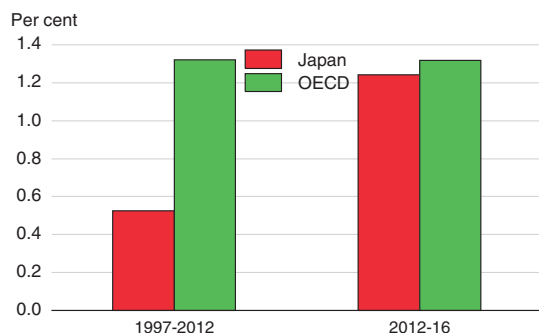


Executive summary

- *Growth has picked up*
- *The dispersion in labour productivity between firms limits inclusive growth*
- *Government debt continues to rise as a share of GDP*

Growth has picked up

Japan's per capita output growth has accelerated

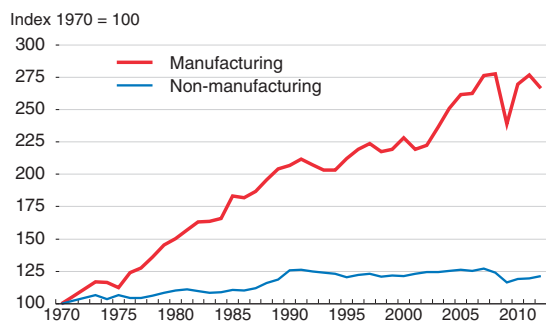


Source: OECD Economic Outlook: Statistics and Projections.
StatLink <http://dx.doi.org/10.1787/888933469489>

Over the past four years, output per capita grew almost as much in Japan as in the OECD area. Faster growth has been supported by job creation and a pick-up in wages in the context of increasing labour shortages and record high corporate profits. Fiscal packages are also supporting growth in 2016-17. However, domestic business investment has been held back by weak growth prospects as the population declines. Underlying inflation is still close to zero. While growth has picked up, more needs to be done for Japan to overcome two key challenges – a record high government debt ratio and an accelerating decline in its working-age population. To sustain per capita output growth and put the debt ratio on a downward trend, it is essential to successfully implement all three arrows of Abenomics.

The dispersion in labour productivity between firms limits inclusive growth

The productivity gap between manufacturing and services is widening

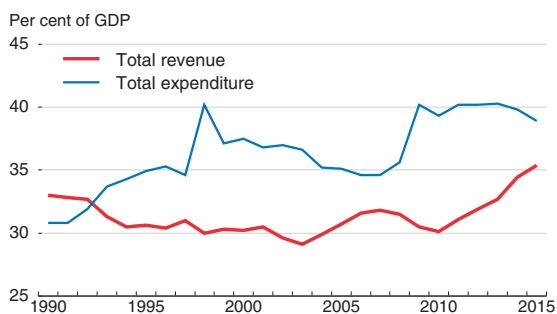


Source: Japan Industrial Productivity Database 2015.
StatLink <http://dx.doi.org/10.1787/888933469257>

Although key structural reforms have been launched as part of the third arrow of Abenomics, labour productivity remains around a quarter below the top half of OECD countries. Obstacles to entry and exit of firms limit the number of innovative new firms and trap labour and capital in low-productivity activities. The productivity gap between the service sector and manufacturing and between leading and lagging firms has widened, contributing to wage and income inequality. Labour market dualism is becoming even more entrenched, with non-regular workers now accounting for 38% of employment, driving up the relative poverty rate. Dualism, which especially affects women, drives up inequality and holds back productivity growth, as non-regular workers are paid low wages and receive little training.

Government debt continues to rise as a share of GDP

Government revenue has not kept pace with spending



Source: OECD Economic Outlook: Statistics and Projections.
StatLink <http://dx.doi.org/10.1787/888933469412>

The 2014 consumption tax hike and spending restraint lowered the primary deficit in 2014-15. Nevertheless, the government debt ratio is on an upward track and government projections show that a primary deficit may persist through FY 2024. A rise in government bond yields, which are currently near zero, poses a risk to fiscal sustainability. Rapid population ageing is putting upward pressure on spending, increasing the already large transfers to the elderly population that raise concerns about inter-generational fairness. Healthcare spending is now the eighth highest in the OECD area, due in part to the burden of long-term care. Tax revenue is below the OECD average, reflecting a very low value-added tax rate and relatively little revenue from Japan's personal income tax.

MAIN FINDINGS**KEY RECOMMENDATIONS****Supporting output growth**

Wage growth remains muted despite the tightest labour market conditions in 25 years. The minimum wage relative to the median wage is one of the lowest in the OECD.

Raise the minimum wage toward half of the median wage and reduce the amount of unpaid overtime by firms.

Headline consumer price inflation fell close to zero in 2016 and lowered inflation expectations, with a negative impact on wage prospects.

Monetary easing should be maintained as planned until inflation is durably above the 2% target, while taking account of costs and risks.

Boosting employment and productivity to promote inclusive growth

Despite the rising female labour participation rate, the employment rate of women is 17 percentage points below that of men, reflecting shortages of childcare, long working hours and a large gender wage gap.

Remove obstacles to female employment by increasing the capacity of childcare and improving work-life balance through a binding ceiling on overtime work.

The dispersion in productivity and labour income between firms is relatively large in Japan and has been widening. Firm entry and exit rates in Japan are well below other advanced economies and the number of entrepreneurs is low.

Increase the productivity of SMEs by strengthening R&D links between firms and universities.

Facilitate the exit of non-viable firms by reducing the use of personal guarantees.

Promote second chances for failed entrepreneurs by making the personal bankruptcy system less stringent.

Start-up firms in Japan tend to remain small rather than expanding and achieving economies of scale.

Implement the planned reform of the Credit Guarantee System to strengthen market forces and keep public guarantees of SME loans on a downward trend.

The large wage gap between regular and non-regular workers is a primary cause of wage dispersion, relative poverty, and the large gender wage gap. Limited training of non-regular workers slows productivity growth.

Break down dualism by relaxing employment protection for regular workers and expanding social insurance coverage and training for non-regular workers.

Achieving fiscal sustainability

Japan's gross government debt continues to rise into uncharted territory, reaching 219% of GDP in 2016, the highest in the OECD, raising the risk of a loss of confidence.

Commit to a more detailed medium-term fiscal consolidation path with specific spending cuts and tax increases to strengthen confidence in Japan's fiscal sustainability.

The tax burden is below the OECD average and has not kept pace with spending. The tax and transfer system has a relatively low impact on income inequality and relative poverty in the working-age population.

Gradually raise the consumption tax rate.

Enhance equity by introducing an earned income tax credit.

Pension benefits have increased due to the failure to apply macroeconomic indexation. The share of the population contributing to the basic pension system has fallen, particularly among young adults.

Fully apply macroeconomic indexation as soon as possible.

Raise the pension eligibility age above 65.

Hospital stays in Japan are almost four times longer than the OECD average and Japan's per capita outlays on pharmaceuticals are relatively high.

Take long-term care out of hospitals, reduce long-term care insurance coverage for those with less severe needs and increase the use of generic drugs.

Promoting green growth

Japan aims to cut greenhouse gas emissions by 26% from its 2013 level.

Rely on environmentally-related taxes and promote energy efficiency and the use of low-carbon energy sources to further cut greenhouse gas emissions.



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