New Development in Economic Policy

Complementarity between Government and the Market Place

By Ichiryu Yoshio and Hosoya Yuji

What is "Market Enhancing Policy (MEP)?"

The economic woes in Japan and East Asia are deepening the conviction that the global trend of attaching importance to market forces is irreversible. Amid this trend is a growing movement to reconsider the role of the Japanese government in setting economic policy. In a symposium sponsored by the Japan Industrial Policy Research Institute and the Research Institute of International Trade and Industry titled, "The role of the markets and government," Joseph E. Stiglitz, vice president of the World Bank, delivered a keynote speech in which he stressed complementarity between government and the market place. Heretofore there have been two mainstream views on the matter and both are in direct conflict. The "market-friendly view" holds that government intervention should be kept to an absolute minimum, thereby allowing the market to follow its own course. The "development-oriented state view," on the other hand, says government should step in from time to time to correct market failures. However, these two views both grasp relations between the government and the markets as "substitute."

Meanwhile, a third body of opinion has emerged in recent years which is being weighed heavily by the researchers of Comparative Institutional Analysis. The "market enhancing view" emphasizes that markets should complement government and vice versa. A concrete example of the former case involves the introduction of Private Finance Initiatives (PFI) in public works projects and the adoption of a U.S.-style auction system for allocating radio wave spectra. We named this type 2 of Market-Enhancing Policy (MEP).

A classic example of the latter case involves the "financial restraint" which lies at the heart of the Japanese "main bank system." Stiglitz and other specialists say this is a system which prevails throughout East Asia, not only in Japan. The system is designed to give banks a certain amount of "rent" by controlling deposit interest rates and restricting new entries into the banking sector. In this manner they can lock in so that they can keep the incentive for a long term to obtain information about borrowers and monitor their financial health. "Rent" in the context mentioned here increases as banks strive to expand their deposit holdings. Such a policy of the government complementing the markets means one that can better facilitate various kinds of private-sector coordinations through such intermediaries as banks so that market functions may fully work. We call this type 1 of MEP.

In an actual economy, unlike the simple models assumed in the microeconomics studied by the beginning student, corporate organizations and inter-company transactions, etc., are advanced and, in some countries, diverse in ways that complement market transactions. This is because coordination among the economic agents engaged in economic activity is extremely important, so much so that market performance is affected by the suitability of that coordination. Institutions imply that such coordination is widely accepted and well-rooted in the economic community. Using the game theory and other new economic theories, the method of Comparative Institutional Analysis explains how private-sector coordination and institutions develop in a unique way in each country through its historical process even among countries with similar market economies. Policy implications derived from Comparative Institutional Analysis are referred to in this discussion as Market Enhancing Policy. The economic agency, envisioned by the Comparative Institutional Analysis, is the holder of "bounded rationality." Therefore, unless there are incentives and penalties, it may cause coordination failures, such as moral hazards which could result in abandoning transactions (the problem of holding up). It is to avoid such trouble and ensure smooth economic activity that corporate organization and long-term employment, main bank and just-in-time delivery systems have been developed. Therefore, the type 1 MEP Model refers to a group of policies that call upon the government to complement markets so that private-sector coordination and institutions can function more efficiently. The establishment and protection of property rights, which is among the roles of government pointed out in Adam Smith's book "Wealth of Nations," is a classic example. Thorough disclosure, the establishment of new rules and insurance system reform, which are observed for the purpose of minimizing risks in such advanced nations as the United States, Britain and New Zealand, along with the full introduction of market functions through deregulation and privatization, fall under the MEP category.

According to the principles of Comparative Institutional Analysis, private-sector coordination and institutions dynamically evolve over time in order to adapt to socio-economic changes. Hence, as evidenced by the financial restraint

Joseph E. Stiglitz, vice president of the World Bank, delivers a keynote speech in the symposium titled "The Role of Markets and Government" in March 1998

policy which supported the main bank system, MEP could lead to "government failures" if it is retained as it is despite the fact that it no longer matches present-day conditions. Market enhancing policies are required by all countries at all times, but they need to be constantly reviewed in order to suit prevailing conditions.

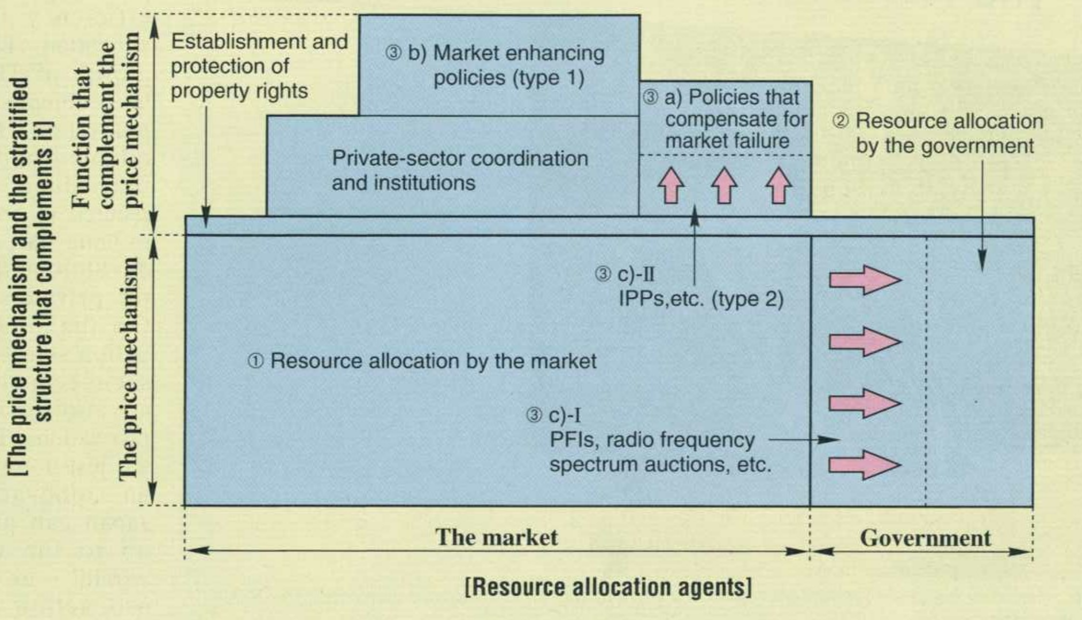
Why is MEP Important to Japan?

The Japanese economy is in dire straits. The trouble has been caused not only by cyclical macroeconomic changes, but also by the fact that Japan now finds itself unable to deal with the considerable environmental and structural changes it is facing toward the 21st century. Progressive globalization, information-induced general economic and social reforms, the pronounced tendency toward falling births in an aging society and Japan as an economic front runner are among the changes in the environment that particularly attract our attention.

Under such circumstances, in order to realize sustained growth of income and wealth, which is the essential aim of any economic policy, it is imperative to enhance the nation's Total Factor Productivity (TFP) by pursuing dynamic efficiency in resource allocation. The sustained growth of TFP can only be accomplished through innovation. To this end, talented and ambitious individuals must be secured at home in order to jump-start research and development (R&D) at the private-sector level. On the other hand, a nation's institutions and socio-economic systems are also closely related to innovations. For instance, the just-in-time concept is an innovation which Japan can proudly hold up to the rest of the world as a new production method. According to Comparative Institutional Analysis, it is closely related to the "horizontal hierarchy" that has evolved in postwar Japan as an information system for intra-business coordination.

The rationale for close relationships existing between innovations and institutions is that "coordination failures" that require private-sector institutions and coordination find their clear manifestation in a dynamic phase involving the lapse of time. In other words, economic agents that make investment decisions five to 10 years in advance are prone to face certain limitations due to the bounded rationality, thereby increasing the likelihood that private coordination will be rendered ineffective. In order to spark innovation, therefore, it is vital to establish an environment in

Figure: The Roles of the Market, Private-sector Coordination and Government



which private-sector coordination and institutions can thrive. Therein lies the need for market enhancing policies. MEP is now an important pillar of Japan's economic policies in that the country can fully realize a dynamic efficiency in resource allocation by combining private-sector coordination and institutions with the market.

It should also be pointed out that another reason why MEP must be mentioned explicitly as a new pillar of economic policy is to counter government "inertia." According to Comparative Institutional Analysis, various institutions have become rooted in certain environments, and they complement each other and become rigid and unalterable due to institutional complementarity. The government's role, too, is complementary to other private-sector institutions, and various institutions within the government have also become complementary to each other. Therefore, a two-stage approach is needed to overcome the inertia and reform the government's role and functions. The first stage is to reduce the government's role through adequate deregulation and introduce market functions on a broad front. The government is now tackling economic structural reform in earnest. The second stage is to energize the private business sector as much as possible through the full-scale introduction of MEP.

What is MEP for Japan to tackle squarely?

Before answering this question, we would like to enumerate several general principles for introducing MEP to Japan. First of all, we attach importance to the viewpoint of "securing diverse options." We need a broad range of feasible options and large numbers of innovative, ambitious individuals willing to make choices that no one else ever has. This is a factor that is relatively lacking in Japan. It is, therefore, extremely important, when the government approaches private-sector coordination under MEP, that an environment be established in which a broad range of feasible options are secured and economic agents can introduce innovations through trial and error.

Secondly, before working out and implementing policy measures, it is necessary that preliminary processes, as mentioned below, will be established. It is a flow chart-like process to check whether market functions are working properly and, if not, what is the reason, and whether spontaneous private-sector coordination is possible for solution, and if not, whether private-sector efforts can be encouraged through a policy measure and, finally, whether the government can create a system for complementing private-sector coordination. If a policy response is required, it is necessary to establish a basic policy in line with type 2 of MEP whereby a cost-effective policy is adopted through the introduction of market functions.

Thirdly, something has to be done to lessen the possibility of "government failures" amid the growing pall of uncertainty over the future. For example, one possible idea for introduction of type 2 of MEP is to set a trial period and call for ideas from the public. It is also possible to encourage diversification of policy choices suitable for particular regions, instead of imposing stereotyped central government policies on them, by promoting drastic decentralization, thereby encouraging competition among local governments through the choice of residence and location by individuals and business. Lastly, it is important to strengthen the system of intra-government checks and balances through administrative reform.

Based on the above considerations, concrete policies of MEP for Japan have been spelled out below: Regarding the most fundamental private coordinating organization of enterprises, it is important that choice between the forms of organizations, that is, pure holding companies, operating holding companies and others, will be neutralized through the introduction of a consolidated tax payment system. This is expected to diversify forms of employment within the same corporate group, replace the main bank system with the pure holding company system in terms of corporate monitoring function and enable the pure holding company to perform the intermediary function for in-house ventures within the same corporate group. Also important is a review of corporate legislation aimed at facilitating and speeding up such organizational changes as mergers and acquisitions and corporate break ups. As regards corporate governance, there are such MEP measures as the preparation of choice between outside directors in the board of directors for internal correction and an outside advisory committee, the creation of an analyst reputation mechanism, the establishment of a governance mechanism of institutional investors themselves through thorough disclosure and a review of the organizational structure of life insurance companies.

To facilitate the creation of new industries, it is important, along with economic structural reform, to accentuate the role of venture capital as intermediaries to increase incentives for entrepreneurs, overhaul the tax system to provide greater incentives to investors and further improve the over-the-counter market.

Next, as a problem for both business and individuals, it is important to review corporate and income taxes to secure fair rents for innovators and also review the retirement pay tax system so that it will not work as a disincentive for those who want to change jobs.

From the standpoint of enlivening personal and corporate innovation, it is also important to set up an intellectual property rights system capable of keeping the balance between proper protection to secure incentives and the benefits derived from the spread of innovations. Also, expert judges should be trained to speed up the handling of disputes involving property rights infringement and secure professional specialization.

Among the measures being advocated for individuals are the diversification of remunerative and employment systems due to deregulation, such as compensation systems and types of employment, utilization of private intermediaries for employment agency services and temporary placement services and a review of various systems and other labor-related matters that discourage job changes. With respect to education, expanding the discretional authority of educational institutions is a policy of the type 2 of MEP category which calls on national universities and other institutions to observe the competition mechanism. It is important to establish an objective accreditation system to complement that policy.

As for environmental problems, it is very important for policy measures to have the viewpoint of how to induce innovations and create new industries through the positive and dynamic adaptive behavior of economic agents. From the viewpoint of such incentives, direct regulation has the advantage of making detailed differentiations possible for economic agents. The introduction of the system of tradable emission permits, which features such benefits and less distortion in resources allocation, is a policy of the type 2 of MEP that is worth considering.

Lastly, a policy aimed at reducing the risk to economic agents from deregulation is important for MEP. To that end, the government has an important role to play in formulating proper disclosure rules, monitoring those rules and imposing penalties if and when they are broken. It is also important to improve various insurance systems for the so-called "safety net." The government needs to urge the private sector to act on a voluntary basis and make a proper review of such public systems as unemployment insurance and pensions. For the macroeconomic policy aimed at controlling aggregate demand, MEP is important in that it enables economic agents to make economic calculations for the future and develop sound expectations through the stabilization of the macroeconomy. To push ahead with the macroeconomic policy in a broad sense, incorporating such macroeconomic measures in a narrow sense and structural reform measures (semi-macroeconomic), including a variety of MEP items already discussed, will provide Japan with a major pillar for its future economic policies. JJTI

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