Japan's Difficulties and Potential as an Investment Location

By Rupert Naylor

Japan's difficulties as an investment location are well known. However, contrary to the popular image, little blame for this can be attributed to government tariffs and regulations (though the tax burden is a problem which is finally but falteringly being addressed).

The OECD has shown that Japan has fewer and less distorting tariffs than the United States and the European Union.

This leave policy makers with no quick-fix option to improve the situation, but it can help in several ways. It can assist companies looking for partners or openings in the Japanese market. It can help bring down the cost of the economy and make supply side improvements. And it can improve its investment promotion effort and introduce internationally comparative incentive programs. In fact, though the government has had a positive attitude towards this issue for several years now, something more proactive might be timely. While inward investment remains low, it can only have a marginal stimulative effect on imports. On the other hand, while imports remain low, companies, particularly small companies, that are currently exporting to Japan will not reach the critical sales mass that means that it will make sense to invest in Japan. Moreover, until costs come down, companies are going to be put off investing, or their investments will be limited. On the other hand, while investment remain limited, the downward cost-pressure of foreign competition will hardly be felt.

The Japanese Government can and is already doing several things that can stimulate inward investment. The most obvious is providing full information about the processes involved in investing, as well as other information for the investor.

Here, JETRO has produced several useful if unexciting documents, including *"Setting Up a Business in Japan"* and other investor guides that include everything from sources of incentives to information on health, education and leisure issues. Most prefectures and regions also produce information for inward investors, but none of these has the sophistication seen in many other countries. *"Australia—a smart move"* argues the case for locating a headquarter for the Asia-Pacific region in great detail, giving information on the cost advantages of investing there. European countries, led by the United Kingdom, are making their inward investment effort increasingly focused, in part because of the competition from neighboring countries. Japan must tailor its own inward investment approach to its strengths—infrastructure, education and support services are very high quality and the domestic market is large. The economy in Hokkaido alone is larger than that of Thailand, for example, and Kanto's economy is larger than that of France.

Acquisition of a domestic company can be a good way of entering a new market. The correct partner can give you instant entry to the market, a recognizable brand name and a service network, the latter being a considerable impediment in Japan. However, M&A activity in Japan remains very limited—in 1996 there were just 36 deals amounting to $2.5 billion of foreign M&A. There are a range of factors inhibiting greater activity in this area. Opaque auditing rules and tax statements that make it hard for outsiders to evaluate a company's financial position, high costs, cross shareholdings and strict limits on the establishment of shareholder companies all contribute. The key factor is however cultural. In Japan, M&A is considered only as a last resort. As a result of this, organizations set up to help companies with investment tend to propose companies that are struggling when asked by foreigners to find a potential takeover partner. This damages the credibility of those investment services and hinders Japan's inward investment position. Recent changes to laws governing mergers and acquisitions and government sponsorship of M&A seminars and workshops may help, but the real change will come when shareholders begin to exercise an independent voice.

Foreign trade associations and companies can also play a role to encourage investment. The German Industry Centre and British Industry Centre (B.I.C.) in Yokohama are examples of where this is beginning, with support from Yokohama City. The highest levels of government are involved in these countries' inward investment efforts. This was shown in January when the U.K. Prime Minister, Tony Blair, opened the B.I.C. mentioned above. At any international meeting, Japanese Trade and Industry Ministers are encouraged to ensure that Japanese firms invest in their opposite number's country, and if a major company is thinking of locating in one of a few countries or regions, heads of state or regional governors will lobby on behalf of locating in their country. Similar priority is rarely given to inward investment by Japanese officials and ministers. There were signs of change, however, when, as troubled East Asian nations were calling for foreign investment at the ASEM summit in London in April, Prime Minister Hashimoto suggested that it was also a good time for investing in Japan.

This general lack of governmental focus can result in policy inconsistencies. As one delegate at the Akita conference pointed out, in some

Aimed at providing support and advice to assist British companies starting businesses in Japan: British Industry Center (B.I.C.) in Yokohama

cases, while the Japanese Government may be encouraging inward investment with one hand, through MITI and JETRO, less outward-looking ministries and agencies act, not necessarily wilfully, to discourage potential investors. Difficult customs procedures were one example cited. If a firmer steer were given from the top, the whole of government might begin to focus on ironing out many of the inconveniences that hinder businesses in Japan, and present a coherent policy front.

Companies are seeking a variety of measures beyond these already mentioned. Firstly, given the high business tax rates, tax breaks and reductions are important, even for the Japanese business community. New companies, however, face a particularly hard time and so several investors felt that they should be allowed to pay a decreasing rate of tax, starting from zero, upon entering Japan, or the current situation where most offices are merely liaison offices (which do not have to pay tax) will continue.

Secondly, accounting practices remain obscure and open to abuse, as has been seen during the recent financial uncertainty. More importantly, they remain out of line with international practice and hinder M&A activity. Linked to this, increasing disclosure and shareholder participation are desirable and likely through the "Big Bang." The high hopes that many harbor for the "Big Bang" must be met—it is essential that the government does not lose heart when implementing the proposals. It is generally thought, and hoped, that these will trigger a chain reaction that will alter the way industry operates in Japan, increasing openness and opportunities. There are already signs of this.

Companies could also benefit from more hand-holding when investing. One company commented on an investment in China, in which the process progressed very smoothly because the same government body handled both investment promotion and licensing. Although this is not a call for Japan to adopt such bureaucratic structures, current efforts received mixed reviews from the companies that I spoke to. Since 1995, JETRO has dispatched senior investment advisers to various major markets to help find potential investors and bring them together with possible partners. This is the type of proactive investment promotion that may begin to increase levels of investment.

Regional competition for investment must also be encouraged—in Japan, the regional investment effort is directed from the center, which stifles potential innovation in investment promotion. While every region produces a glossy brochure saying that it provides the best location for foreign companies, central budgeting ties regional hands. Foreign investment outside the Kanto and Kansai regions is limited. Of course there are exceptions, and foreign firms are located throughout the country. As far away as Memanbetsu in the east of Hokkaido, Nihon ABS, a maker of brakes, has a factory producing speed sensors. The product is significant, since only producers of products with low weight to price ratio can still afford to pay the high distribution costs associated with locating outside of the golden corridor between Osaka and Tokyo.

Regions are beginning to respond, such as through the seminar on regional inward investment held in Akita during October 1997. But this also illustrates how far there is to go. While the hospitality was first class, the presentations did not really concentrate on presenting a persuasive case for investing in Akita or other Japanese regions. No mention was made of the benefits available for foreign companies, the reasons for investing in Akita (land prices and low susceptibility to natural disasters were not even mentioned) and possible partner companies in the region. Eventually, local governments must be able to seek out such potential investors and tailor their approach accordingly.

Finally, Japan must introduce internationally comparable investment incentives. Although it does not compete for investment with neighboring countries in the way that European countries do, given the high initial capital costs and the long payback time, investment incentives could certainly help sway some companies' decision. Japanese companies know in reverse when they invest in Europe how such incentives can affect a decision. In the U.S., Alabama enticed Mercedes Benz to Tuscaloosa with state subsidies of $300million, which for a Mercedes workforce of 1,500 means some $200,000 for each new job. Regions in the U.K. compete against not only other regions nationally, but other European regions, which forces them to increase their incentives. In fact, in some cases, it is only EU rules that hold payments back. Japanese regions are at last realizing that they have to do more than rely on JETRO and a glossy brochure if they wish to attract investment from overseas, but until they are allowed greater freedom in encouraging investments, this will be limited.

Japan's potential as an investment location and the size of the market, especially once domestic demand revives, means that if these changes are enacted, the large imbalance in investment flows should, over time, be reduced. JJTI

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