

Challenges Facing the Abe Government

– Boosting Growth & Rectifying Disparities –

By Kono Ryutaro

How to Boost Economic Growth

Prime Minister Abe Shinzo's government has made boosting economic growth the primary focus of its economic strategy, but what does this entail? We occasionally hear that a certain neighboring country, which continues to boost its economic growth, has dramatically raised its national standard of living compared to 10 years ago. Intuitively, there seems to be a close connection between raising the national standard of living and maintaining strong economic growth over a long period of time. Since a country's standard of living (real national income) is determined by its productivity, namely its output per individual worker, achieving sustainable economic growth and raising the standard of living require improving labor productivity.

Labor productivity is determined by capital stock per worker and the level of technology, so to sustainably raise labor productivity requires constant advances in technology and sustainable capital accumulation. Technology advances are especially important, because without them new capital accumulation (capital investment) will stall owing to a diminishing return on capital (ROC). Meanwhile, the source of capital is savings, and while Japan's aging society will necessarily put constraints on domestic savings, it is always possible to tap into overseas savings thanks to the high level of Japan's ROC. Thus, innovation and society's openness are both vital, which is why they are key elements of the Abe government's economic mantra of "technological innovation as a cornerstone of economic growth."¹⁾

Note 1): For a society such as Japan's with a diminishing population, technological advances become all the more important, but it is also vital that the dwindling human resources be utilized to the utmost. Thus, improving Japan's human capital is also essential for raising labor productivity.

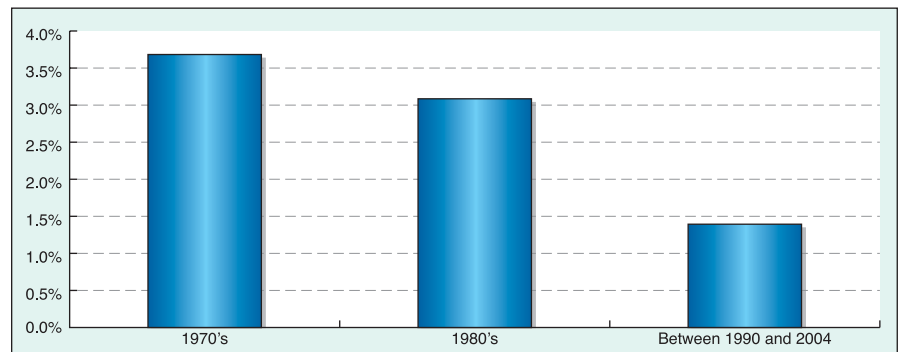
Japan's growth in labor productivity, however, has fallen from an annual average of 3.7% in the 1970s and 3.1% in the 1980s to just 1.4% in the period between 1990 and 2004. (*Chart 1*) A comparison of business sectors shows that productivity growth among manufacturers declined from 3.8% in the 1980s to 3.2% in the 1990s, a drop of 0.6 point. Worst off, however, were nonmanufacturers, where the figure fell from 2.4% to just 0.6%, a steep plunge of 1.8 points. (*Chart 2*) While both sectors showed declines, the most telling on the economy overall was that of non-manufacturers because this sector occupies about 70% of the total economy.

While the common wisdom might argue that we need to give the more pro-

ductive manufacturers a greater slice of the economy if we are to boost the nation's overall productivity, the fact of the matter is that when productivity improves and economies become more affluent, people's spending habits tend to change. Spending no longer focuses primarily on goods, as services also start coming more and more into the picture. For no matter how cheaply we might be able to buy the latest LCD TVs, no one will buy three or four of them. As people become more affluent, they tend to think more about dining at restaurants and the like. Because of this fact, there is no escaping from nonmanufacturers taking a larger share of the economy.

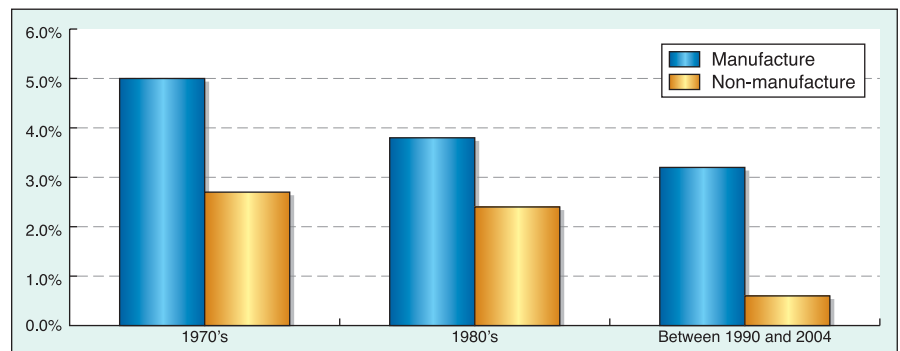
Moreover, when viewed over the long term, productivity growth among manu-

Chart 1 Labor productivity (annual rate)

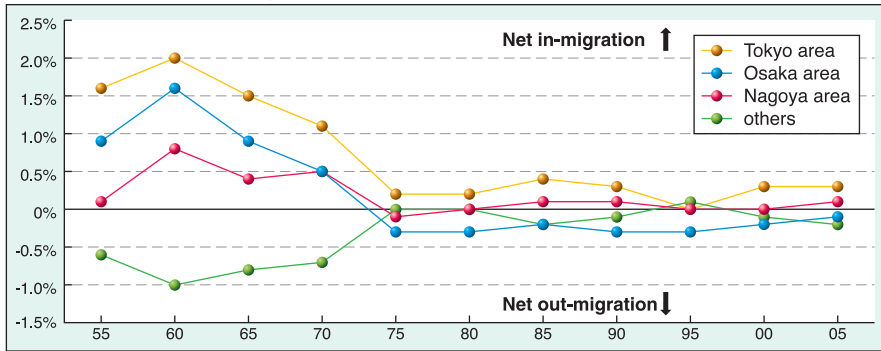


Source : Cabinet Office, BNP Paribas

Chart 2 Labor productivity (annual rate)



Source : Cabinet Office, BNP Paribas

Chart 3 Rural → Urban migration trends (net in-migration rate= net in-migration total / total population of area concerned)

Source : MIC, BNP Paribas

facturers has not meant creating more value added using the same amount of labor but using less and less labor to produce virtually a constant amount of value added. In other words, the manufacturing industry has become rationalized. Thus, even when manufacturers enhance their productivity growth, it does not translate into a greater share of the economy. So while productivity of manufacturers is indeed important, what is required for raising the overall productivity level is greater productivity growth among nonmanufacturers.

Of course, boosting productivity among nonmanufacturers the world over is easier said than done. The problem in Japan's case, however, is that the sector's productivity is extremely low because of official intervention. Not only is productivity low in industries that are regulated, but it also remains low for sectors dependent on government spending including public works outlays. The situation is especially bad for those sectors shielded from real competition by protectionist policies since the 1970s aimed at the economy's weakest members like "mom & pop shops." Companies that otherwise should have left the market long ago or at least switched over to more viable business lines have been kept in operation thanks to such protectionist policies. The result has been that economic resources, be it money, labor or materials, are locked up by businesses with virtually no potential for growth.

Given such a situation, the only way to bring about an improvement in non-manufacturers' dismal productivity growth is to open the closed sectors to outside competition and to limit as much as possible all government interfer-

ence in the private-sector economy. In an economy where businesses are allowed to freely come and go, vital resources will naturally flow from companies with little growth potential to those with greater promise. Boosting productivity growth among nonmanufacturers through greater competition, and by allowing individuals the freedom to innovate, will both enhance the nation's overall productivity and continuously raise the standard of living. This is what structural reform is designed to achieve.

How to Rectify Regional Disparities

Now that the economy has exited its prolonged stagnation, people are becoming aware of growing disparities in society. Issues such as the "income gap" and "regional disparities" have become political hot potatoes with Upper House elections looming this summer. Calling the widening income gap the "negative legacy of Koizumi's reforms," Ozawa Ichiro, head of the Democratic Party of Japan, the largest opposition party, has let it be known that he intends continue taking up this issue with the Abe government, which has vowed to continue the reforms pursued by Abe's predecessor, Koizumi Junichiro. How should we address the problem disparities in the context of boosting economic growth?

Looking first at regional disparities, measures aimed at correcting regional imbalances are rife with problems (rent-seeking, etc.). If markets are allowed to operate freely, economic resources will naturally concentrate in cities with the best growth potential. Thus, it is natural to encourage capital accumulation in areas with the highest ROC. Labor,

meanwhile, will also naturally migrate to cities with the highest earning potential. (Chart 3) In countries the world over, the concentration of economic resources in metropolitan areas is the springboard for national economic vitality.

But in Japan from the 1970s until rather recently, the government, under the slogan of "equal development in all regions," actually embraced policies aimed at thwarting the urban concentration of economic resources. For all its noble pretenses of "equal development," the policies went beyond merely extending favorable treatment to regional governments and regional public organizations through subsidies and tax grants to include some very drastic measures aimed at driving businesses from the cities to the countryside. For instance, the business office tax, which is levied only on corporations of specific sizes (office floor space or the number of employees) in designated cities such as Tokyo, has no other purpose than to discourage businesses from opening up in urban areas. A similar law, which was recently abolished, prohibited the construction of new factories and universities in major cities such as Tokyo and Osaka. The most vocal proponent of such policies was none other than former Prime Minister Tanaka Kakuei, who in his political pamphlet "Building a New Japan" (1972) wrote: "In order to curtail urban functions of the big cities and to accelerate local development, the political adjustment functions of the taxation system should be used effectively to discourage some activities [urban concentration] and promote others [regional development]."

If the central government limits its involvement in regional affairs, local populations will further decline and some areas might become poorer than they already are. But it should be clear by now that measures to thwart the concentration of economic resources in the most productive areas have not led to the development of the regional economies. Japan can no longer maintain a system that strives to provide uniform living standards for everyone from the all, whether you live in the mountains or in the cities. Repeating such policies won't lead to greater growth in the national economy, and the regional

economies will be worse off as a result. So, rather than adopt more policies to close regional imbalances, what must be done now is repealing those remaining policies that block the free movement of economic resources.

What to Do About Income Disparities

Turning next to the issue of income disparities, I would like to start by explaining why income gaps occur. The most fundamental cause lies in the individual differences in productivity, the source of income. Even if two people do the exact same job, the performance (resulting value added) will differ depending on each individual's productivity (valued added ÷ labor input = labor productivity). Such productivity differences arise owing to innate talent, education/upbringing, effort, and luck (or the lack thereof) in circumstances.

What will happen if regulations and other forms of government interference are eliminated, allowing private-sector economic entities greater freedom to achieve their full potential? All conditions being equal, it is only natural that income disparities will arise because people inherently have different income-earning potential. If income was uniform for everyone that would either be because work was being done in such a way that would not yield productivity differences or because the pay system was geared not to reward differences in productivity. And if income over the long haul is the same regardless of performance differences, the most productive workers will naturally put less effort (labor input) into their jobs. Thus, keeping income the same for all will ultimately lead to the worse scenario of a uniform deterioration in both income and performance for diligent workers and slackers alike.

To keep the economy vibrant and avoid succumbing to such a scenario, bolstering the performance of the overall economy through structural reform was one of the top objectives of Koizumi's reforms. Since Prime Minister Abe pledged after winning the LDP presidency last September 20 that "the reform program will not be stopped, but will accelerate, as I'll keep the flame of

structural reform burning," if Abe's take on structural reform is the same as Koizumi's, such talk of accelerated reform could be construed as endorsing the widening income gap.

While embracing free market economics ultimately requires condoning the existence of income disparities, excessively large disparities cannot be allowed to undermine social stability. Thus, it is appropriate to somewhat narrow the disparities by redistributing the income that is so unevenly dispersed throughout society. Income redistribution, in fact, is one of the functions of fiscal policy, and is something widely practiced by all capitalist nations.

But in Japan's case, large-scale redistributions to correct the income gap are rife with problems. Since any policy-based remedy will necessarily entail using the taxpayers' money, once a decision to employ such funds is made, there is a risk of returning to the spendthrift days of yore, when subsidies and other forms of pork-barrel spending were passed off as income redistribution. It will then become all the harder to reduce the budget outlays that otherwise need to be slashed. In such a situation, there is a chance that Japan will not be able to concurrently address its most pressing post-deflation issue of rebuilding state finances. It is easy for politicians to staunchly oppose (or not enthusiastically embrace) spending that is widely deemed to be pork barrel, but there is less compunction to resist expenditures that are nobly earmarked for correcting income imbalances. If the opposition and mass media start hammering the LDP on income disparities prior to this summer's Upper House election, even the reformists in the LDP will likely find themselves pressed into doing something about income disparities.

Although I do not deny the necessity at times for policies to redistribute income, I take a wary stance on this issue for several reasons. First of all, income redistribution to correct income imbalances should be undertaken on an individual basis. Unfortunately, the income redistribution tends to target groups belonging to specific categories such as sunset industries, with the result that the individuals most in need often are overlooked. The fact of the matter is

that the majority of individuals in need of real assistance are not organized in a way that could bring help their way. This is in stark contrast to groups that are eager for fiscal largesse, which are organized to the extent of having lobbyists on their payrolls. As a result, decisions on where to channel taxpayers' money structurally tend to favor the organized rent-seeking groups, something that will act to breathe new life into these vested interests.

Another reason for my qualms about resorting to income redistribution is because of the difficulty in identifying those who are truly in need. From the outside it is impossible to know the real reason income is low, so welfare systems designed to help people when their luck is down often are subsequently abused as they inevitably attract people who feign destitution while taking no steps to improve their lot (the "hidden action" problem in the economics of information). More often than not, the real "have-nots" do not get help. To make matters worse, there is a risk that the introduction of welfare measures will weaken some people's incentives for becoming diligent productive members of society. Because costs such as these inevitably haunt programs to redistribute income, we must be very careful when adopting new income-sharing measures.

Koizumi's structural reforms have been criticized for being insensitive to society's weakest members, but then economics is not called the dismal science for nothing. Economics teaches us that real relief for the "have-nots" does not spring from increased regulations or pork-barrel spending. The question then is: Will a populist politician such as Abe be long able to tolerate being slammed as insensitive to the underprivileged? **JS**



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