

April, 2007

Research Report on Redesigning Government

Applying Corporate Governance to Government
Strengthening Citizens' Monitoring
improving management discipline through private sector idea

Mitsuhiro Fukao

President, Japan Center for Economic Research

It would be possible to improve government efficiency by applying corporate governance mechanisms. Specifically, I would like to make the following proposals: (1) have strict public accounting and introduce citizens' audit requests in respect of government institutions; (2) special public institutions including the Bank of Japan should employ board of director systems; (3) medical care and pension systems, which are in urgent need of streamlining, should be redesigned.

Insufficient Monitoring

'Small government' has been a catchphrase ever since the days of the Junichiro Koizumi cabinet, but it is not so much the size of government that we should be questioning as whether government is functioning effectively or not. At the Japan Center for Economic Research, we have carried out investigations into the shape of government from the following two perspectives: (1) the creation of mechanisms to combat misconduct such as collusive bidding at the initiative of government agencies; (2) streamlining in fields such as medical care and pensions, while maintaining the 'peace of mind' of the nation. I would like to explain part of our research into 'redesigning government'.

How can we go about reducing government misconduct? It is not as if there is no governance at all in respect of the administration. The nation keeps an eye on Diet members in the form of elections. In addition to elections, in respect of local government there is a system to facilitate lawsuits by local residents, and this has been strengthened in recent years. The budgets and accounts of central and local government are published, and checked by the assemblies. Local government has audit commissioners and central government has the Board of Audit in order to monitor misconduct or wasteful budget spending.

However, the governance system in respect of government is still lacking. The reason checks are weak is because, unlike market transactions, costs are not in line with benefits when it comes to government services. When consumers purchase goods or services, they make strict evaluations based on the price and contents. In contrast, with police, fire station, schools or road services or national health insurance the beneficiary bears none or only part of the costs. The vast majority of costs are born by ‘national systems’ such as taxation or social insurance. For this reason, checks against the contents of individual services and their costs become weak. This is the reason why there are auditors in respect of government assemblies.

From a historical perspective the position of monitoring in respect of government assemblies is becoming weaker. During the early days of the Meiji Constitution when only high tax-payers were entitled to vote, the Imperial Diet called on the government to seek strict spending and taxation cuts. However, after the introduction of universal suffrage, the Diet became to allow increased spending.

Stricter Public Accounts and Audit Requests for Government

There is plenty of scope for tightening of public governance if lessons are taken from corporate governance. This is because the mechanisms of corporate governance have been built up after a long history of responding to the misconduct and failures of management.

Leadership elections for mayors and governors are in many respects similar to hostile takeovers of companies. At companies with poor management and sluggish stocks, it is possible to gain a majority of voting rights at the general shareholders meetings through buying up shares while proposing to shareholders methods for management improvements. In the same way, when local governments are run inefficiently and fail to provide low cost services that meet the needs of residents, it is possible to bring about political change by proposing administrative changes and standing as a leadership candidate.

However, disclosing administrative costs is essential to allowing challenges for changes in administration based on specific policy proposals. Lessons should be learned from the ‘segment information’ provided by enterprises, with disclosures of costs for separate administrative fields, latent real estate losses, and consolidated financial statements for public corporations or joint public-private ventures. In doing so, strict evaluation standards along the lines of corporate accounting principles should be applied.

What would happen, for example, if a director at a company were to procure materials at an artificially high price from a supplier company in order to gain reemployment? He or she would become the target of a shareholders lawsuit for breach of duty. If the transaction had been approved by the board of directors, any directors not opposing the transaction would bear responsibility for paying compensation.

The equivalent systems to shareholder lawsuits for local government are citizens' audit requests and lawsuits, which have carried out a certain checking function in respect of government misconduct. For some strange reason, however, there is no equivalent system in respect of central government. The role of the citizen's audit request system is said to have been significant in allowing local government to seek compensation for damages from companies which have been engaged in bid-rigging. Surely a similar citizen's audit request system to that for local government should also be introduced in respect of central government institutions.

Any citizen who became aware of misconduct would be able to file a citizen's lawsuit to seek accountability from the offending official if any objections were discovered by the Board of Audit or any external auditors which it had requested to implement auditing measures.

Board of Directors System Effective for Bank of Japan

There is also plenty of scope for improving managerial discipline through the introduction of the design principles of corporate organizations to governmental institutions. The heads of governmental financial institutions are appointed by the government. The executives are acting simply as assistants appointed by the heads. For this reason, the fact that while a board exists it does not monitor the governor is completely different to corporate boards of directors. The executives should be appointed by the government, with the head being chosen through a mutual election with accountability for monitoring on the part of the executives. A powerful deterrent against collusive bidding at the initiative of government agencies could be expected if officials of governmental financial institutions were the target of a citizens' lawsuit system.

The governor, as head of the Bank of Japan which is also a special public institution, is appointed by the government. Although the Policy Board of the Bank of Japan differs from the boards of governmental financial institutions in that it is a council system, it is not possible for the Policy Board to replace the governor. Even if there are problems with the governor's policy-making or internal management, the government

can not replace him or her unless criminal penalties or a serious physical malfunctioning occurs. In terms of organizational structure, corporations can be considered superior.

There are additional areas at the Bank of Japan where streamlining is required. For example, these include massive reductions in a branch network that was built when transport and telecommunications were still poor, large-scale cost savings in bank note issuing and distribution costs through the introduction of a 100,000-yen note and auditing savings and bank note movement cost reductions by including bank-held cash in reserve deposit calculations.

Comparison of governance structures of government and companies

	Corporations	Central Government	Local Government
Financial contributor	Shareholders	Taxpayers	Taxpayers
Administrative management	Board of directors	Cabinet	Local government
Management checks			
Collegiate system	General meeting of shareholders	Diet	Local assembly
Checks by individual investors	Representative action	None	Audit request or lawsuits by local citizens
Transfer of managerial authority	Hostile takeover	Election defeat	Election defeat
Limits to financial deterioration	Bankruptcy	None (IMF intervention)	Becoming target of governmental fiscal reconstruction
Auditing	Corporate auditors and external auditors	Board of Audit of Japan	Audit commissioners
Accounts reporting	Published financial statements	Budgets and accounts	Budgets and accounts
Disclosures by segment	Segment information	None	None
Market checks on quality and cost	Evaluation by customers	None (market testing introduced in some area)	None (market testing introduced in some area)

New Rules for Medical Care and Pensions

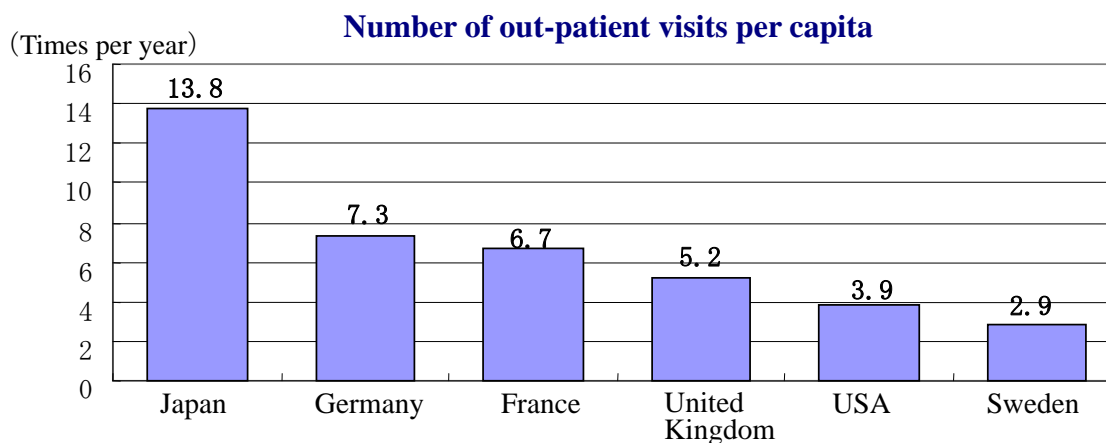
In addition to introducing private sector idea, consideration needs to be given to implementing new rules for previously unrestricted areas. One example is medical care.

The Japanese medical care system is far better than most Japanese people realize. There are no other countries which guarantee the fair provision of medical care to all citizens at low costs as well as Japan does. However, the number of out-patient visits is dramatically higher than in other developed countries. There are inefficiencies in the sense that hospitals are overcrowded and doctors are overwhelmed with patients who only have minor ailments.

I would like to propose here the introduction of a ‘family doctor’ system. This system is one employed by many developed countries and involves having residents choose family doctor to whom ordinary consultations are carried out from among the local doctors or doctors groups, with specialist doctors or hospitals being introduced as required. This would correct the situation wherein patients crowd into well-known hospitals by providing a form of traffic control through family doctors.

However, opposition could be expected because of the fact that this would partially limit patients’ rights and would lead to the breakdown of the free consultation system in which it is possible to visit ‘any doctor, at any time and in any place’ of which Japan is so proud. In order to ease this opposition, it might be prudent to allow people to choose between the current free system and the alternative system of family doctors.

If a patient selected the free system of consultation, the current system of charging 30% of costs to patients would continue to be applied, but if he or she selected the family doctor system a fixed cost per patient would be paid by public insurance and costs born by outpatients reduced to zero (a capitation payment). The patient would only need to bear the cost of prescribed drugs (with an upper limit). It has been proved by international comparative studies that the capitation system saves medical costs compared to the fee-for-service system.



(Note) The data for Germany is from 2000, Sweden is from 2001 and all other countries from 2003.
(Source) OECD “Health Data 2006”

It is also necessary to redesign the pension system. It ought to have become easier to maintain the system after the introduction of the 'macro-economic slide' which will limit rises in benefits to levels below rises in consumer prices, but given the new population trends towards an increasingly aging society that were published at the end of last year it is difficult to be optimistic. Moreover, when the actual benefits levels are examined, it is possible to see large numbers of pensioners on low-level pensions considerably below what is required to maintain reasonable living standards. In fact, given the falling rate of participation in national pensions and future predictions of rises in the numbers of people without pensions, there are many groups in society for whom the security of a pension will not be possible.

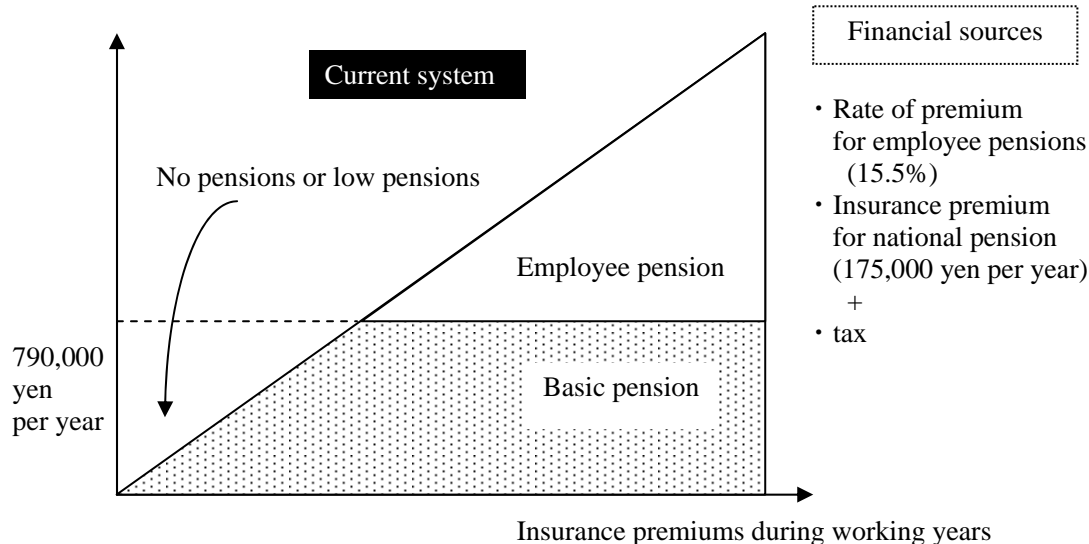
In order to solve this situation fundamentally, I would like to propose a minimum guaranteed pension (see diagram on next page). In substitution for the current basic pension, the system would provide all elderly people with a fixed pension which was 90% funded by consumption tax. The amount provided has been assumed at the current full amount of the basic pension (790,000 yen per annum). This would form the new base pension.

The employee pension would continue to provide a higher level of pension benefits, meaning that the incentive to work would not decrease. Only those receiving above 1,000,000 yen per annum from the higher pension system would be regarded in the high income bracket, and overly lavish benefits would be avoided by partially reducing their minimum guaranteed pension.

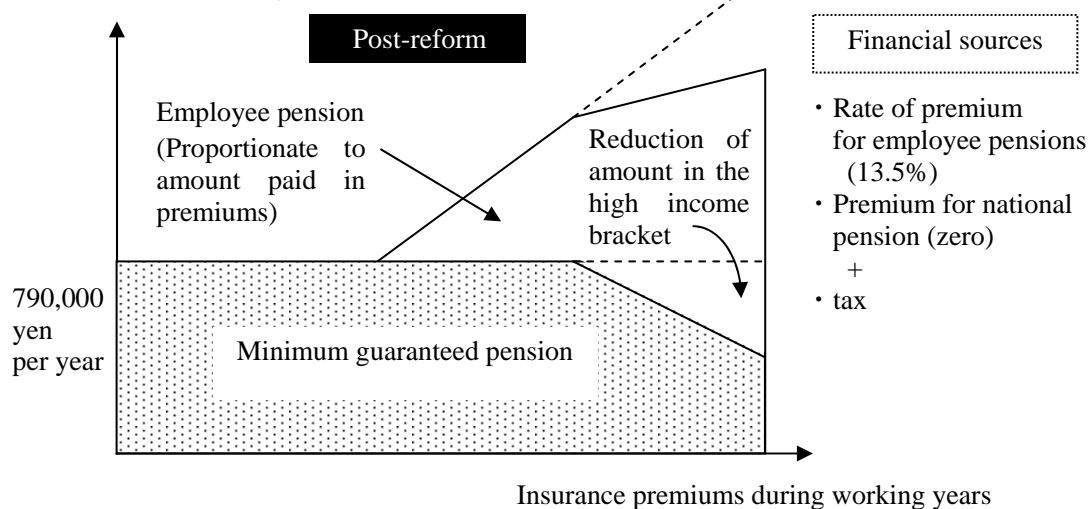
An increase in consumption tax rate of approximately 3.1% would be required at introduction, with the maximum future increase predicted to be 6.3% in 2040. There would be good news for working generations. The national pension contributions would be cut to zero and employee pension contributions also would be cut largely.

Concept Diagram of Pension Reform (at time of introduction in 2009)

Amount received in old age



Amount received in old age



The need for a 3.1% increase in consumption tax will accompany the system change.

(The original Japanese article appeared in the February 6, 2007 issue of The Nihon Keizai Shimbun)

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Japan Center for Economic Research (JCER)
 Nikkei Kayabacho Bldg. 2-6-1 Nihombashi Kayabacho, Chuo-ku, Tokyo 103-0025, Japan
 Phone:81-3-3639-2810 / FAX:81-3-3639-2839 / E-mail:jcernet@jcer.or.jp