

# Economic Reform

By Kosai Yutaka

Since the autumn of last year, the Japanese economy has been in great difficulty. The present critical condition of the economy is partly due to the fact that both the government and the business community underestimated the effect of the government's austerity budget on the economy. Despite the ¥9 trillion increase in the national burden in fiscal 1997, a great many business corporations adhered to a bullish management policy and, as a result, they are now poised to adjust their inventories. Normally, when the government adheres to a belt-tightening fiscal policy, the worst effects of deflation are avoided through a weak currency and low interest rates. In Japan today, however, the beneficial effect of the weak yen has been nullified by the economic and currency crisis in Asia, and the growth of exports is being hampered. Moreover, interest rates are tending upward because of banks' reluctance to lend. The Japanese economy is at present in such dire straits, and speedy actions are needed to extricate it from its predicament.

On Dec. 24, 1997, the Ministry of International Trade and Industry completed a follow-up on the government's Action Plan. I believe it is most important that the government steadily imple-

ment structural reform of the economy, centering on deregulation at present, and build strong foundations for the economy simultaneously with such near-term measures as stabilizing the nation's financial system. The government has decided to accelerate implementation of the Action Plan instead of putting off structural reform, while introducing a series of emergency measures. This decision will produce the effect of leading the economy in the right direction. The Great Depression of the 1920s to 1930s prompted the introduction of a managed economy and protectionist trade. This is an age, however, when technological innovations are progressing on a global scale. The main cause of the present crisis in the Japanese economy has been the continuation of excessive government protection for the financial industry up to the present. To fundamentally defuse this crisis, the government must proceed further with liberalization and deregulation and restructure the Japanese economy into one which is compatible with the rest of the world.

## Need for tax reform

First of all, changes in the tax system are an indispensable measure in the context of structural reform of the

economy. The effective corporate tax rate in Japan is clearly higher than in other industrialized countries (Table 1). If the corporate tax rate is left at its present level, it will become difficult to attract foreign and domestic investment at a time when capital movements transcending international borders are accelerating, and the Japanese economy will be unable to survive the age of mega-competition. In view of the levels of corporate taxes in industrialized Western countries, the effective tax rate in Japan should be lowered by about 10 percentage points. Moreover, instead of adhering to the policy of maintaining single-year tax revenue neutrality, the government should lower the real tax burden. If such a step is taken, the domestic return on investment will rise, and Japan will become a more attractive country for capital investment. The announcement of a tax cut will be effective also as an economic stimulus, because it will engender expectations of a higher return on investment and stimulate the appetite for domestic capital investment even before the implementation of a tax reduction.

The basis for corporate taxation should be made more reasonable by taking the global standard into consideration in order to allay the sense of

Table 1. The effective rates of corporate taxes in industrialized countries and their breakdown (in 1997)

	Japan	U.S.	U.K.	Germany	France
National tax	33.48%	31.75%	31.00%	34.18%	33.33%
Local taxes	16.50%	9.30%	0.00%	15.61%	0.00%
Total	49.98%	41.05%	31.00%	49.79%	33.33%

inequality and bolster the dynamism of the economy.

## Economy as a fertile parent of new business activities

An environment that facilitates the birth of new business activities in succession should be created in order to ensure that Japan will maintain its vitality in the future. However, the fact at present is that there is widespread reluctance on the part of financial institutions to lend in the current economic recession, with not only small and medium-sized enterprises but also large business corporations finding it difficult to obtain necessary funds. Ease of obtaining funds is an important factor determining the economic vitality of a nation, and financial institutions' present reluctance to lend is not only depressing the economy for the time being but also may nip the creation of new business activities in the bud. Under the indirect financing system, one which is typical of Japan, the flow of funds to new growth ventures is destined to slow down in times of recession because such ventures carry high risk. In order to maintain the Japanese economy's dynamism hereafter, re-channeling the flow of funds to new growth ventures and new business activities from indirect financing to direct financing via the stock market, etc., is of paramount importance. Then, even new ventures with fragile financial foundations can diversify their sources of fund procurement, and the supply of risk capital, including private funds, of which there is an abundance in Japan, will begin to flow smoothly.

Since new growth ventures basically have no tangible assets that can be used to secure their loans, venture capital that can supply funds by using as security the intellectual properties they possess, such as technology, should be fostered in order to ensure a smooth flow of funds. To this end, abilities and methods to rate the value of intellectual property rights as security are necessary, but at present in Japan, such competencies do not exist. Therefore, train-

ing individuals to acquire such abilities and establishing such methods is an urgent task. Reforms, including reform of the education system to enable people with the technological knowledge to manage venture capital, should be carried out.

## Importance of policy relating to research & development

Like human resources, financial capacity, and information and telecommunications, technology is one of the important factors that determine the international competitive strength of a nation. With its technological superiority, Japan built today's prosperity. Moreover, it has lost none of its superior technological abilities. In the United States, however, new technologies and business activities are being created mainly in universities and in such areas as information and telecommunications, and are working as the motive power for the dynamic U.S. economy. The U.S.' technological prowess is the result of a federal government policy that attaches importance to technology, adopted in the mid-1980s. Japan still maintains high technological levels, but research and development expenditures have declined due to the present economic stagnation, and it is feared that development of new technologies will slow down. In addition, in Japan, inventions developed cannot be channeled into industry in an efficient manner for practical implementation, and thus there are many cases where worthwhile inventions remain unused. The lag in intellectual foundations is blamed as a major cause of this. Such intellectual



*International intellectual race: Improving intellectual foundations is an urgent task for the Japan Patent Office*

foundations as standard systems, measurement and weighing standards and various databases are indispensable to the efficient utilization of technology, but Japan deplorably lags behind Western countries in such foundations. Improvement and expansion of intellectual foundations through concerted endeavors by the government and the people will prove to be the vital factor in determining Japan's international competitiveness. To encourage research and development, the protection of new technologies by the patent system is indispensable, but in Japan, damages which defendants in lawsuits for violations of intellectual property rights are ordered to pay are in most cases the equivalent of the licensing fees, so violators usually make a profit by violating others' intellectual property rights. Since the scope of intellectual proper-



*A burden: High transportation costs hurt competitive companies*

ties is expanding as a result of progress in electronic information technology and genetic engineering, therefore the subjects receiving protection under law should be expanded whenever necessary. To provide stronger and broader protection to intellectual property rights and encourage the creation of new business activities, the emphasis on protection should be shifted from catch-up type technology to leading-edge technology, such as basic inventions.

## Correction of the high-cost structure through deregulation

The high-cost structure of the Japanese economy should be changed

to create a more attractive business climate. In Japan, distribution and energy costs are very high compared to other countries. If they are allowed to remain at current levels, Japanese companies, including even internationally competitive ones, will be forced to transfer their production bases overseas, and hollowing-out of Japanese manufacturing industries will occur.

In particular, deregulation in the transportation area is an urgent challenge. For example, domestic marine freight charges are so high that the cost of transporting goods between Yokohama and Kobe is almost the same as that between Japan and Europe. Thus, even the production of quality products that have price competitiveness on shipment from the factory does not pay off if transportation costs are

added, so manufacturers are moving production overseas. Moreover, such costs as international air cargo freight and port charges in Japan are very high by international standards (Table 2). In such a business environment, it is feared that even internationally competitive companies will shift their production bases overseas to survive the escalating international competition due to the globalization of the economy, intensifying industrial hollowing-out in Japan. In the follow-up on the Action Plan in December 1997, the government decided to abolish regulations limiting new entries by adjustment of supply and demand in the distribution and transportation areas by between fiscal 1999 and fiscal 2001. To bolster the vitality of the Japanese economy in the present recession, however, immediate deregulation is necessary.

## Curbing the public burden by introducing PFI

It is important to promote the Private Finance Initiative (PFI)\* (refer to note) by tapping the private sector's resources for building infrastructure. In Japan, construction of public facilities has been undertaken by the national government, local government, special public corporations and the third sector (corporations in which national or local governments have invested). However, the high cost and inefficiency of this method has begun to pose a serious problem from the viewpoint of public finances. Construction of infrastructure under the initiative of private corporations is desirable from the viewpoint of economic structural reform as well as of public finances, because it creates new businesses and induces new investment. The revised plan contains a policy of studying the advisability of introducing PFI. This deserves consideration.

Now that the Japanese economy is in such great difficulty, it is most important that the government correct the economy's high-cost structure through deregulation, create an environment that facilitates corporate reform and at the same time cut expenditures, reduce cor-

porate taxes and downsize itself by actively introducing PFI. It is widely hoped that an effective structural reform of the economy will be carried out.

\*(note) The Private Finance Initiative

(PFI) is a project to build infrastructure and supply public services of higher quality and efficiency by using private sector funds and know-how. It was introduced in Britain in November 1992

and is being utilized in the execution of diverse types of public investment, including the construction of buildings, transportation infrastructure and information systems.

**Table 2. Examples of high costs for structural reasons in Japan (international comparison of industrial locations)**

		Japan	U.S.	Germany	Korea	China	Singapore
Energy cost	Petroleum products	100	67	117	152	54	53
	Electric power rate for industry	100	77	81	44	71	38
	Tap water charge for business	100	-	-	191	39	374
Transportation and telecommunications cost	Railway freightage	100	61	67	24	10	-
	Coastal shipping freight charge	100	131	-	40	22	-
	Port charges	100	90	-	47	-	53
	International air cargo freight charge	100	55	73	98	30	80
	Customs clearance cost for exports	100	-	-	24	-	20
	Local telephone charges	100	97	155	52	14	29
	Long-distance telephone charges	100	48	85	23	5	-
	International leased circuit (general)	100	88	101	95	-	85
Domestic leased circuit fee	100	32	185	123	87	-	
Fund-raising cost	Corporate bond issue cost	100	86	-	-	-	-
Land development cost	Land for plant construction	100	71	62	54	-	-
	Land in Class 1 commercial zone	100	11	24	28	9	38
	Office rent	100	55	52	56	135	70
Personnel expenditure	Personnel expenditure	100	73	135	31	-	31
Taxes	Corporate taxes (effective tax rate)	100	82	100	65	66	54

#### Notes

1. The periods of comparison between Japan and other countries are as follows—Petroleum products: March 1996 for Germany and December 1996 for the U.S.; Electric power rate for industry: April 1997 for the U.S. and Germany (The above is based on surveys by MITI, etc.); Tap water charge for business: May–June 1996; Coastal shipping freight charges: January–March 1995 for the U.S.; Port charges: 1995; Customs clearance costs for exports: October 1995; Corporate bond issue cost: July 1994; Land development cost in Class 1 commercial zone and office rent: January 1994; Personnel expenditure: 1995; Corporate tax rate: 1995; Others: April through December 1995
2. Comparison of land development cost in Class 1 commercial zone with South Korea and Singapore is based on estimated purchasing power parities.
3. Comparison of the coastal shipping freightage is based on a 40-foot container freightage per kilometer for the U.S. and the charter fee for a 1,600-ton cargo ship for South Korea and China.
4. It should be remembered that the quality of goods, specifications and trading terms are diverse and differ from country to country and that the comparison of costs are not based on overall comprehension.

Sources: "Monthly Budgetary and Finance Statistics" and "Problems and Prospects for the Yen-denominated Foreign Bond Market, etc." by the MOF, "Research into Domestic and Foreign Prices Relating to Intermediate Inputting by Industry" by MITI, "Research into Domestic and Foreign Prices Relating to Transportation Service" by the Ministry of Transport, "A Survey of Land Prices, etc., in the World" by the National Land Agency, "Daily Labor Report" by the U.S. Department of Labor, and "JETRO White Paper" and "Comparison of investment-related costs in major cities and regions in Asia" by JETRO.

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