants risk paying a fixed annual fee, which in some cases can reach 2.4 billion yen.

strategies to reduce peak loads, as well as to improve efficiency.³⁵ To prevent the adoption of time consuming delay tactics, it is important to have a rapid and impartial dispute settlement framework.

36. Japan is one of the largest *natural gas* consumers in the world and the structure of the industry is characterised by many, mostly private, vertically integrated regional companies with little interconnection capacity among regions, as pipeline networks are not very developed.³⁶ The 2000 revision of the Gas Utility Law opened a bit more than one-third of the market to competition as large industrial consumers were allowed to choose suppliers and negotiate rates. Subsequently, 11 new gas suppliers have entered the market, gaining a combined market share in the liberalised segment of about 2 per cent. The amended Gas Utility Law will enter into force in April 2004, introducing regulated third party access (TPA) to gas pipelines and negotiated TPA to LNG terminals, with pipeline owners having to notify standard TPA contracts to METI and terminal owners having to publish manuals for TPA.³⁷ Moreover, non-discriminatory access is intended to be secured through accounting unbundling, information firewalls and a prohibition against discrimination. To stimulate investments in pipelines, new pipelines will be exempted from the TPA obligation or be allowed to have a higher rate of return in their TPA tariffs for a limited time period. The amendment also includes a time table for further opening of the gas market in two steps to reach 50 per cent in 2007. Moreover, the current *ex ante* METI approval for acquiring a client from another gas company's supply area is proposed to be changed to an *ex post* notification obligation, with the possibility of an administrative METI prohibition order if the transaction has a significant impact on prices for captive consumers.

37. Gas liberalisation can potentially yield very high consumer surpluses as prices converge with international prices. Moreover, the importance of gas as an input in manufacturing and in electricity generation means that the supply-side effects of liberalisation will have a ripple-through effect through direct price reductions in the manufacturing sector and indirectly as electricity becomes cheaper. However, to reap these benefits and in view of international experiences with deregulating network industries, the reform process should be reviewed. An independent sector regulator should be established to ensure proactive *ex ante* regulation. Moreover, effective unbundling of vertically integrated gas utilities is difficult, as in the electricity sector, and should be ensured through formal, rather than accounting separation. The client notification requirement is overly prescriptive, with a potentially high regulatory cost if METI reverses a transaction. Moreover, the requirement is hardly needed as in other countries similar problems are dealt with through licenses to distributors, stipulating transparent and equal conditions for all players. International experience with negotiated TPAs is relatively limited and in some cases, like in Germany, the approach is in the process of being reconsidered as dominant incumbents have been able to maintain high access charges. The limited entry possibilities for new LNG terminals (existing terminals have ample capacity and the supply of suitable and available sites is limited) give present terminal owners a strong bargaining position, indicating that non-discriminatory access to LNG terminals should be secured through regulated TPA. Obviously the construction of an inter-connected pipeline network is the prime objective in the process of creating a competitive gas market. Allowing higher profits on new pipelines for a limited time period should stimulate this development. However, the very high construction cost is a concern and points to the need for addressing problems in the construction sector. A change in the currently very strict government safety regulation and standards in line with international experience could further reduce costs.

35. The May 2000 Action Plan for Economic Structural Reform identified load factor levelling as a key measure to reduce the high cost of electricity. The reform's line of action includes new technologies in air conditioning and load levelling, adjustable electricity tariffs, and public information campaigns.

36. See IEA (2003) for a more detailed discussion of the energy situation.

37. METI and FTC will establish joint guidelines to facilitate voluntary negotiation for TPA to LNG terminals.

The telecommunication sector

38. A decade after the formal opening of the telecommunication sector, the liberalisation process accelerated in the second half of the 1990s by reorganising the incumbent into a NTT holding company of four service providers (NTT East Corporation, NTT West Corporation, the long-distance provider NTT Com and the mobile phone service provider NTT DoCoMo). This has also encouraged a sharp increase in inflows of FDI in this sector.³⁸ The telecommunication business law was revised during the summer of 2003 with the principal aim of abolishing *ex ante* regulation for non-dominant carriers and the prior permission system, as well as to remove the regulatory distinction between network-owning and leasing carriers, which should ease entry into the market. Prior to that, rules for (accounting) unbundling, unrestricted collocation (including physical access to facilities) and asymmetric regulation had been put in place to secure non-discriminatory interconnection. The system of asymmetric regulation implies strict rules for dominant incumbents concerning determination of tariffs (price-cap regulation), authorisation and disclosure as well as legal “firewalls” and a code of conduct, while non-dominant carriers are only subject to prior notification and disclosure requirements.³⁹ In addition, a dispute settlement commission has been created, which should further secure interconnection in a rapid and efficient manner.⁴⁰

39. Prices for all services have declined considerably and rental charges for line sharing are even among the lowest in the OECD area, contributing together with other measures -- like pre-selection (known as “My-Line” system in Japan) -- to lower charges for local calls to levels at least comparable with those prevailing in other OECD countries.⁴¹ Nevertheless, at current exchange rates, telephony prices for both business sector and residential users remain among the highest in the OECD area, while charges for mobile phone services are also in the high category in the OECD area (Figure 9).⁴² The emergence of new service providers and the low rental charges for line sharing are the two factors shaping competition in the telecommunication sector. The former increases choice and allows cost-conscious consumers to obtain favourable deals, while the latter is boosting broadband penetration, bringing it from one of the lowest in the OECD area at the end of 2001 to one of the highest (Figure 10). Broadband charges are among the lowest in the OECD area, and the connections provided in Japan tend to be much faster. The latter enables broadband not only to provide fast Internet connections, but also very low cost (IP) telephony services, thereby putting further downward pressure on service prices.⁴³

38. Inflows of FDI increased from only 2.1 billion yen (\$19 million) in 1996 to around 800 billion yen (about \$7 billion) in 2000 and 2001.

39. The code of conduct and the legal firewalls are put in place principally to prevent abuse of proprietary information from competitors so as to ensure equal treatment of outside companies seeking interconnection..

40. The Telecommunications Business Dispute Settlement Commission was established as an independent body in late 2001 and consists of five commissioners appointed by the Ministry of Public Management, Home Affairs, Posts and Telecommunications, subject to Parliamentary consent. The Commission’s functions include mediation and arbitration in industry disputes as well as interaction with the above ministry with respect to administrative rulings. In addition, the Commission can make recommendations to the minister with respect to changing regulation to further competition.

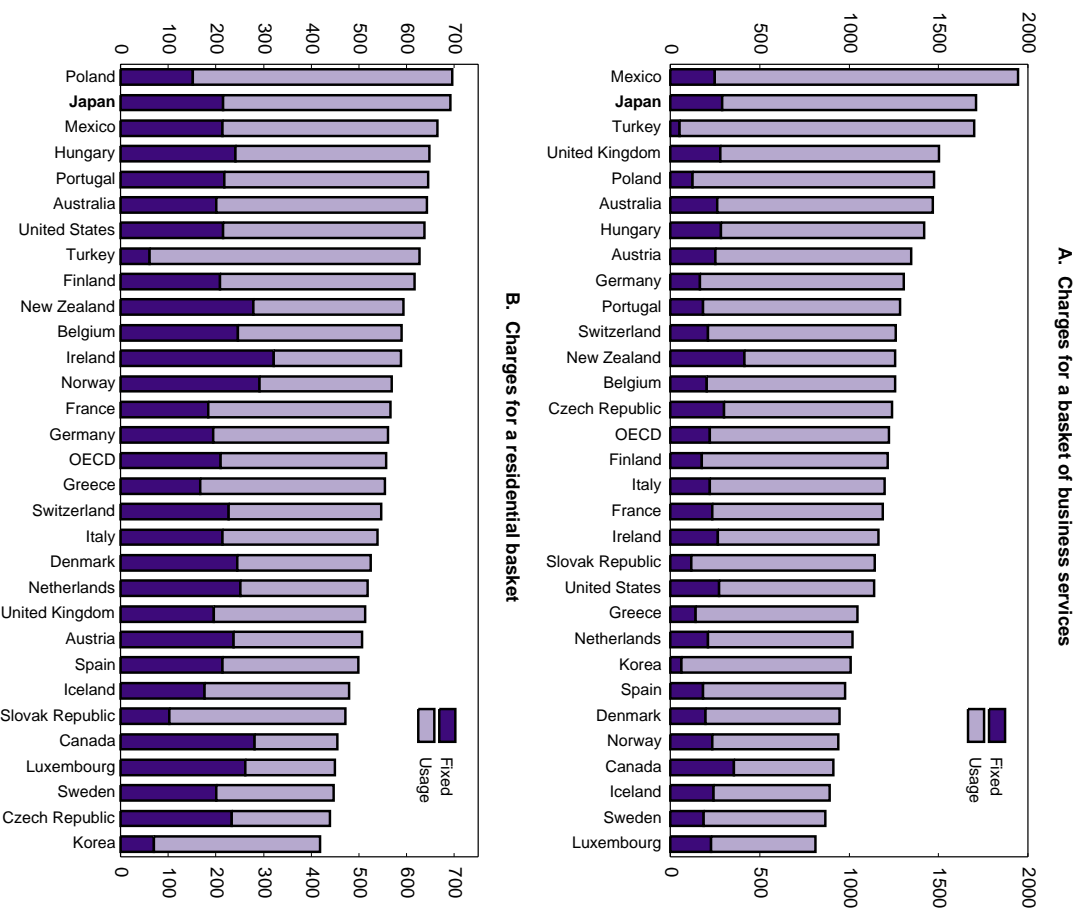
41. The background for the very low line-sharing charges is to be found in a previous high once-in-a-lifetime connection charge that customers paid the first time upon becoming a NTT customer. It has been argued that this has financed NTT’s infrastructure and consequently line-sharing charges should only reflect maintenance and other variable cost.

42. Measuring telecommunication prices at purchasing power parity exchange rates indicate lower prices for Japan. See also footnote 70.

43. One provider is offering international calls for an internationally low 7½ yen per minute. Moreover, the incumbent NTT has a smaller share of this market segment than in other large OECD countries.

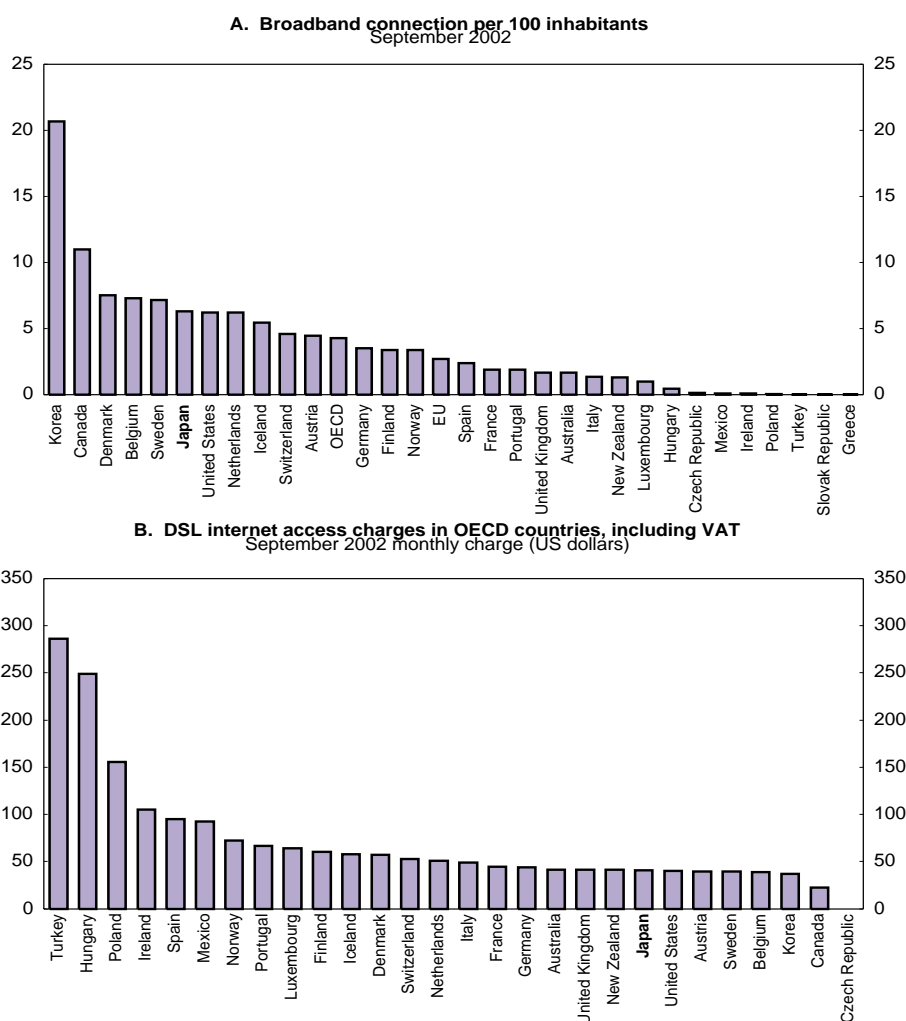
40. To further sustain these positive developments, a number of regulatory issues should be addressed. As in other network industries, the regulatory challenge is to secure non-discriminatory access to areas of the sector, such as the local loop that are difficult to subject to competition because of the incumbent's dominance. Regulatory efforts should also concentrate on setting non-discriminatory interconnection charges, which is the case when they recover associated costs for each network operator. In Japan, the Long Run Incremental Cost (LRIC) method used at present aims at achieving this objective. However, substantial pressure has emerged from special interest groups to maintain a common nation-wide telephony interconnection charge, for universal service reasons, even though this would lead to a cross-subsidy between NTT East and NTT West, which have different cost structures. This points to the benefits arising from the complete structural separation of NTT East and NTT West. Another area of concern is the termination charges for mobile phones – which are higher than best practice in Europe -- where calls originating from the fixed-line network and terminating in the mobile network take place in an inherently non-competitive situation as the calling party has no alternative and the receiving party is not concerned. Reflecting this lack of competition, other countries have started to regulate termination charges. For example, the British telecommunication regulator has recently imposed price cap regulation to more than halve the termination charges over three years. Moreover, the practice of having mobile phone service providers determine all telephony charges between mobile phone and fixed line networks was recently replaced by the common international practice of having charges determined by the originating network's operator. This will introduce an element of competition through potential customer switching. However, experience from Europe indicates that in practice such pressures only have a limited effect on termination charges. Most of the restrictive regulations will be abolished by, at the latest, the summer of 2004. The promotion of competition in a network industry like telecommunication requires the active implementation of *ex ante* regulation, which is best carried out within an independent regulatory framework.

Figure 9. **Telecommunication charges in the OECD**
US dollars, August 2003



Note: Composite basket that includes international calls and calls to mobile networks.
Source: OECD and Teilgen.

Figure 10. Broadband penetration and user charges in the OECD



Notes: Commercial ADSL service was not available in the Czech Republic, Greece and the Slovak Republic. Modem rentals, where applicable, are excluded as in most countries these can be purchased by users.

Source: OECD.

41. Ownership restrictions on NTT's share elaborated in the NTT law stipulate that the government must always hold at least one-third of all shares in the holding company.⁴⁴ The latter must in turn own all shares in NTT East Corporation and NTT West Corporation on grounds of ensuring the provision of universal services. Foreign ownership of NTT holding is restricted to a maximum of one-third of all shares. Substantial government ownership of the dominant incumbent discourages the emergence of vigorous competition, as private companies will refrain from effective price competition due to the associated political risks and as the subsidiaries of the holding company are unlikely to compete against each other. To ensure the provision of universal telecommunication services, a Universal Service Fund can be established for each area to which all carriers with a turnover exceeding 1 billion yen must contribute.⁴⁵

44. Currently, the government holds 46 per cent of all shares in the holding company NTT Corporation.

45. No universal fund is presently in operation as neither NTT East nor NTT West have applied to become the designated carrier. The scope of universal services includes subscriber line access, emergency bulletin

Similar compensation systems have been installed in other countries. However, the associated payment for providing universal services should be set as the difference between the cost of universal service obligation and associated benefits, such as brand recognition. Otherwise the transfer becomes a subsidy. The net cost of a universal service obligation can be small as is the case in the United Kingdom, where OFTEL (the telecommunication regulator) reached the conclusion on the basis of a cost-benefit analysis that the net cost was so marginal that no compensation would be made -- a decision that was accepted by the incumbent. Another approach is found in Germany, where the government states that the supply situation is satisfactory, so no operator is required to provide universal services, although Deutsche Telecom is the *de facto* universal service provider.

Postal services

42. The market for postal services has been liberalised. There is already free entry into the parcel and special letter segments and in principle there is also free entry to the standard letter segment. However, new entrants are subject to part of the same universal service obligation as the -- recently incorporated -- incumbent, implying that new entrants have to install and service nearly 100 000 letter boxes across the country (European Commission, 2002).⁴⁶ Moreover, regulatory costs are high in the letter market as the ministry approves new entrants and their business plans and new entrants are obliged to provide prior notification of their tariffs.⁴⁷ Furthermore, even if new entry took place, there would not be a level playing field as the incumbent is subject to a special, more favourable, tax regime. Some sort of a corporate tax should in principle be paid by the incumbent, but is due only every four years and can be waived if it harms the financial stability of the corporation. No new entry has taken place so far in the non-competitive standard letter segment, while 18 companies have obtained business permits for the competitive segment. Prices for standard letters in September 2003 were about one-third higher than the average of other large OECD countries. In contrast, prices in the competitive markets were on average equal to those in other large OECD countries, reflecting higher prices for inter-city handling of small packages (less than 2 kilos) and lower prices for intra-city packages.⁴⁸ This price pattern implies that benefits from further liberalisation of the postal market are likely to be substantial, particularly in terms of expanding consumer welfare. It also points to the potential risk of cross-subsidisation, particularly in view of the provision of non-postal services, through the extensive network of post offices.⁴⁹ For the provision of such non-postal services, Japan Post receives what is in principle cost-based commissions, although cost estimates are likely to be distorted as it has only been subject to commercial accounting standards since its incorporation in April 2003.

services and public telephone services. The latter is defined as one public telephone for each 500m in urban areas and 1km outside urban areas.

46. The incumbent (Japan Post) must provide a wider range of services, including services requiring special handling such as mail for the blind.
47. The borders between various mail services are defined in the guidelines issued by the ministry rather than specified in the law. Thus, an additional concern is that the ministry -- in connection with a revision of the guidelines -- can extend its regulatory powers to areas that are presently less regulated, such as business mail for advertising new products.
48. See www5.cao.jo.jp/seikatsu/koukyou/towa/to07.html. There are some indications that these price differentials have narrowed somewhat recently.
49. There are nearly 25 000 post offices which provide post, postal savings and life insurance services as well as a wide range of other government services (such as payment of pensions, issuance of resident cards and lottery tickets) and even some private-sector services like compulsory liability insurance for motorcycles. As in some other OECD countries, post offices in less densely populated areas are operated by private operators as "franchises", who often also provide other commercial services (OECD, 1999).

43. The lack of competition in postal services was pointed out in a report by the Study Group on Government Regulations and Competition Policy, which recommended that the conditions for fair competition should be secured through the application of the competition law. However, to reveal cross-subsidisation often requires substantial regulatory effort which, together with the need for *ex ante* regulations to secure non-discriminatory access, points to the need to establish an independent sector regulator. Naturally, the effective market foreclosure and *de facto* tax exemption do ensure universal services, but as indicated by the high prices for postal services this is a very costly solution. Moreover, many of the services provided could easily be delivered through other networks, such as financial retail institutions or convenience stores. Thus, the provision of universal service obligations should be evaluated in terms of the cost of provision and the benefits of a nation-wide network. In Sweden and New Zealand, for example, the benefits of owning nation-wide networks are considered to be larger than the associated costs and the incumbents receive no compensation for their obligations.⁵⁰ In case the cost is higher than the benefits, the compensation for the universal service obligation should take the form of a fiscal transfer from the government, ensuring that no cross-subsidisation would arise from the servicing of marginal areas. This would level the playing field in other segments of the postal market, removing the need for imposing the universal service obligation on all operators, as the possibility of cream skimming would no longer exist. Moreover, if competitive tendering for the universal service obligation were introduced, then a mechanism is put in place to secure increasing efficiency in the provision of such services. An additional issue is to secure unrestricted access to the incumbent's essential facilities and services, which in a number of OECD countries has led to the establishment of explicit access regimes.⁵¹ Experiences from other countries suggest that a sector regulator is more effective in preventing incumbents from engaging in anti-competitive measures, such as selective discounting, tying or bundling.

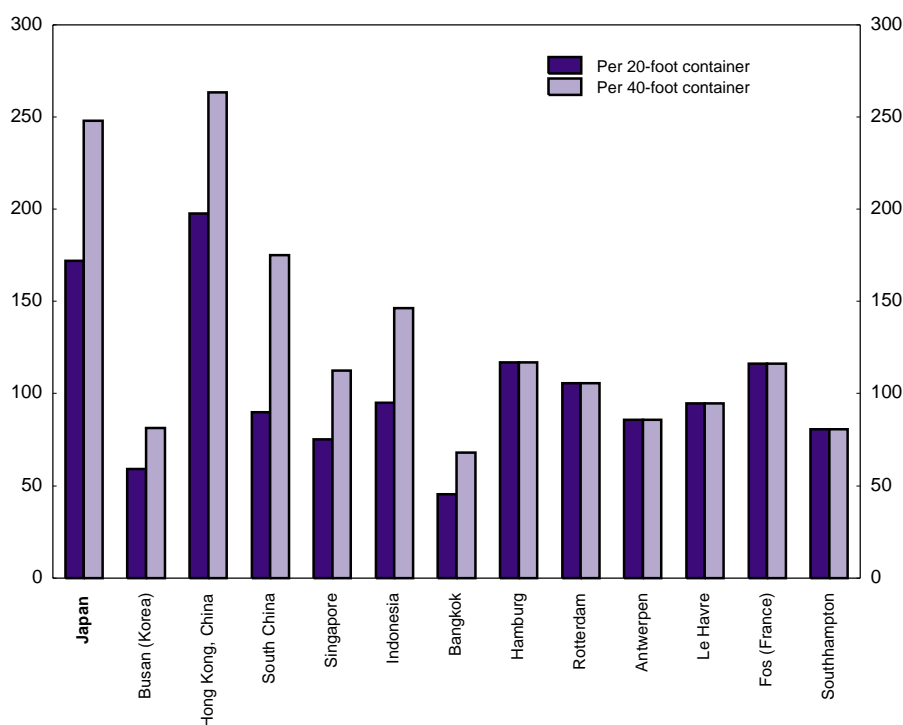
Selected issues in the transportation sector

44. The costs of using Japanese *harbours* are among the highest in the world. Fixed costs of services (tugging, berth rental, etc) are high, and rental cost of other infrastructure (offices, cranes, etc) are administratively determined by the local government owners. Variable costs such as terminal handling charges are also very high by international standards (Figure 11). These high prices originate from the lack of price competition between Japanese harbours. Operation charges are subject to a prior notification requirement to the Minister of Land, Infrastructure and Transport for the largest harbours and an approval requirement for other harbours, preventing the development of flexible pricing-to-the-market strategies. The Japanese Harbour Transportation Association (comprising all service providers) coordinates -- if invited -- changes to operations that may significantly reduce employment or adversely affect working conditions. The association mediates in some cases, in a so-called "prior consultation" process, applications for changes to operations (including switching service providers) and, after consulting with labour unions, issues recommendations -- which all involved parties must agree to abide by prior to commencement of operations. Moreover, some industry sources point out that there is a high degree of uniformity of cargo handling charges across Japanese harbours, although this is difficult to verify because of a lack of official data. Furthermore, it is pointed out that new entry is hindered by the legal minimum employment requirement of 1½ times that of existing operators, which acts to prevent competitive bidding for open tenders of harbour services. While there are no regulatory barriers that prevent the FTC from launching investigations, the authority is normally reluctant to do so without prior complaints. Industry sources have indicated that complaints are unlikely to emerge in the present environment.

50. Specific requirements for universal service are different by countries. For example, in the case of Spain, accessibility to the postal service is ensured, while higher charges are required in remote areas.

51. These may include the right of access to post-office boxes on the premises of the incumbent and establishing centralised arrangements for change-of-address and mail forwarding. In some countries (Australia and New Zealand), the explicit access regime includes access to the incumbent's delivery services.

Figure 11. **International harbour terminal handling charges**
Index with major Europe=100, March 26, 2003



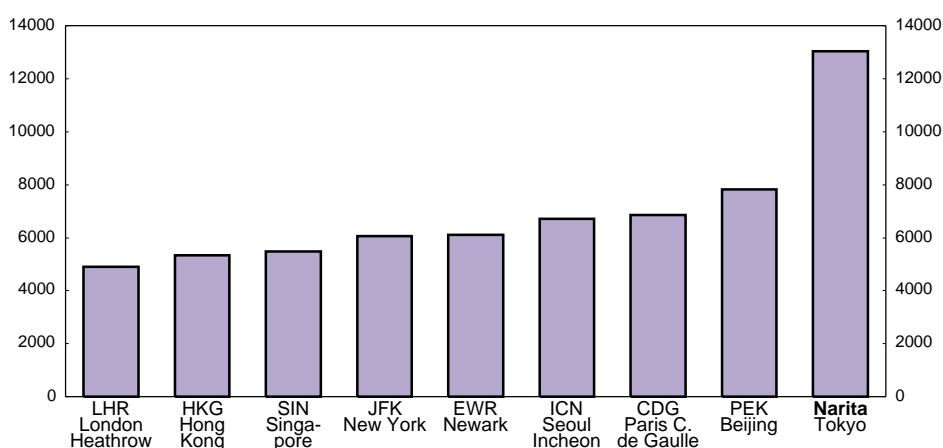
Source: Asia Westbound Rate Agreement Carriers.

45. In an effort to boost the competitiveness of Japanese harbours *vis-à-vis* other harbours in the region, they have been allowed to receive ships around the clock year around. However, the additional cost of services outside normal business hours is between 30 to 60 per cent and appears to be higher than warranted by for example the overtime surcharge stipulated in the Labour Standard Law.⁵² The impact of the take-up of this additional service, however, is difficult to judge as no statistics are available. To further strengthen the competitiveness of Japanese harbours, the government plans to designate a limited number of “super-hub container ports” by March 2004 with the aim to lower charges by more than 30 per cent through better management and economies of scale effects and shorter cargo clearance time. The objectives of any reform in this area should be to improve resource allocation by aligning charges with the cost of provision. This can be achieved by introducing competition between Japanese harbours, most efficiently by encouraging local governments to privatise harbours and adopting a more pro-active competition policy.

52. The additional cost of custom services outside normal business hours varies between 7 800 to 8 300 yen (between \$65-70), while the Labour Standard Law stipulates an overtime pay surcharge of 25 to 35 per cent, depending on job category. The tugging surcharge can be between 20 and 120 per cent.

46. The high cost of airports and restrictions on ticket sales drive up the cost of *air transportation*. Airport charges at Japan's main international airport (Narita) are more than twice as high as the average of other international airports (Figure 12). Moreover, following the recommendations in IATA's scheduling guidelines, slot allocation on individual runways is based on the grand-fathering principle and unrelated to aircraft type. This prevents the free transfer of smaller aircraft to the new and shorter runway at Japan's main international hub, to free up additional slots on the old and longer runway for the aircraft used on international long-distance routes, which cannot use the short runway. Moreover, additional misallocation problems may arise once the new runway is extended to full size as by then most sought after slots will be allocated to relatively small aircraft. Consequently, available scarce capacities can be more efficiently utilised with the implementation of a market-based slot allocation system. The OECD view is that such a system should preferably be put in place before the government's planned privatisation of airports. Moreover, indirect costs are also high with import cargo-handling charges, office rents and navigation fees being among the highest in the OECD countries (FAAJ, 1999). Costs are further increased by the lack of competition in the provision of transport related services as reflected in a recent FTC investigation. It concluded that collusion was taking place in the provision of fumigation and warehouse services at Japan's main airport, leading to an internationally high cost of such services.

Figure 12. **International airport charges**
US dollars per aircraft



Source: IATA.

47. Additional costs are imposed on the passengers through the overly prescriptive regulation of distribution, pricing and settlement of air tickets. The regulation used to allow airlines only to advertise and sell tickets for international travel at rates fixed by the IATA and approved by the Ministry of Land, Infrastructure and Transport, although fare approval has been relaxed recently, allowing airlines to offer officially approved discount fares. Consequently, most tickets are sold at "negotiated" fares through travel agents and wholesalers, hampering the development of other sales channels, such as the Internet. This disadvantages smaller carriers without the economies of scale to establish their own distribution channels. Thus, even though list prices for tickets are well below those in other larger OECD countries, the actual sale price of a ticket is about 75 per cent higher. It is difficult to identify the benefits for consumers of such highly prescriptive regulation, which should be abolished.

48. *Highway transportation* has benefited from the near doubling of the highway capacity over the past couple of decades, which with the planned 60 per cent expansion will be a relatively dense highway network compared to other OECD countries. The highway system is self-financed through the "toll-pool" system, which allows cross-subsidisation between profitable and unprofitable highways, and costs are very high, leaving Japanese toll charges among the highest in the OECD area.⁵³ Some cost-benefit analysis of the planned expansion of the highway system was carried out, but the underlying assumptions were subsequently criticised for being overly optimistic about future traffic volumes (assuming an increase of about 20 per cent in traffic by 2002), by not fully taking into account such factors as a sharply falling population. Already today, nearly a third of the highway system that connects the major cities needs additional subsidies to cover annual costs. An additional concern is that cost control has been rather poor as witnessed by recent bid-rigging scandals in the sector (Box 3).

Box 3. "Family" group companies related to the government highway construction corporations

The government's four major highway construction corporations (HCCs) organise the construction, maintenance and facility operation (such as restaurants, toll collection, etc.) of highways by contracting out each element to privately owned "family" companies.

A study by the Promotion Committee for the Privatisation of the Four Highway-related Public Corporations identifies nearly 600 such companies, defined as those with close links to the HCCs (such as having two or more board members coming from the HCCs). In addition, there are 136 core family companies with very close links as defined in Japanese accounting rules and recognised by the HCCs' consolidated accounts. There are close personnel ties between the HCCs and the family companies, with more than 1 800 ex-officials from the HCCs working for the family companies and most of the family companies have an ex-HCC official as director.¹ The study revealed a close positive correlation among the number of ex-HCC officials employed and the share of sales with the HCCs. In addition to a substantial exchange of personnel between the family companies, there are also close financial ties among them. For example, for almost 90 per cent of the core family companies, the majority of their shares are held by other family companies. Competitive bidding for HCCs' contracts was introduced in 1997. However, in the period 1997 to 2001, only a fifth of all new contracts have been awarded to non-family companies, which presented more than half of all bids. This supports the criticism that the closed business community among family companies prevents new entry -- an accusation further supported by the cease-and-desist order issued by the FTC to some of the family companies in November 2002 for being engaged in bid-rigging.

Against this background, the Committee proposed in late 2002 to ease the requirements for participating in the tendering process, as present requirements include possessing some experience in the highway business, which effectively has excluded new entrants, particularly from abroad. Moreover, the Committee proposed that some operations currently conducted by family companies should be operated directly by privatised new HCCs or their direct subsidiaries. On the recommendation of the Committee, the government has presented two bills in parliament, where they have been passed.

1. The number of ex-HCC officials working for the family companies might well be much higher as the list of retired officials suggests more than 3 400 ex-HCC officials working for the family companies.

53. According to Japan Highway Corporation, the average Japanese toll per kilometre is 27.8 yen as compared with Italy 8.48 yen, France 10.37 yen, Korea 7.75 yen, and the United States 12.48 yen. All prices are measured in PPP.

49. The government decided to privatise the four main highway public corporations in December 2001. Following this decision, the Promotion Committee for the Privatization of the Four Highway Related Public Corporations has proposed to restructure the corporations into a holding company of assets and liabilities and five regional operating companies, with the latter being responsible for maintenance and servicing of existing highways as well as for future construction. The incorporation of the companies will require them to observe the commercial law, including the obligation to follow commercial accounting rules, which should improve cost transparency. Privatisation in itself would increase incentives for cost control. The latter is expected to be furthered by more active competition for public tenders in this sector. Privatisation should also help to reveal the true full cost of the highway system, making the subsidies more explicit. The highway construction companies must finance new projects by raising funds from the financial markets, ensuring a full financial risk assessment of new projects, which will be reflected in loan conditions. This will improve resource allocation -- although only in full if the highway construction companies are completely privatised to avoid implicit government guarantees. In addition, clearer rules for toll setting would help to increase transparency. The current system for determining road charges is to recover construction costs over a suitable payment period and ongoing maintenance costs for the entire highway system, implying subsidies from profitable to un-profitable highways.⁵⁴ An alternative way of financing the latter could be through a fiscal transfer combined with charge setting on an individual route basis. Negative external effects of highway transport, such as pollution, should be addressed through the tax system.⁵⁵

Public procurement

50. Public procurement with competitive bidding for tenders is an important instrument to secure the efficient provision of public services (other measures to reach similar objectives are dealt with in other parts of the Economic Survey of Japan 2003) and can in itself promote competition through the creation of new market possibilities. However, in Japan public procurement has faced a number of competition problems. Collusive bidding has been the main problem observed at the central government level.⁵⁶ At the local government level industry sources complain of problems with securing public procurement contracts, including lack of transparency, unclear procedures and close ties between commissioning entities and incumbent firms, involving the entire process of tender specification, bid qualifications and evaluation as well as the awarding of contracts.⁵⁷ Moreover, no well-developed and transparent common framework is in place for appeals and complaints. The Office for Government Procurement Challenge System deals with complaints regarding procurement of the central government and its agencies and similar systems are in place at the local level. One of the elements contributing to the arbitrary operation of the tender process is the large degree of regional variation in requirements and processes. Given the problems in this area, clear, transparent and non-discriminatory public procurement rules that would apply to all levels of government should be established. To counter bid-rigging and to promote transparency and non-discrimination in public procurement, the government has enacted laws, which among other things empower the FTC to ask for corrective measures. Supervising compliance with contracting processes is outside the usual scope of

54. A possible consequence of introducing the cost recovery principle in the toll-setting system may be to make it difficult to privatise low-usage highways. However, this reflects past disregard for whether individual highways were economically viable and the associated sunk cost is only making the former implicit cross-subsidy explicit. Furthermore, this general principle would allow the highway construction companies to implement toll schemes that take into account different demand conditions, such as higher charges during rush hours, which would enhance capacity utilisation.

55. See European Council of Ministers of Transport (2003) and OECD (2001b).

56. This is a problem not only in highway construction, but also in public procurement of jet fuel for the Self-Defence Force, which since 1985 has incurred an additional cost of 48 billion yen.

57. EBC (2002) and European Commission (2002).

competition law enforcement. But Japan's long-standing problems with bid-rigging and the importance of public procurement for promoting competition support expanding the FTC's responsibilities to include compliance with competitive tendering requirements. Moreover, non-conforming contracts should be declared null and void.

Potential macroeconomic effects from regulatory reform are large

51. The macroeconomic benefits of regulatory reform are substantial. The propagation and channels through which regulatory reform affects the economy depend on a number of factors (Box 4). Obviously, assessing the impact of regulatory reform is a complex undertaking, but at least two simple approaches are useful to provide some rough indications. First, including synthetic indicators of regulatory stance in regressions of aggregate performance variables is a relatively straightforward method that does not require assumptions about the character of reforms. Following this method, Nicoletti *et al.* (2001) estimated that regulatory reforms in Japan in the 1980s and 1990s have increased the employment rate by around 1½ percentage point. Moreover, if Japan moves towards best practices for product market liberalisation in the OECD, the rate could increase by another 1 percentage point.

Box 4. Economy wide effects of sectoral reforms

In general, sectoral reforms change relative prices, which improve overall resource allocation and consumer welfare -- effects that are further enhanced by dynamic effects (see below). Regulatory reform within a sector improves that sector's economic performance through a number of channels.

- Reforms reduce output prices via a lowering of price-cost margins, which in turn diminishes the scope for rent sharing, putting downward pressure on wages in the sector.
- Reform forces firms to reduce slack in the use of input factors (boosting X-efficiency), enhancing labour and/or capital productivity.
- In addition to these static gains, a more competitive environment stimulates efforts to innovate and adopt new technologies, which raises productivity growth.

Quantifying the possible magnitude of reforms' effect on sectoral performance, let alone their timing, is bound to be subject to considerable uncertainty, which is only multiplied in the assessment of economy-wide effects. An example is that a sectoral reduction in wage premia may have beneficial effects on wage formation more generally. Furthermore, propagation of sectoral effects into the wider economy depends on the labour market, as the initial effects of a sectoral reform may be a reduction in employment, which has to be employed elsewhere in the economy – highlighting the importance of a flexible labour market in maximising the economy-wide effect of reforms.

A number of economy-wide evaluations of broad-based regulatory reform have been carried out. In the mid-1990s, a collection of studies showed that the economic impact of a comprehensive regulatory reform over a relatively long period would increase GDP by around 6 per cent, despite using different models and assumptions.⁵⁸ Kawasaki (2003) highlighted within the context of a general equilibrium model that even when regulatory reforms only have small overall effects, the change in relative prices can induce considerable variation in how individual sectors are affected. Furthermore, the Council for Economic and Fiscal Policy has estimated that the present reform process in the service sectors may create more than 5 million jobs over five years.

Several sectoral studies have indicated relatively large economy-wide benefits of sectoral reform. Bradford (2003) estimated that the welfare gains of removing all trade barriers could amount to an increase in private consumption of between 2 and 2½ per cent. The relaxation of large-store regulation in the mid-1990s is estimated by the EPA (1996) to have boosted GDP by 1 per cent. The liberalisation of oil imports in the mid-1990s has, according to Nagaoka and Kimura (1999), enhanced consumer welfare by an estimated ¼ per cent of GDP.

58. Ministry of International Trade and Industry (1997), OECD (1997) and Economic Planning Agency (1997).

52. The second approach is to make explicit assumptions about the potential for reforms to reduce price-cost margins and to enhance productive efficiency and performance. Following this approach, Table 5 presents estimates for the possible economic effects on sectoral and aggregated economic performance of reforms in network industries, distribution and professional and community services. The presented estimates suggest that the scope for regulatory reform in these sectors may increase aggregated labour productivity by 5-6 per cent and a decline in producer prices of some 5-7 per cent -- effects that tend to be somewhat larger than similar estimates for other countries. The estimates rely on judgemental assumptions about the scope for reducing price-cost margins and increasing labour and capital productivity within each sector based on realignment with practices internationally. The economy-wide effects are obtained by using the 1997 input-output tables. To avoid assessing the degree of labour market flexibility, aggregated employment was conservatively left unchanged even though dynamic effects of regulatory reform are likely to lower the NAIRU and increase the labour supply. The reported estimates do not include effects of increased dynamic efficiency and an improved resource allocation.

53. The above estimates are in some instances fairly conservative as compared with other studies. Bradford (2002) applies a general equilibrium model to estimate the effects of regulatory reforms, which align Japanese price margins (relative to world market prices) in the distribution sector with best practises internationally.⁵⁹ This approach takes into account the full potential gains of regulatory reforms in the distribution sector and leads to economy-wide estimates that are more than double those presented above.

Overall assessment and scope for further action

54. The inadequacy of competition in Japan arises from a combination of enforcement of competition policy that historically has not been strong enough and a prevalence of regulation that has been too prescriptive, originating in industrial policy objectives formulated by line ministries. The specific formulation of regulation is often influenced and implemented by trade associations, which are also often involved in various types of anti-competitive collusive behaviour. Not surprisingly, economic performance has suffered as a result. For Japan to achieve its goal of strengthening competitive pressures, the main thrust of reform must be to set up a transparent system of regulation, which is not hostage to unwarranted political pressures and vested interest groups. An important step in this direction and demonstrating independence has been the transfer of the FTC to the Cabinet Office. This approach should be extended by introducing independent sector regulators. An additional step could be to unify the sector regulators into a single regulator, covering relevant network sectors, to reduce the risk of regulatory capture and to concentrate scarce expertise in implementing pro-active *ex ante* regulation to secure non-discriminatory third party access.

55. For the FTC and the sector regulator(s) to carry out their task effectively, it is important to ensure their independence and provide sufficient resources and power. Independence can be further enhanced by selecting the commissioners from a wide range of representatives from the public. Resources should be evaluated both in terms of quality and quantity. The latter could be enhanced by establishing self-contained career paths within the authorities to attract talent and secure operational independence and by reducing the reliance on seconded personnel from other ministries. The introduction of some elements of private-sector remuneration could attract personnel with a broader range of experience. The evaluation of manpower requirements should be continued at the FTC and extended to the sector regulator(s). To combat wide-spread anti-competitive practices, specific measures should be introduced, including leniency and

59. The price margin relative to world market prices measures, in essence, the cost of moving one dollar's worth of a good (valued at world prices) from the factory to the shop shelf. The advantage of this approach is that if producer prices are artificially high because of trade barriers then a simple *ad valorem* calculation of margins in distribution would be misleadingly low. Indeed, studies using the simpler approach tend to show that Japanese margins are *at par* with those in the United States.

whistleblower programmes, which would create incentives both at the company level and for individuals to collaborate with the competition authorities. However, a precondition for leniency programmes to be effective is a rigorous implementation of sanctions. Other measures to create a level playing field and promote the development of competitive markets, partly through increases in foreign rivalry, include replacing prescriptive regulation and unnecessary price reporting requirements with a system of notification and licenses as well as an expansion of the government's privatisation programme. An extension of such a reform should be to eliminate indirect barriers to inward FDI, such as removing ownership restrictions and remaining obstacles to trade. In addition, the government could further level the playing field by ending implicit guarantees associated with state ownership, either financial or political, through an expansion of its privatisation programme as well as by introducing a more rigorous approach for evaluating and financing the net cost of universal service obligations. Besides these general recommendations, summary of the more detailed recommendations are presented in Table 6.

Table 5. **Assumptions and effects of pro-competitive regulatory reform in selected industries**
Percentage change

	Energy	Post and telecommunications	Road transport and railways	Retail distribution	Professional services ¹	Community social and personal services ²	Total economy
Assumptions							
Costs of intermediate inputs	-10	0	0	-5	0	-5	
Labour costs							
<i>Labour productivity</i>	-25	-25	-15	-20	-10	-10	
<i>Wages</i>	-10	-5	0	0	-10	-10	
Capital costs	-30	-30	-20	-25	0	-10	
Profits	-20	-10	-10	-10	-25	0	
Price elasticity of demand	-0.5	-0.5	-0.2	-0.5	-0.5	-0.2	
Sectoral effects:							
Direct price effect	-18.1	-16.2	-8.6	-14.9	-25.7	-12.2	
Price-induced output effect	9.1	8.1	1.7	7.5	12.9	2.4	
Employment, price-induced effect ³	-15.9	-16.9	-13.3	-12.5	2.9	-7.6	
Economy-wide effect on:							
Producer prices, direct effect	-0.4	-0.3	-0.4	-1.7	-0.9	-1.2	-4.9
Producer prices, total effect ⁴	-0.7	-0.4	-0.6	-2.2	-1.6	-1.2	-6.7
Employment (after full labour market adjustment)							
Labour productivity (weighted by share in aggregate output)	0.6	0.4	0.7	2.2	0.4	1.0	5.2
Output							5.2
<i>Memorandum items:</i>							
Share in aggregate output	2.4	1.6	4.4	11.1	3.6	10.1	

1. ISIC74, other business services.

2. Effects from improving public procurement policies and greater use of competitive tendering.

3. Resulting from the direct effect via productivity and the induced effect via higher output.

4. Combines the direct effect of the fall in prices of the sector being deregulated with that resulting from the fall in prices in other sectors due to lower input costs.

Source: OECD.

Table 6. Summary of recommendations

The competition framework needs strengthening
<ul style="list-style-type: none"> To enhance the independence of the FTC, its commissioners should be selected from a wider set of representatives from society, and the authority should be less dependent on seconded personnel. The authority's in-house expertise should be increased by establishing self-contained career paths within the organisation as well as by considering elements of private-sector pay.
<ul style="list-style-type: none"> A more pro-active regulatory stance is required. This could be furthered by authorising the FTC to instigate criminal investigations. Alternatively, the prosecutor's office should be involved at an earlier stage of an investigation, although the office's limited capacity needs to be expanded substantially to allow criminal sanctions to be applied credibly. As part of a more pro-active stance, the FTC could be made responsible for consumer protection.
<ul style="list-style-type: none"> Sanctions need to be substantial and credible to secure deterrence. Part of such a reform should be to expand the possibilities for private recoveries. This would also allow the introduction of effective measures explicitly aimed at cartels, such as leniency and whistleblower programmes.
<ul style="list-style-type: none"> The reform of the merger control review process should be continued to clearly reveal standards in the law for blocking mergers. Moreover, the current approach should be evaluated in view of possible negative effects on competition.
<ul style="list-style-type: none"> As a part of a comprehensive programme to expand the role of competition, remaining import barriers and implicit restrictions on inward FDI should be abolished to increase foreign rivalry.
Regulation in retail distribution should be relaxed
<ul style="list-style-type: none"> Relax large-store regulation by applying it only to much larger units and by removing the possibility for competitors to block establishment of large stores.
Sector regulation needs comprehensive reforms
<ul style="list-style-type: none"> The current approach to regulating network industries should be comprehensively reformed with the establishment of independent sector regulators as part of active <i>ex ante</i> regulation to secure non-discriminatory third-party access. This process could be taken further to establish one unified sector regulator, covering relevant network sectors, to reduce the risk of regulatory capture and concentrate available expertise. Moreover, a common approach to universal service obligations needs to be introduced, entailing cost-benefit analysis to determine the net cost of such obligations, which should be financed through a fiscal transfer.
<ul style="list-style-type: none"> In the <i>energy sector</i>, international experience points to the need for effective unbundling through legal or ownership separation. Interconnection capacity must be enhanced both within a given region as well as between regions to allow physical access. Moreover, rapid and impartial dispute settlement frameworks should be put in place. Entry barriers in the form of high administrative costs should be lowered by streamlining all approvals into one level of government and bring infrastructure standards into line with international standards. Overly prescriptive regulation should be replaced with licensing regimes. Additional measures in the <i>electricity sector</i> should be considered to bring together the networks under a separate company to enhance infrastructure investment incentives. Additional measures in the <i>gas sector</i> should be to replace the negotiated third-party access to terminals with a regulated third-party access approach.
<ul style="list-style-type: none"> In the <i>telecommunication sector</i>, government ownership restrictions should be reconsidered and preferably removed to level the playing field. Interconnection charges should be set independently in each telecommunication region to avoid cross-subsidies. Termination charges in the mobile networks should be regulated unless competitive pressures substantially lower them.
<ul style="list-style-type: none"> In the <i>postal sector</i>, the universal service obligation for new entrants should be abolished. Moreover, an explicit access regime for new entrants to the incumbent's essential facilities and services should be introduced. Measures to eliminate cross-subsidisation should also be introduced.
<ul style="list-style-type: none"> Introduce competition between <i>harbours</i> so as to lower high costs. This process would be most efficiently achieved by encouraging local governments to privatise harbours.
<ul style="list-style-type: none"> To better exploit scarce <i>airport</i> capacity, a system of market-based slot allocation needs to be installed prior to privatisation. Prescriptive ticket regulation should be abolished.
<ul style="list-style-type: none"> Privatisation of the <i>highway</i> corporations should be accompanied by new toll rules, stipulating cost-recovery for each individual highway, in order to abolish cross-subsidisation and to ensure an efficient expansion of the highway system.
Public procurement can be used to promote competition
<ul style="list-style-type: none"> Introduce a common nation-wide framework for public procurement with clear dispute and settlement facilities. Given the scale of problems, the FTC could be made responsible for compliance. Such a reform should also give the FTC direct sanction possibilities against agencies or officials involved in bid-rigging.

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