III. Improving the sources of growth and higher living standards

A return to growth is increasingly urgent in Japan to facilitate dealing with the serious fiscal situation and the rapid ageing of the population. Maintaining living standards in the face of an ageing and shrinking population requires substantial increases in productivity per worker. But to underpin this, multi-factor productivity will need to accelerate, reversing a trend that has been in place since the first oil price shock of 1973. Labour and per capita productivity have been driven increasingly since that time by high rates of investment but the marginal returns have been declining. The problems essentially arise from the inability of the Japanese economic system to reallocate resources efficiently, be they human, entrepreneurial, intellectual and financial, thus requiring reforms in a wide range of areas.

Maintaining a consistent policy focus on productivity is difficult in any country but particularly so in Japan. The presence of a strong export sector, which has often set world standards for efficiency, has led to a public preoccupation with exports as almost synonymous with growth. As a result, the question about sources of future growth is often put in terms of which industries will grow and be the winners (*e.g.* nanotechnology and biotechnology) and how they should be supported. High performance export industries also serve to distract attention from getting the rest of the economy to work more efficiently and it is here that there is considerable scope for improved performance. Emphasis on leading sectors and exports can lead to distrust of general systemic approaches to growth issues, a tendency reinforced by a barrier to thinking about improved productivity at a time of rising unemployment and widespread discussion about job sharing. Yet the evidence in Japan and elsewhere, which has been examined by the OECD *Growth Project*, is that general market mechanisms that are allowed to function without excessive restrictions are paramount, even though it is not possible to fully explain the variation of growth over time or between countries.

The general market mechanisms which are clearly connected with growth include those factors determining the nature of the competitive environment for goods and services and that determine the allocation of resources. The list is long, including the ease of entry and exit by entrepreneurs, the rules of competition and trade and the institutions determining the allocation of labour. These factors have long been viewed as essential for growth and have therefore comprised the core of OECD structural surveillance. More recent studies have renewed interest in the role of human capital, technology and R&D, and the special role of ICT in stimulating productivity gains. There is in fact a close relationship between the factors touched on above that the *Growth Project* has served to better substantiate. For example, the *Growth Project* has documented a close positive relationship between the degree of competition and productivity growth; and competitive telecommunications systems have accelerated the diffusion of ICT, which has in turn contributed to productivity growth. Any division of these inter-related factors into two chapters is thus somewhat arbitrary. This chapter deals with the elements of policy which the *Growth Project* characterised as "Getting the Fundamentals Right". The following chapter deals with a number of, nevertheless, important issues including competition in "network" sectors, human capital formation and issues surrounding what is loosely termed technology and innovation.

The first section of this chapter reviews the productivity and growth record, placing the 1990s in a cross-country and time perspective and uses the results of the *Growth Project* to identify main drivers at the macroeconomic level. The analysis points to some puzzling features that are related to the dualism of the Japanese economy. These are best explained by micro/structural factors. The second section, therefore, examines the competitive environment including entrepreneurship, barriers to entry and to exit, the overall regulatory framework, and the openness of the economy. The third section focuses on the need for labour mobility, better job matching and increasing the labour force participation rate for women. The final section draws together the main conclusions. This section also includes the customary update of progress in structural reform more generally.

The productivity and growth record

Productivity has been slowing for several decades with growth being factor intensive

A critical feature of growth for quite some time now has been its reliance on increasing inputs rather than improvements in efficiency.[57] During the period of convergence, with catch-up to international standards, growth was exceptionally rapid due to high rates of growth of both MFP and capital inputs. GDP grew at an average annual rate of 9¼ per cent in the period 1956-1973. Population growth was also rapid which translated into labour force growth of 1-1½ per annum. MFP growth was in turn driven by economies of scale and by the transfer of workers out of agriculture and other low productivity sectors into export sectors where productivity was high and growth rapid.[58] In the period after 1973 growth slowed markedly (as in many other countries) to around 4 per cent in the period 1975-91 and the underlying components also shifted. The picture is, however, obscured by the "bubble" period at the end of the 1980s, which should be considered an aberration. Inter-sectoral shifts of employment to maintain or raise aggregate productivity became more difficult and capital accumulation became the main driving force for growth, supported by a steady increase in labour force participation (Figure 21). Labour productivity has been underpinned since then by extraordinary inputs of capital which have contributed to a declining rate of return through the 1980s and into the 1990's that is now far below that in other OECD countries. The subsequent slowing of capital accumulation has in turn led to the reduced growth of labour productivity (after adjustment for the significant trend decline in hours of work) (Figure 22).

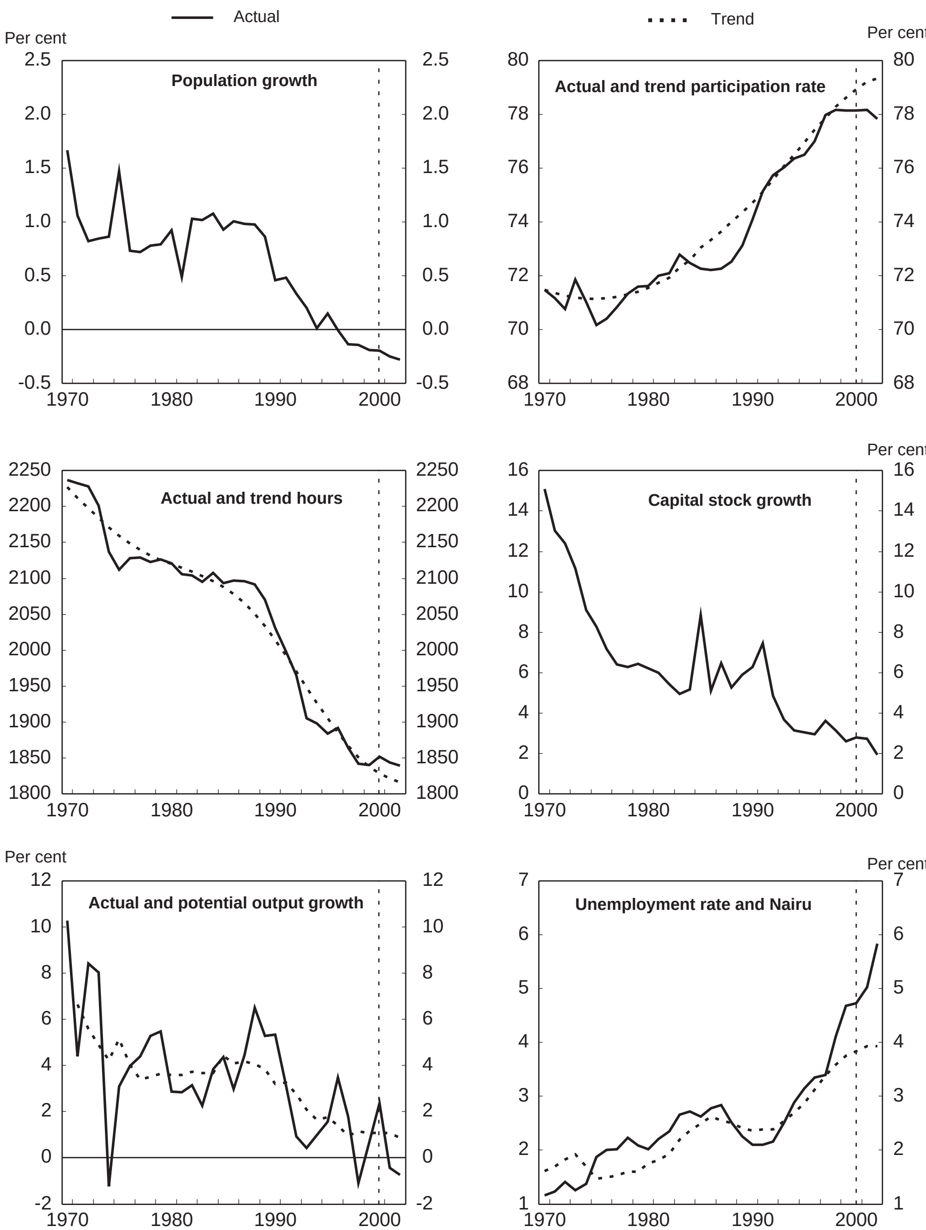
A consequence of this long run pattern of input-intensive growth is that the economy is surprisingly unproductive. One study shows that the Japanese economy is 31 per cent less productive than the US economy in terms of labour and 39 per cent less productive in terms of capital (Table 18). The Japanese economy uses 11 per cent more labour input (hours) per worker and 13 per cent more capital input per hour worked than the US to maintain its level of output.

The extraordinary capital intensity of Japanese growth is apparent in Figure 23. The comparison with Germany is interesting since it also had to embark on a long process of post-war capital accumulation. Nevertheless by the early 1970s this process had run its course, the investment ratio had come down with, as a counterpart, a consumption share of GDP some 5 percentage points higher than in Japan. The pattern of potential output growth has also shown a more pronounced path than in other countries, although the pattern of slowdown after 1973 was shared with the major European economies.

The 1990s saw this slowing growth trend continue

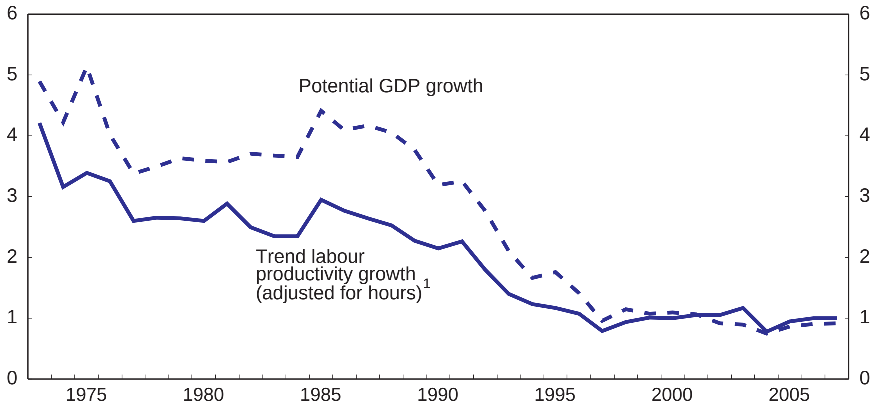
Average GDP growth in the 1990s fell to 1½ per cent following 4 per cent growth in the 1980s, and MFP probably declined from around 1 per cent per annum to only a half of that, although these measures are very imprecise (Table 19). Conventional growth accounting shows that reduced labour and capital inputs contributed more to slower growth during the decade than did reduced MFP growth. The reduction of labour input has been driven by several opposing tendencies. The growth of population of working age turned negative around 1995, and average hours of work have continued to decline, in part reflecting more part-time work. On the other hand, labour force participation has risen. The contribution of capital stock to growth declined, probably due to the lower marginal rate of return on capital from an already high capital to GDP ratio. The capital-output ratio nevertheless continued to rise, which can imply that MFP growth has fallen to a new lower steady state level.[59] Although the OECD estimates point to much slower MFP, the decade has been difficult enough to render estimates more than usually

Figure 21. **Factors underlying growth**



Source: OECD.

Figure 22. **Labour productivity growth has declined**
Annual averages, percentage points



Note: For a description of the derivation of potential GDP and labour growth see *Economic Outlook 70.*
1. Between 1990 and 1992 Japan moved from a 6-day to a 5-day week.
Source: OECD.

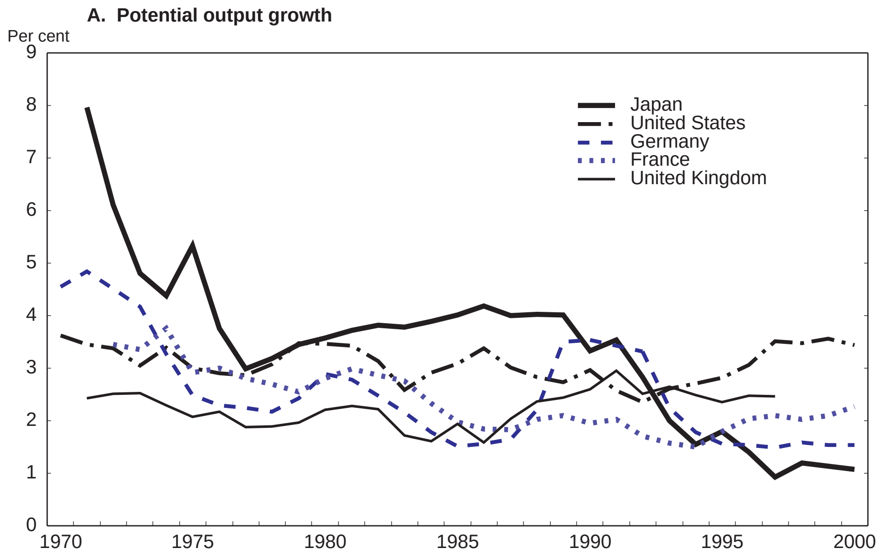
Table 18. **Productivity is low**
Index: United States = 100 in 1999

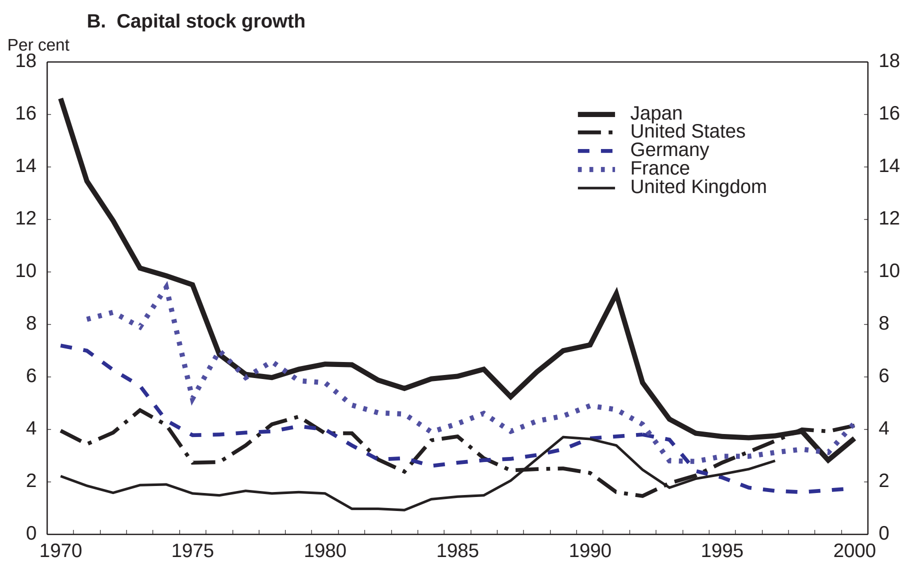
	Japan	United States
Capital productivity	61	100
Capital per hour worked	113	100
Labour productivity	69	100
Labour inputs per worker	111	100
GDP per capita	77	100

Source: McKinsey Global Institute, 2000.

uncertain. MFP is given as a residual after accounting for the volume of inputs, but the different inputs are linked and are not exogenous.[60] With business cycle conditions unfavourable during the 1990s and evidence of widespread labour hoarding, the decline in labour input might easily be understated – which would lead to an apparent decline in MFP growth. While this is a plausible story, there are nevertheless indications that MFP has been slowing, reflecting longer run developments which were also at work during the "lost" decade. The key question is why MFP has slowed so much over several decades?

Figure 23. **Growth has slowed more in Japan**
Annual percentage change





Source: OECD.

Table 19. **Accounting for growth**
Annual rate of change

	Labour input	Capital input	MFP	Output in business sector
1980-89	0.5	6.9	1.0	4.3
1990-99	–0.9	3.8	0.4	1.4
Difference 1980s-1990s	–1.4	–3.2	–0.6	–2.9
(contribution)	(–0.8)	(–1.3)	(–0.6)	

Note: Figures before 1990 are based on SNA68, while those for 1990-99 are based on SNA93. Difference between 1980s and 1990s partly reflects the shift of the system of National accounts. The calculations are not detrended and use actual factor shares.
Source: OECD.

The macro perspective of the Growth Project does not explain the Japanese slowdown

The OECD *Growth Project* considered a broader set of macroeconomic forces driving growth and its development over time.[61] The *Growth Project* focused not on growth but on growth per head of working age population which slowed continuously from the 1970s to the end of the 1990s. Although other countries have also exhibited a slowdown over time, it is more marked in Japan and less well explained by regression models which include investment and trade intensity (relative to GDP) and human capital formation (defined as cumulative years of schooling). However, in Japan, these macroeconomic forces suggest strong growth per capita. A "missing variable" which was also investigated by the *Growth Project* for a smaller range of countries concerns R&D intensity which was found to be positively related to productivity growth – and also for Japan. The R&D/GDP ratio is high in Japan and, moreover, it is mostly privately financed which the *Growth Project* showed improved the impact on productivity. The R&D/GDP ratio remained constant through the 1990s rather than increasing as was previously the case. It is thus unlikely that the excluded variable, R&D, can "explain" the growth slowdown over time.

One response to the results for Japan is that the major macroeconomic forces for growth might not have been adequately measured and/or the indicator utilised might be intermediated by institutions or behaviour in a way that reduces their impact on activity. For example, human capital and investment might have been misallocated through inadequate market mechanisms. The *Growth Project* recognised the need to consider the microeconomics of human capital, R&D/innovation, and openness as well as the need to understand the role of factor market and product market institutions. These are particularly important in Japan in explaining the growth record and future prospects.

Leaving much to be explained by structural factors

Estimates of MFP growth exhibit a very wide variation between sectors and over time, although caution is required since the national accounts methodology changed in 1990. Even in the boom-dominated 1980s, a number of sectors showed poor productivity growth, including services and the highly protected textile and food processing sectors (Table 20). Not surprisingly, finance and insurance, while their output is difficult to measure, showed high productivity growth rates during the boom period. Previous *Surveys* have identified construction and real estate as sectors with major restructuring problems. Indeed, the deterioration of MFP in these two sectors reduced overall MFP growth by around 1 percentage point. These sectors expanded substantially in the 1980s and suffered from the burst of the financial bubble in the 1990s. As the banking sector continued to provide loans to these sectors even after the bubble burst, low profitability and excess capacity have remained, leading to the deterioration in their MFP. Moreover, MFP has declined in the construction sector even as public works surged

Table 20. **A number of sectors have poor productivity growth**
Average annual rate of change in MFP

	1980 to 1989	1990 to 1999
	Per cent	
All industries	0.9	0.3
1. Agriculture, forestry and fishing	–0.8	–4.7
2. Mining	–4.6	–4.4
3. Manufacturing	2.4	1.5
a) Food products and beverages	–4.7	0.5
b) Textiles	–2.1	1.4
c) Pulp, paper and paper products	1.0	–1.8
d) Chemicals	8.2	1.5
e) Petroleum and coal products	1.1	–0.4
f) Non-metallic mineral products	3.7	–1.2
g) Basic metal	–4.1	–0.1
h) Fabricated metal products	4.8	–0.3
i) General machinery	4.3	–0.6
j) Electrical machinery, equipment and supplies	15.1	7.9
k) Transport equipment	2.0	1.9
l) Precision instruments	4.6	–0.3
4. Construction	0.9	–7.1
5. Electricity, gas and water supply	–2.2	–1.1
6. Wholesale and retail trade	1.4	2.3
7. Finance and insurance	7.4	–0.1
8. Real estate excluding rent	–3.8	–6.8
9. Transport and communications	2.0	2.0
10. Service activities	–8.7	–1.0

Note: Figures for 1980 to 1989 are based on SNA68, while those for 1990 to 1999 are based on SNA93.
Source: OECD and *National Accounts*, Japan.

during the 1990s. The financial sector itself also faced a sharp decline in MFP growth in the 1990s. These findings point to the need to accelerate restructuring in the construction and real estate sectors as well as to restore efficiency in the financial sector. But Table 20 also points to something more significant: a dual economy.

The characterisation of Japan as a dual economy with some leading-edge manufacturing industries and lagging domestically oriented sectors is confirmed not only by inter-sector differences in MFP growth rates, but also by estimates of productivity levels across countries (Table 21). While Japan is very productive in export-oriented industries such as autos, steel, machine tools and consumer electronics, the level of productivity in domestic sectors such as retailing, construction and food processing is a half or less of that in the US, and also significantly lower than in Germany. One view is that services and construction are less traded internationally, so that competitive pressure is weaker in those sectors and more variable across countries.[62] There is good evidence that domestic sectors – including food processing – are subject to less competition from foreign rivals both through imports and inward FDI than in many other countries (Box 4).[63] Domestic competition also matters. One detailed study of companies suggested that weak domestic competitive intensity, little exposure to global best practice, poor management skills and market distortions in the domestic sector reduced the pressure on firms, thereby leading to lower efficiency.[64] This conclusion is supported by Porter, Takeuchi and Sakakibara (2000) who reviewed successful and unsuccessful cases of industrial policy in Japan. They concluded that at the end of the day, competitive markets and standard setting by the government were crucial in those sectors in which Japan has enjoyed success.[65] By contrast, productivity has grown least in those sectors where competition has been suppressed by

Table 21. **Open sectors have high labour productivity**
Index: United States = 100

	Japan	Germany	United States
Auto	145 (127)	93 (84)	100
Food processing	35 (42)	95 (84)	100
Steel	121 (110)	100	100
Computer	95	89	100
Consumer electronics	115	62	100
Metal working	119	100	100
General merchandise retail	54	96	100
Healthcare	93 (75)	n.a.	100
Telecom	82 (51)	51 (42)	100
Construction	45	70	100

Note: Figures in parentheses are MFP.
Source: McKinsey Global Institute, Bailey and Solow, 2001.

Box 4. The case of two low productivity sectors: a lack of competitive pressure

Food processing and construction are two sectors characterised by low productivity levels and low or even negative productivity growth. In both cases, the quality of the regulatory system and curbs on foreign and domestic competition are key factors.

Food processing is one of the largest manufacturing sectors in Japan employing 11 per cent of manufacturing labour. It is characterised by small establishments and productivity is low compared with the United States: multi-factor productivity (MFP) is only around 40 per cent and labour productivity only 35 per cent of the levels in the United States. Productivity in France is about the same as in the United States so that the explanation is, arguably, not related to consumer demand for freshness and quality. There are many small processors that do not compete nationally and especially in the packaging segment there is so much product proliferation that some processes cannot be automated. Detailed studies, however, show that some firms are as productive as those abroad, begging the question why they cannot or do not expand. The cause for the current situation appears to be due to the lack of foreign competition as a result of trade barriers and the absence of FDI – and the discouragement of it – in the packaging industry. Lack of domestic competition is also important, but this might be due to the highly fragmented nature of the retail sector. The structure of the retail sector has been maintained to some extent by the regulatory barriers to large stores and also to the slowness with which banks have moved to deal with non-performing loans (NPL) in the sector. Tax policies and other measures have supported small stores (see the 2001 *Survey* for details). In France the growth of large retailers has led to the development of large food processors with smaller firms moving to niche markets involving higher valued goods that cover their higher costs.

The construction sector is marked by the absence of domestic and foreign competition. This is made possible by bid rigging on the part of firms (*dango*, see the 2000 *Survey* for details), complex relationships with suppliers making it difficult for new entrants to cut prices, and well known government standard prices. A number of practices have also come to light with public institutions distributing contracts between firms with a preference in many cases for local enterprises or (in some instances) for those in which former civil servants are employed. Construction costs are among the highest in the world and cannot be fully explained by earthquakes, urban density or by a high level of employment of non-construction workers (*i.e.* in security, directing traffic, making the site tidy). A more important factor has been the lack of competition for inputs which has led the sector to pay prices for cement and steel far above world prices. Another set of issues arises in the residential construction part of the sector, which is also characterised by low productivity and lack of dynamism. Price competition is limited in this area and the lack of standardisation of materials and methods lowers productivity. Lack of dynamism in residential construction is also related to the underdeveloped state of the second-hand housing market due to high transactions costs, other regulatory impediments and the lack of standardised property appraisal (see the 2001 *Survey* for details).

For detailed information see, McKinsey Global Institute, *Why the Japanese Economy is not Growing: micro barriers to productivity growth*, Washington July 2000.

cartels (in the 1980s) and by import restrictions. These perspectives lead to some striking working hypotheses: the low level of the productivity in domestic service sectors (including construction and some manufacturing sectors) suggests that Japan still has great potential for productivity growth. From the policy perspective therefore, an important source for future growth may not be exclusively in the high technology export sectors (which will nevertheless remain important for the economy), but in the less glamorous domestic and protected sectors.

Raising productivity in domestic sectors is in itself insufficient unless it is accompanied by product and supply innovation which is usual in a dynamic market economy. In other words, the process of innovation will involve raising demand at the same time. The potential for such a development in Japan is suggested not only by microeconomic studies, but also by macroeconomic developments. For example, in the housing sector, building laws have restricted redevelopment of housing yet potential demand by households appears to be strong (see 2000 *Survey* for details). At the macroeconomic level, a puzzling factor has been the high household savings rate and the very high level of household assets left by senior citizens.[66] After declining continuously till the end of the 1980's in line with the ageing population, the savings rate stopped falling in the 1990's and remained at a high level throughout. The high level of prices relative to OECD standards for items such as housing might be one factor at work but in a rapidly ageing society uncertainty about the future and the possible supply of goods and services relevant for their needs might be another. The conclusion is not more public provision but greater possibilities for potential suppliers to discover latent demand (Box 5).

In sum, weak growth during the 1990s reflects a longer-run slowdown of dynamism with growth becoming more input intensive and demand driven by exports and investment. Seen from a macroeconomic perspective, growth performance should have been good with R&D, human capital and the rate of investment all favourable. The fact that these proved ineffective suggests that other factors, termed "fundamentals" by the *Growth Project*, have been more than usually important. With the labour force already declining, the rate of return on assets low and the world competition for mobile resources more intense, future growth prospects will be determined by how policy deals with these resource allocation issues.

Promoting a competitive environment

A review of the empirical literature for the *Growth Project* (Ahn, 2002 and Ahn and Hemmings, 2000) concluded that a large number of studies do confirm that the link between product market competition and productivity growth is positive and robust. This result is also generally supported when composite measures of regulation are compared with the change of MFP in the OECD area

Box 5. Innovation and growth

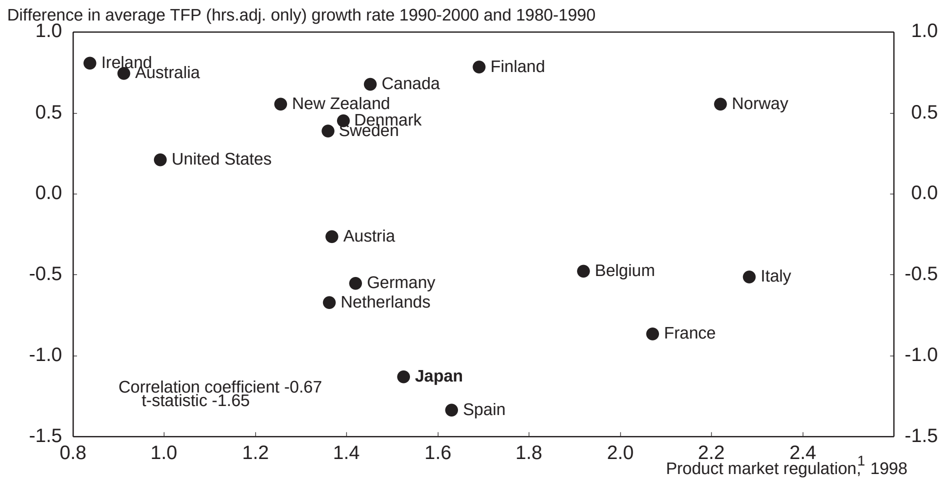
The Ministry of Economy, Trade and Industry's advisory Industrial Structure Council has produced a report on *New Growth Policy* which draws on the ideas of Yoshikawa and others. The main cause of Japan's economic stagnation is seen to be high savings in great part due to uncertainty about the future and to the weakening of the virtuous cycle between innovation and demand. Mobile phones and convenience stores are examples where the process of innovation, productivity growth and demand still works, but there are barriers of a structural nature preventing innovation (or new forms of supply) from meeting latent consumer demand in other areas. Such demand is expected to arise in the areas of social services for an aged society, leisure and demand for associated activities, and further education. Based on surveys the report estimates that consumption of new goods and services could amount to 39 trillion yen in 2010 as opposed to 24 trillion under a no change assumption. Stimulating supply will involve regulatory reform, some technology programmes and a socio-economic system to incite innovations. The latter is projected to include greater labour market mobility, more individual involvement in organising their own training, and flexible wage structures. Under the assumption that reforms are carried through, the economy is seen to have a potential for growing by 3 per cent on average from 2006 to 2010 with a contribution from consumption of 2¼ percentage points. Employment in the economy would rise by some 3 million relative to the no change baseline, with employment growth marked in the service sector. Unemployment would decline and female labour force participation would rise.

This "strategy view" marks a welcome break with a great deal of political opinion, which remains focused excessively on exports and the need for newer technologies (*e.g.* nanotechnology and biotech). Indeed, in this domestically driven scenario, some deterioration of the contribution from net exports is projected. Many of the detailed propositions to support such a scenario are discussed in more detail below.

Note: *Interim Report of the New Growth Policy Committee*, Industrial Structure Council, Ministry of Economy Trade and Industry, July 2001.
Source: H. Yoshikawa, *Japan's Lost Decade*, LTCB, 2002, Tokyo.

(Figure 24).[67] A first section examines the enforcement of competition policy, which has been relatively weak in Japan,[68] with cartels and "refusal to deal" prevalent in some sectors at different times. The openness of the economy, both trade policy and barriers to FDI, is then discussed since it has important implications for competition. The following section takes up the key area identified in the *Growth Project*: entry and exit including the role of the banking system in delaying adjustment. The final section deals with the ongoing evolution of corporate governance and the regulatory process more generally.

Figure 24. **Less stringent regulation is associated with improved productivity**



1. The scale of indicators is 0-6 from least to most restrictive. See Nicoletti *et al.* (1999).
Source: OECD.

Competition policy

Last year's *Survey* noted favourably that the government was committed to strengthening the Fair Trade Commission (FTC) in order to increase the role and efficiency of market forces. Indeed, there were suggestions, supported by the *Survey*, to shift the FTC from the Ministry of Public Management, Home Affairs, Posts and Telecommunications to the Cabinet Office. However, resistance over the past year to change has been intense which has also been the case with structural reform more generally. A key issue documented in some detail in the public expenditure chapter of the 2000 *Survey* is bid rigging in public works projects.[69] Under the existing Anti-Monopoly Law it is not possible to punish public servants for their involvement. A new law, which gives the FTC statutory powers to require heads of ministries or agencies to take necessary measures to eliminate and prevent the involvement of public servants, went into force in July. However, there are no explicit sanctions. The organisation of public tendering restricts competition, not only in the poorly performing construction sector but in business more generally (Table 22).

While the new civil litigation system (since May 2000) for those harmed by anti-competitive practices is a step forward, it cannot compensate for the lack of aggressive enforcement by the FTC. Prosecutions of competition violations

Table 22. **The relative quality of the Japanese business environment**

Adjusted for per capita income, 1999

	Rank[1]
Advantages	
Railroad infrastructure development	3
Domestic supplier numbers	3
Public investment in non-military R&D	3
Domestic supplier quality	4
Adequacy of average years of schooling	4
Buyer sophistication	7
Quality of scientists and engineers	4
Quality of science research institutions	8
Extent of locally based competitors	6
Demanding regulatory standards	9
Intensity of local competition	8
Disadvantages	
Hidden trade barrier liberalisation	45
Computer utilisation	26
Legal barriers to entry	39
Ease of access to loans	31
Venture capital availability	42
Quality of business schools	50
Difficulty of financing start-ups	35
Air transport infrastructure quality	29
Openness of public sector contracts	56
Stock market access	30
Financial market sophistication	26
Financial disclosure requirements	25
Tariff liberalisation	24
Business information availability	19
Adequacy of private sector legal recourse	26
Administrative burden for start-ups	37
Port infrastructure quality	18
Bureaucratic red tape	20
Road infrastructure quality	17
Effectiveness of antitrust policy	17
International direct dial communications costs	17

1. Rank refers to Japan's ranking on each measure compared to 58 nations surveyed.

Source: Porter *et al.* (2001), calculations based on data and models from The Global Competitiveness Report 1999.

continue to average fewer than one per year. For example, the FTC imposed administrative sanctions, rather than seek criminal penalties, on major chemical companies for their participation in a price cartel. The same companies had been involved in similar activity in the early 1990s. Although this cartel constituted a major violation of the law, and therefore could have been subject to criminal charges, the FTC did not refer the case to the public prosecutor. The FTC cited lack of evidence due to the fact that it does not have coercive discovery powers – only the prosecutor has such powers. This situation does not constitute an efficient allocation of powers, which should be corrected by the FTC obtaining coercive investigating powers. In addition, reforms will also have to include much stiffer fines and the legal flexibility to offer leniency. This combination creates a powerful tool for investigating and deterring cartels and bid rigging. Financial sanctions imposed in Japan remain low by international standards. The European Commission can levy up to 10 per cent of the world turnover of a company (and some consider that this is still inadequate relative to potential gains), and the US courts can impose a fine of up to two times the loss or gain from the cartel. But even after the amendment in May 2002, fines are capped at 500 million yen in Japan, a level low enough that companies may simply factor the possibility of payment into their budget plans. Administrative surcharges can be higher, but are still well below the fines that are being exacted elsewhere. To increase the exposure of companies to further penalties, the prescription period for violations should be extended, for example, to five years from the discontinuation of the violations. But raising sanctions is the key to deterring such actions.

Enforcement and implementation of competition policy should also be a responsibility of ministries, which maintain substantial regulatory powers and are often said to continue to issue informal guidance. An example concerns the foundation of a joint holding company of two major domestic airlines. Widespread reports indicated that the Ministry of Transport was favourable to the merger, but on this occasion the FTC ruled it as unacceptable since it formed an effective duopoly of the domestic market. The FTC is said to have insisted that landing slots, which are controlled by the Ministry, be given up to competitors and that essential facilities such as check-ins also be opened to other airlines.[70] The final deal saw the two airlines giving up only nine slots, to be allocated to new airlines, with a further three slots by 2005 if required. Taking into account the FTCs concern about the possible reduction of competition, the newly created entity has reduced fares by 10 per cent for three years. The whole process appears to be very opaque, and "encouraging" the incumbents' fares to remain low might even reduce the incentive for new airlines to enter the market. Fares should be set by market forces working in a competitive framework. The Ministry continues to allocate landing slots from time to time using conflicting criteria (see the 2000 *Survey*).

The FTC is widening its scope to examine competition issues in social services and the number of staff is also set to increase. In addition, it also co-operates with the relevant ministries in producing competition guidelines in the electricity, gas, and telecommunications sectors. In view of its growing responsibilities, the FTC might even be understaffed. But it is not only a matter of numbers: the FTC still does not have enough professional economists to handle its responsibilities for complex enforcement and problems in network industry regulation. And lack of suitable staff is even more of a problem in the line ministries that are now also assuming greater responsibilities. The tradition of generalist staff rotating every two years may not fit well these new and often complex tasks.

Increasing the openness of the economy

A major strength in the past has been the competitiveness of Japanese producers on world markets. The country's increased integration into the world trading system has underpinned growth.[71] However, the world economic system is evolving far beyond trade only in goods while regional integration has accelerated. For example, integration has been marked in Europe and in the NAFTA area. However, when considered from different perspectives, Japan appears to be relatively closed so that it may not be well positioned to reap the benefits of the new global economy:

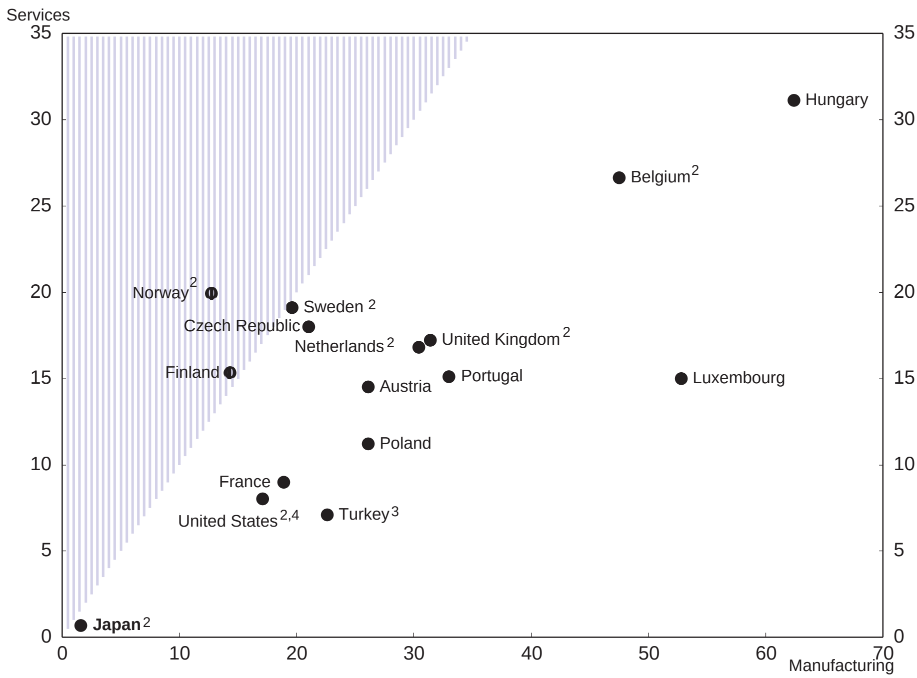
- Trade: the combined ratio of exports and imports is on the low side even by the standards of being a large economy, some 20 per cent compared with 38 per cent for the euro area and 26 per cent for the United States.[72] The pattern of trade flows has normalised somewhat in comparison with the mid-1980s with greater imports of manufactured goods and increased intra-industry trade. However, manufactured imports remain very low as a share of GDP.
- Investment: Japan remains a remarkably closed economy in terms of inward FDI stocks although flows have picked up in recent years (Figure 25). Outward investment flows normalised during the late 1980s and in the 1990s with greater flows to other OECD countries. Nevertheless, Japan remains only a small source of annual FDI in the world economy, ranking twelfth in the OECD after Sweden and Switzerland.

Trade policy: promoting regional trading arrangements

With respect to trade policy, the country has been in the unusual position of not belonging to a regional trade arrangements (RTA) although 60 per cent of its trade is with countries which are members of one (*e.g.* NAFTA, EEA, ANZCERTA, AFTA). This has led to fears that the commitment to pursuing only multilateral arrangements might have left Japan at a disadvantage. Indeed, there is now some econometric evidence from a study using a gravity model of trade which suggests that exports could have been some 13 per cent higher (in 1997) and imports 8 per cent higher (total trade volume 11 per cent higher) in the absence of RTAs.[73] Moreover, it appears that FDI has displaced some exports (to Europe and the United States) as Japanese companies have chosen to locate production within a trading bloc. AFTA is still in its early days and is not nearly as deep as other RTAs. Nevertheless, it is as potentially important to Japan as the EEA and even more so if a free trade agreement (FTA) between China and ASEAN comes into existence.

Figure 25. **The economy is remarkably closed**

Foreign controlled share of total services and manufacturing turnover[1]



1. Foreign-controlled turnover/domestic turnover.
2. 1997.
3. 1994.
4. The data used for foreign affiliates are broken down by industry of sales to be comparable to national total data.

Source: OECD, FATS database.

Concern about RTAs and the desire to re-invigorate the economy led Japan to adapt its policy last year in negotiating an FTA with Singapore.[74] Nevertheless, the government quite rightly views FTAs as complementary to the WTO process, which remains the main pillar of trade policy. After Singapore, feasibility studies have been launched *vis-à-vis* ASEAN, Thailand, Korea, Mexico, and the Philippines. The contentious issues which will need to be addressed include agricultural products. Negotiations will become easier once the implications for agriculture of the WTO's Doha round become clear.[75] Free Trade Agreements have been discussed in the Council for Economic and Fiscal Policy, and between relevant ministries and agencies. Studies using an applied general equilibrium model point to benefits of about one per cent of GDP per annum from extending the geographical coverage of FTAs.[76] In such static models the level of prospective benefits depends very much on factor mobility whereas in dynamic models including economies of scale, improvements of productivity and investment, the returns are usually much greater. To realise these potential gains will, however, require structural reforms.

Incoming foreign direct investment: informal barriers

An increased presence of foreign companies can contribute to higher productivity in several ways. First, it adds to the intensity of competition in domestic markets and especially in those sectors which have been protected. The increased competition should lead to increased productivity and, to the extent the foreign firm is successful, its increased market share will also raise overall productivity. Second, FDI will provide managerial dynamism, particularly in weak protected sectors with high prices. In such sectors FDI will also help to improve regulatory quality and improve transparency. A good example of this to date is in the telecommunications sector. Finally, it may also help to change those labour practices that have become counter-productive. However, barriers to FDI remain.

Not only is the level of inward FDI low but Japan (and its regions) do not compete aggressively for FDI as do most other OECD countries, including those with a higher level of per capita GDP. The low level of FDI was due in the past to direct government barriers, but in most cases these have been lifted.[77] Officially supported cartels and lack of enforcement of "refusal to sell" provisions of the law were also important in some sectors, serving to control supplies to new entrants and also preventing the company from exporting to Japan.[78] The current barriers are now more in the nature of the general business environment (see Table 22) and the associated regulatory structure. Direct econometric evidence is provided by Fukao and Ito (2001) who show that FDI penetration in the service sector (three digit level) is higher in sectors with a lower presence of government activities and a lower presence of official restrictions.[79] There is also a less than open attitude on the part of some government institutions including the FSA, which is now taking a much more cautious attitude to FDI in the banking sector. The continuing barriers to FDI were also well illustrated in 2002 when the Ministry of Agriculture stated that Japanese people would not welcome FDI in a large private food processing company, a sector of the economy that is particularly inefficient.[80] It even stated that dairy farmers would prefer the company to merge with several co-operatives. Increased inward FDI, which will support future growth and strengthen competition, will thus depend on regulatory reform including an improvement in the quality of regulation and a fundamental change in policy outlook, particularly at local level.

Now that land prices, which constituted a major barrier to some FDI, have come down, it is time to make improvements in other areas. A particular barrier that needs to be addressed as part of the current revision of the corporate code is the inability of foreign companies to acquire Japanese firms by using share swaps.

Arguments put forward by interest groups to the effect that the prohibition protects domestic shareholders from being "forced" to accept shares in unknown foreign companies appears dated in the context of a well developed system of brokers and the integration of the world's financial system. There are also some complex tax issues that can restrict M&A activity and which need to be reviewed.

Outward FDI *and trade: increased regional integration should drive future growth*

Looking forward, Japan is fortunate to be located in a region which is growing rapidly and that should see rising regional integration in the future. Such dynamism is being driven by rapid growth in China whose imports and exports are set to surge following its entry into the WTO.[81] Trade with China is already growing rapidly and it is now Japan's second biggest trading partner after the United States. Japanese firms are also raising their investment in China, often with the goal of transferring labour intensive operations to that country with the intention to re-export to Japan. Gains from comparative advantage are thus being generated in a manner similar to regional integration elsewhere.

Despite the advantageous gains from trade both now and in the future, many in Japan persist in seeing China as a threat with some senior politicians even calling for an appreciation of the Chinese currency. There is also much talk of the "hollowing-out" of Japanese industry by investment in China and of China "leapfrogging" the development process and therefore becoming a direct competitor in third markets. Trade relations were also allowed to reach a low point in 2001 when Japan introduced provisional safeguards for three agricultural commodities, while China retaliated by imposing tariffs on three industrial products. Following extensive discussions between the two countries, the safeguards were allowed to lapse in November. The outcome serves to confirm the conclusion in last year's *Survey* that consumers economic interests had been outweighed by other concerns.

Even putting aside the positive effects of rising incomes on China's imports, concern about "hollowing out" is misplaced. Japanese investment in China is still small (the stock is only some 0.02 per cent of Japanese GDP) and is in any case more profitable than investment in Japan.[82] As for competition in the goods markets, there is little evidence of leapfrogging and the overlap between exports to the United States is only around 20 per cent.[83] This is actually an upper limit, which does not fully allow for quality effects and for exports by Japanese firms from China to the United States. It remains true of course that at the margin the two countries are competing, but for the Japanese firms the response should be either to improve productivity or move to a higher value market niche. For the economy it will be necessary for resources to exit from some activities, such as textiles, and to move to other sectors. The process of exit and entry is, however, one that is proving difficult in Japan.

Entrepreneurship: promoting entry and exit

The process of entry and exit appears to be more difficult than in many other countries, particularly since 1973, with important consequences for growth. The White Paper on SMEs suggests that the rate of firm turnover is about 8-9 per cent compared with 16-22 per cent in other OECD countries (Figure 26). The link between competition and productivity relies in part on entry and exit. A study for the *Growth Project* based on micro data shows that firm dynamics (*i.e.* birth and death, growth and decline of individual firms), while not the most important component of innovation and aggregate productivity growth, nevertheless makes an important contribution.[84] In some sectors, such as those with fast changing technology, entry is a key factor, but in others exit is a key to productivity growth. As in many European countries, regulatory barriers to entry are important (Table 22). However, in certain aspects Japan has also had excessive entry. The strong commitment to lifetime employment and the lack of emphasis given to profitability means that firms have competed in all market niches rather than specialising. Moreover, to absorb employment they have also tended to expand into the same areas at the same time (Porter *et al.*) and into fields in which they have no evident comparative advantage, such as steel companies opening theme parks. This has led to inefficient – and probably excess – investment and to low productivity and profits. Correspondingly, the process of exit has been exceedingly difficult (despite the widespread use of recession cartels and agreed cuts to capacity in the late 1970s and early 1980s),[85] and is a major factor explaining low productivity in key sectors such as construction and retailing.

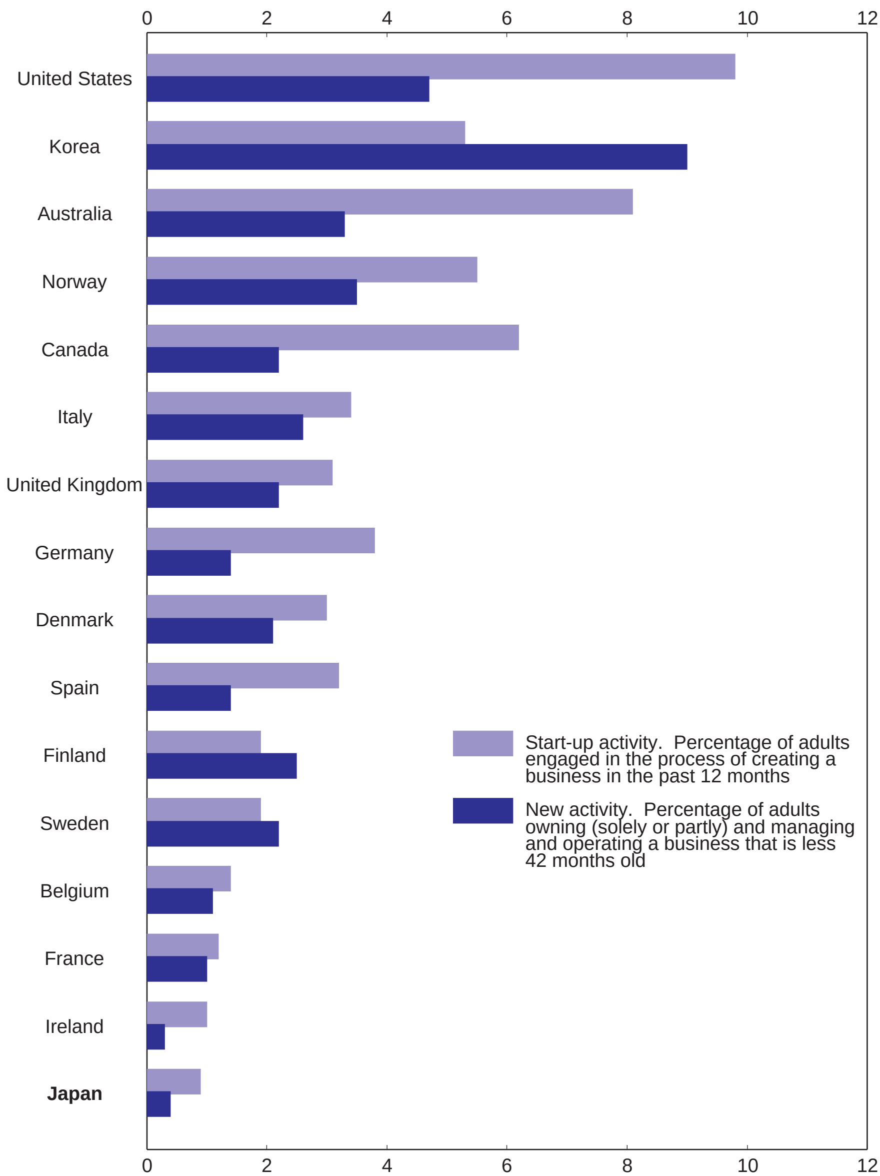
Entry

Although the rate of business start-ups increased somewhat between 1996 and 1999 the trend has been firmly downward for several decades including the boom years of the 1980s. The consequences appear to be similar to other countries: multi-factor productivity growth is positively related to the business start-up rate in the sector.[86] The relation reflects more than sector expansion since the business start-up and closure rates are also closely related.[87] With land prices falling through the 1990s, start-up costs should have eased, thereby promoting new businesses. However, a survey has found that this has not happened: start-up costs are still 40 million yen if real estate is purchased and 10 million yen without. The self-financed portion amounts to some 30 per cent. This could be a barrier for entrepreneurs, particularly as the bankruptcy code (unlike in the United States) does not protect their home and car.

Venture capital is thought to remain in short supply and what there is appears to be rather light in providing managerial assistance to the new enterprise (Figure 27). Moreover, venture capital institutions tend to handle a comparatively large number of cases (see the 2000 *Survey* for details). A great deal

Figure 26. **The level of start-up activity is low**

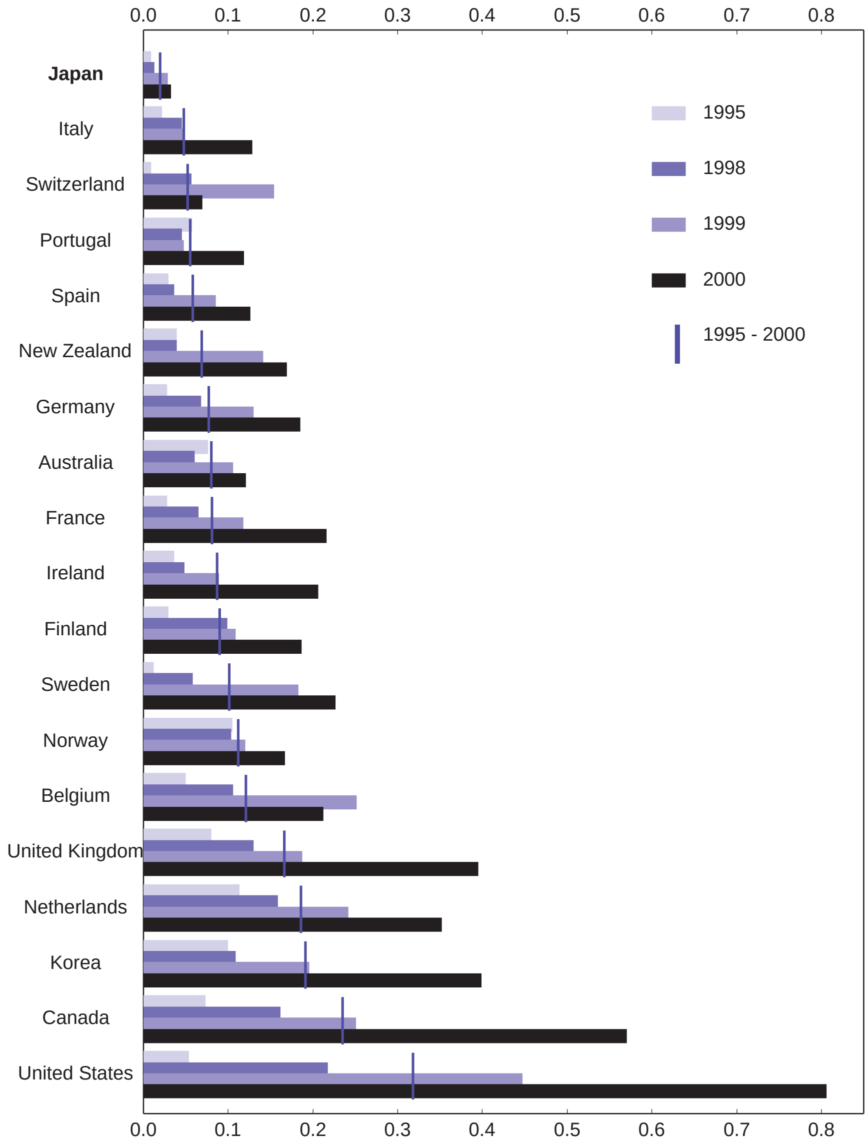
The level of entrepreneurial activity across OECD countries



Source: Global Entrepreneurship Monitor 2000.

Figure 27. **Japan is behind in venture capital**

Venture capital investment in early stages and expansion
“country of management” approach, % of GDP



Source: EVCA. various Yearbooks, NVCA, various Annual Reports, Canadian Venture Capital Association (CVCA), Asian Venture Capital Journal, The 2002 Guide to Venture Capital in Asia.

of hope has been placed in the development of three competing markets for venture securities in recent years (*i.e.* NASDAQ Japan, the Tokyo Stock Exchange special board (MOTHERS), and JASDAQ, the over-the-counter market of the Japan Securities Dealers Association in Tokyo). MOTHERS and NASDAQ Japan adopted an auction system similar to that of NYSE and the latter also introduced a market maker system. The exchanges have promoted the adoption of quarterly disclosure of financial results and of corporate governance arrangements. One of the markets (MOTHERS) has also tightened its de-listing requirements to increase confidence in listed stocks. IPOs on the three exchanges are expected to be 150-160 in 2002 up from 147 last year but the volume of finance to be raised is expected to be sharply down, NASDAQ Japan closed in August.

Against this background, the government has introduced over the years a large number of measures to aid start-ups. But the key issue is to lower regulatory entry barriers which might also open the way for more FDI (*e.g.* Box 6). Support for start-ups include management training, loans, subsidies and special tax treatment. However, the support system appears to be complex and confusing with a participation rate of only 10 per cent by new entrepreneurs. A single source has been proposed but it would need to be accompanied by efforts to reduce regulatory barriers to entry more generally. An important initiative proposed by the central government is the creation of "special structural reform zones". It is intended for local authorities to take the initiative in identifying key regulatory barriers to development in a given area. The proposed system would then allow them to give a waiver to avoid such regulatory hurdles. Examples might be a port facility being given a waiver from say some labour regulation, or an industrial park being allowed to employ foreign engineers more easily.[88] In many instances, the barriers are not due to local actions but to the central government. A graphic example of the lack of power at the local level was illustrated in Mie prefecture. Having promised to cut regulation of economic activity, the prefectural government discovered that it only controlled some seven regulations, with thousands directly controlled by the central government. Unfortunately, the proposal to create "regulation free zones" with local initiatives is already facing opposition from Ministries, which wish to bring the programme under their control, with each having their own programme. This would risk allowing interest groups to block an area or city moving ahead on its own. The key should remain local initiative, which makes it easier to identify specific regulatory barriers. However, the initiative should be seen as a pragmatic way forward with the objective in the end to extend the regulatory reform nationally. The importance of opening opportunities more generally is acknowledged by the government, so that its economic strategy includes a very wide range of proposals (Table 23).[89]

The process of exit: bankruptcy and restructuring institutions

A significant problem has been the slow exit process from activities that are no longer profitable. This is particularly the case in the troubled sectors such

Box 6. Barriers to entry in the professions

An important aspect of the move to a more transparent and accountable system of both business and public administration is a greater demand for legal and accounting services. Demand for such services is also rising with the gradual formalisation of corporate governance and commercial relations. However, entry to these two occupations is restricted by formal and informal regulatory barriers.

Last year's *Survey* welcomed the Judicial Reform Council's recommendations to, *inter alia*, ensure an adequate supply of candidates for the restrictive bar exam by allowing law schools to be established from 2004 with the objective of increasing the number of lawyers. Moreover, the new government announced that it would implement the recommendations. Nearly one year later it appears that the process has become entangled in a dispute involving not just the current members of the bar but also members of the government. The case highlights the tendency for regulations to undo what is intended at the outset as well as the complexity of the legislative system, with the government having to deal with LDP policy councils before submitting a bill to the Diet. The idea of post-graduate law schools was strongly opposed initially by judges, prosecutors and lawyers who argued that quality would be jeopardised if the number of legal professionals increased significantly. In response, the government promised that the schools will thoroughly train people from a wide range of backgrounds. The training system will, however, remain complex: the judicial apprentice system run by the supreme court for people who pass the bar examination will be maintained even after the post-graduate system of practical education is introduced. The freedom of association between foreign and domestic lawyers remains highly restricted and a regulation even disallows the use of foreign partnership names in that used by a Japanese practice.

Accounting and audit is another crucial business service activity hamstrung by restrictive practices and regulation. Japan has only 14 000 certified public accountants (CPA) (one tenth of the CPA/population ratio in the United States) with 800-900 passing a very difficult examination each year. Demand is set to rise further if the Tokyo Stock Exchange demands that quarterly audit reports be released to the public as in other financial centres. Yet the restrictions which are intended to preserve "high quality candidates" have not prevented a string of misleading corporate accounts being issued. Reforms will need to aim at boosting numbers, and with some further convergence to the international accounting standards (IAS) underway, the qualification system will need a more fundamental review.* Moreover, the accountancy sector should be made more competitive by allowing firms to advertise and by liberalising audit fees, which are currently set by the Financial Services Agency. Audit firms and consulting activities are generally separated in Japan thereby lowering the danger of conflicts of interest.

* Accountancy services will also come under pressure to reform from commitments to GATS and movements to greater acceptance of mutual recognition. For a discussion see F. Kimura, "Globalisation and harmonisation: the case of accountancy services in Japan", in T. Ito and A. Kreuger, *Trade in services in the Asia-Pacific region*, NBER, 2002.

Table 23. **The new three-year programme for regulatory reform: a summary**

Medical care
- Liberalisation and computerisation of examinations of medical fee bills and reinforcement of the functions of the insurers
- Review of the regulations of management of medical institutions
- Review of the medical fee system

Welfare and childcare
- Competition on equal terms among various management bodies in in-facility long-term care
- Expansion and qualitative improvement of childcare services
- Review of regulations concerning social welfare corporations

Human resources (labour)
- Securing smoother job transition (expansion of the job placement market)
- Increase of temporary workers and expansion of fixed-term work contracts, etc.
- Measures for dealing with new types of workers

Education
- Development of competitive environments for higher education
- Reform of elementary and secondary education

Environment
- Reduction of greenhouse gas emissions
- Reviews of various systems concerning waste/recycle problems

Urban renaissance (housing/land, public works)
- Ensuring transparency of the real estate market
- Review of various systems related to cities, such as planning
- Facilitation of condominium rebuilding, etc.

Competition policy
- Expansion of the open and competitive bidding system

Legal affairs
- Clarification of the scope of legal affairs that are to be monopolised by lawyers
- Ensuring speedy reorganisation procedures through the revision of the Corporate Reorganisation Law

Financial sector
- Legislative measures for over-the-counter sales of Exchange Traded Funds (ETFs) by registered financial institutions including commercial banks
- Establishment of a new transfer system for reducing settlement time and cost

Agriculture
- Examine the current system and situation with regard to farming corporations and take measures to facilitate joint-stock corporations to be established for farm management

Distribution
- Development of a regulatory system for franchise systems
- Investigation for the early review of the "guideline" of "Daiten-Ricchi Ho"

Energy
- Expansion of the scope of liberalisation of electric power retail sales
- Expansion of the scope of liberalisation of gas retail

Transport
- Acceleration of introduction of one-stop services of import and export procedures at ports
- Regulatory reform in the truck transportation business (shift in the charges and freight regulations from the current prior notification system to the *ex post* facto report system, abolishment of the regulations regarding business areas)

Source: The Three-Year Programme for Promoting Regulatory Reform (revised), Cabinet Office, April 2002.

as construction, retailing and food processing. Underlying the system has been the process of governance that placed little emphasis on servicing capital, strong *de facto* employment protection combined with a commitment to life-time employment by management (see below), and a banking system that has extended extraordinary forbearance and large scale debt forgiveness to companies in difficulty until only recently (Chapter II). The role of the banking system has been particularly important. A number of studies have failed to find much evidence of a credit crunch during the 1990s. Nonetheless, there is evidence that the banks stifled growth by misallocating credit.[90] Bank support for troubled and non-competitive firms prevented the needed restructuring of non-financial firms from occurring, but banks in turn suffered from weak balance sheets reducing their capacity to force such a redirection of finance. Exit is now picking up strongly and deepening, although the process is far from optimal.[91]

In dealing with reorganisation and bankruptcy there is an important role for debtor in possession financing (DIP) and the government recognised its importance in the Emergency Package of April 2001. Legal changes are being investigated with the intention to legislate any revisions in FY 2003. In the meantime, the government's Development Bank of Japan (DBJ) has been authorised to set up a Corporate Reorganisation Loan System which, *inter alia*, provides DIP financing to companies in distress that have filed for bankruptcy, provided they are "economically or socially useful" and involved in a business with the potential for growth.[92] The market remains small, only amounting to some 100 billion yen most of which is provided by the DBJ.

The small size of the DIP market, despite the fact that lenders are said to be able to earn some 1-2 per cent in fees and charge up to 300 basis points above LIBOR, is due to regulatory/legal barriers that should be changed and behavioural patterns which might only change over time. On the legal and regulatory side, lenders are not accorded "super priority", with tax and labour claims taking precedence over DIP loans.[93] Moreover, although the FSA has now stated that DIP loans will be treated as "healthier loans", following changes to the examination manual in 2001, banks still have to disclose them as loans to bankrupt companies, hence inflating their bad loan numbers. Legal and regulatory changes are therefore required in order to facilitate reorganisation and exit from activities. However, efficient DIP financing also depends on a company filing for bankruptcy in time while there are still unimpaired assets and cash flow. In Japan companies often file for bankruptcy only just before they become insolvent – or otherwise not at all – due to the social stigma involved. The Civil Rehabilitation Law (M*inji* S*aisei-ho*) was intended to encourage firms to file sooner, but some observers feel that this has not happened to date.

There are now several procedures for firms to settle with their creditors and these will have an impact on resource allocation. The multi-creditor out-of-court guidelines (based on the "London conditions" set down by INSOL International) provide a framework for, *inter alia*, debt/equity swaps. Companies would need to hold a creditors meeting to discuss a restructuring plan and they must win endorsement from all creditors within three months. The plan would need to show a return to pre-tax profits within three years and negative net worth should also be redressed in a similar period. Shareholders would also be required to suffer a loss and the management would resign once a plan has been agreed. These guidelines have been used on only a few occasions (see Chapter II for details). The preferred path has been via the Civil Rehabilitation Law, which has been used by 1 502 companies up to the end of 2001 with accumulated debts totalling just over 12 trillion yen.[94] Courts can approve a restructuring plan more quickly than under existing laws and approval is required by only half the creditors as opposed to two thirds under other procedures. Courts can also protect vital assets against a creditor. Another advantage of this route is that it ensures that shareholders and not just creditors bear part of the losses: the courts can authorise a capital reduction as part of the plan and allows companies to issue new shares to creditors once the reduction has taken place. This makes debt/ equity swaps in the context of a restructuring plan easier. One criticism often heard is the lack of a statutory creditors committee.

The normal bankruptcy law and the corporate restructuring law (K*aisha* K*osei*) remain available, but with the latter a restructuring plan requires on average two years to be approved and so has not been the preferred method.[95] There are now proposals to bring the restructuring provisions closer in line with those of the Civil Rehabilitation Law in 2003. Courts will be allowed to approve large asset sales without creditor approval of the reorganisation plan. This would allow subsidiaries, plants, etc. to be sold rapidly. As with the Civil Rehabilitation Law, the reorganisation plan would need to be approved by over half the creditors rather than two thirds as at present, and the plan would need to be agreed within one year. Finally, DIP financing would be given clear priority if the firm under reconstruction fails.[96] However, in contrast to the Civil Rehabilitation Law, existing top management must leave the company under this rehabilitation procedure.

The developing framework and practice of corporate governance

The relationship of corporate governance systems to growth and, more importantly, its sustainability is controversial. Given the importance of other factors such as the degree of competition, a consensus on anything but specific aspects might never be reached.[97] In Japan, "insiders" dominate practically all aspects of corporate governance and this is strongly related to two other features: high gearing and excess use of capital with consequent abnormally low returns. It would appear then that "outsider" influence should be increased, but this is not simply a matter of having more outsiders on the board. Rather, shareholder rights need to be better enforced since they are the only group with a focus on the rate of return to investment. Such a rebalancing should also include more demanding accountability of fund managers. It should be noted that large exporting firms already give a greater weight to shareholders, but this is not true of the domestically-oriented sectors.

The amendments to the commercial code include a mixture of good and bad features from the perspective of corporate governance (especially shareholder rights) and the efficiency of Japan's capital markets. On the positive side, on-line voting will be permitted and needless restrictions on capital structure, per share value, stock options and share buybacks, including opening the possibility to hold treasury stock, have been eliminated. On the other hand, the minimum period between mailing the notice of a shareholder meeting and the distribution of proxy forms will remain two weeks.. Given the fact that 95 per cent of shareholder meetings take place during the same week of June (85 per cent this year) and 77 per cent of these on the same day, little time is available for shareholders to vote responsibly. This is also important given the rise in foreign shareholding and might partly explain problems some companies are said to have had in obtaining a quorum for shareholder meetings.[98] In response, the new code makes it possible for firms to reduce the quorum requirements for extraordinary resolutions from above 50 per cent to one third. In the context of tight cross-shareholding by friendly firms the provision could be problematical. As such resolutions cover aspects such as mergers, the proposal may weaken the power of a number of shareholders to defend their interests. This is particularly so seeing that most mergers are not negotiated on an arms length basis. Having a quorum above 50 per cent at least means that management will have to convince a larger number of shareholders and not just a group of "stable shareholders" who usually control at least a third of the issued capital. A notable omission from the amended code, is that the prohibition on using shares of a foreign company to finance mergers and acquisitions in Japan has not been lifted.

The new corporate law allows firms to choose between three models for their board of directors and increases the role for more clearly defined outsiders.[99] The corporate officer has also been established in the new law allowing a formal separation of overall supervision from the management of daily operations. Firms can choose to move to a US-style system where the responsibility for overseeing management will be with non-executive directors. The statutory board-level auditor (*kansayaku*) would then be abolished. Those introducing the new system will be required to set up three committees, which are composed mainly of outside directors, charged with auditing, appointing directors and deciding compensation of each director and corporate officer. Outsiders must account for a majority of members of these committees. The law also specifies that the outside directors should never have worked for the company or its subsidiaries. Firms can choose to stay with the present system but will be required within three years to increase the number of statutory auditors. A variation of the existing system has also been established by which a critical assets committee will be set up that promises the firm greater decision making flexibility.[100] The company which establishes such a committee must have 10 or more directors and at least one non-executive director.

Although enterprises have accepted the corporate officer system and have started to appoint more outside directors, indications are at this stage that the US style option for the board does not have a large following. One recent survey indicates that some 50 per cent of major companies (some 300) have introduced the chief executive officer (CEO) system.[101] The motive for doing so appears to be as part of reforms to decrease the size of their boards, which have come down to an average of 15 directors (25 per cent smaller than three years ago).[102] A growing number of firms are also increasing the number of outside directors but their numbers remain small. Moreover, there is a trend to appoint people from firms with no relationship to the company. Nevertheless, many companies are cautious about introducing the new US style system often arguing that the pool of suitable candidates to be outside directors is not large enough. This is in part because lack of job mobility among talented managers means that not many individuals are available with generalised business experience. In any case, they argue, outside directors will be put off by the potential for shareholder law suits.

Improving the quality of regulation

Despite welcome moves to increase transparency and accountability of the regulatory process through the introduction of comment periods for the public and no-action letters (by which the authorities confirm that a proposed action by a firm will not lead to regulatory action), there is still a long way to go before Japan reaches comparable international standards which should, *inter alia*, promote inward FDI. The Administrative Procedure Law has been in existence since 1994, and the public comment procedure since 1999. For 88 per cent of applications received by the central government there is now an explicit criterion for judging the application and for about 80 per cent there is a standard procedure. These ratios are much lower at municipal level.[103] Nevertheless, submissions to the Council for Regulatory Reform suggest that the regulatory system is still regarded by many as unsatisfactory. It remains hard to know what the rules are and, when they are known, they are applied arbitrarily. The problem appears to stem from fundamental attitudes toward clarity even though it seems to vary greatly across ministries and institutions. For example, some ministries treat the comment period and the incorporation of comments in only a pro-forma manner.[104] For fiscal year 2001, comments were requested on 331 cases but these resulted in revisions in only 56 cases. Public comments were not requested in 11 cases that concerned cabinet decisions which are exempted from the procedure. Some key regulators

Box 7. The spread of regulation and increased barriers to entry: the example of fitness clubs

Fitness clubs started up in Japan during the 1980s but before long two Ministries set up a system of permits, mandatory lectures, study sessions, credentials and levels for sports club professionals. The Ministry of Health and Welfare (MHW) created the Foundation for Activities Promoting Health and Bodily Strength which licensed two categories of workers: health exercise guides and health exercise practice guides. In conjunction with the Ministry of Education they then jointly sponsored the Japan Health and Sports Federation which granted permits to the first category while the MHW founded the Japan Aerobics Fitness Association which granted permits for the latter category. The Ministry of Education then set up the Japan Gymnastics Association that devised two credentials for Sports Programmer at the first and second level with fees to be paid. The Central Association for Prevention of Labour Disabilities then requires the instructor to attend twenty days of study sessions at a significant cost before obtaining a permit to be either a health care trainer or a health care leader. Thus to be an aerobics teacher requires dealing with four agencies and to pay for six permits.

The example illustrates several features dealt with in this *Survey* and in the 2000 *Survey*. First, the widespread use of agencies, foundations, etc. that are related to the Ministry responsible for the activity and for regulation. Moreover, these bodies are invariably staffed by retired civil servants from the same Ministry (*amakudari*) and are responsible for managing their own revenues. Second, the regulations control access to an activity and restrict business to the routine path. However, they frequently tend to leave the activity itself largely unregulated.

and officials do not appear to see the primary role of government as providing a supportive and facilitating framework for market operations.[105] This means that the temptation to back up new systems of governance with old style administrative measures and controls must be continuously resisted. Yet the mechanisms to do this are weak and the tendency to revert to old practices strong (Box 7). A good example of this weakness concerns the application of the no-action letter system, which is in principle a big step forward even though only nine have been issued so far in FY 2002. However, each administrative body has established its own guidelines with the risk of inconsistent application and understanding. Moreover, the letters are not legally binding and there is no clear appeals procedure.

In some cases, regulations simplified in one area have been replaced by new ones elsewhere as other administrative institutions rush to fill what might be regarded as a void. This appears to be the case with the new Large Scale Retail

Location Law, which came into force in June 2000. There appears to be excessive and sometimes inconsistent regulation at local level which the Council for Regulatory Reform believes has led to procedures becoming more complicated and expensive. A number of affected parties have called for the new law to be backed up with strict enforcement and by access to an appeals procedure. These calls raise a key issue which is probably at the heart of continuing complaints about the regulatory system: weak enforcement.

Improving the allocation and supply of labour

Enhancing growth prospects requires labour market policy to meet two challenges: maintaining labour supply and utilisation over the medium term, and promoting/assisting the redeployment of labour from poorly performing activities. The Japanese population is estimated to start declining from 2007 and the population of working age has already been in decline since the mid 1990s. The most recent projection by the National Institute of Population and Social Security Research in January 2002 is for the population to reach its peak of 127.7 million in 2006 and then to decline to 121.1 million in 2025 and 100.6 million in 2050. The dependency ratio (share of population above age 65) will accordingly increase from 17.4 per cent in 2000 to 28.7 per cent by 2025. The expected fall in population is not only due to a delay in the timing of marriage but also to a significant decline in the number of children per couple.[106] Many experts suggest that women tend to avoid having children in favour of maintaining their employment. Faced with these developments the participation rate of both the older population and women will need to be increased or at least held at present levels to maintain labour supply.

Low aggregate labour productivity is *prima facie* evidence of misallocation of labour. Improving labour allocation necessitates greater labour mobility and a much larger role of external labour markets than hitherto. Pressure for change in this direction will rise with progress in the reform of the banking sector, which provided financial backing to the misallocation of labour and the dependence on internal labour markets. External labour markets are underdeveloped, which means that essential market information that is also important for human capital decisions by individuals might be inadequate (see Chapter IV). The reasons for this situation come down to private arrangements which were efficient in the 1950s and 1960s but which now involve negative externalities. Being essentially private contracting arrangements they are difficult for public policy to address. The key institutions are: a seniority-based wage structure that discourages labour mobility and makes firms unwilling to hire mid-career workers;[107] lack of portability of firm-based pensions;[108] lack of information; and a promotion system based on a firm-specific age cohort.[109] It follows from such a system that the practice of employment protection is extremely important for the workers involved (*i.e.* the insiders). The potential levers for policy are changes in employment protection legislation (EPL), support for job matching and training institutions (Chapter IV), and measures to raise female labour force participation and employment of older workers.

Easing the restrictive employment protection practices

The tradition of life-long employment (prevalent in large firms but also respected in spirit by smaller enterprises) appears to remain very much alive despite the difficulties of the 1990s and the large reduction of employment in manufacturing.[110] In the past, firms have kept redundant workers during a downturn, while inter-firm and occupational mobility has remained restricted. To support the practice, firms have often diversified into completely different activities, financed by free cash flow and easy bank lending. Labour policy has also supported such firms by providing employment subsidies. Public infrastructure projects in rural areas have been used to absorb unemployed and redundant workers, even though they might be a very costly policy measure. However, with economic growth weak during most of the past decade, firms have intensified restructuring efforts to reduce excess labour and they have increasingly replaced permanent employment with part-time workers and temporary workers. Since chronic excess labour in some industries seriously lowers productivity and profitability, a shift of labour from those unproductive sectors to productive activities needs to be promoted through enhancing labour mobility. This requires both easing the actual implementation of employment protection legislation (EPL) and strengthening the social safety net, which is poorly developed in Japan. Empirical studies suggest that easing EPL could increase employment by encouraging the participation of youth and women, offsetting some negative impacts on employment for the prime-age groups. A number of studies also show that strict EPL could affect growth and innovative activity, though the precise impact depends on the type of wage bargaining in place. The institutions in Japan appear to be consistent with industries such as auto-production or steel with a cumulative knowledge base, but less suited for a range of other activities (Box 8).

International comparisons of employment protection (OECD, 1999) indicate that Japan is one of the countries where it is relatively strict.[111] In particular, protection for regular employment is strict, as shown by Table 24, which ranks Japan at 20th among 27 OECD countries (*i.e.* Japan's employment protection is stricter than 19 other OECD countries). Restrictions on temporary employment are also relatively tight, though they might have become somewhat weaker than the table shows as the evaluation is based on the situation in the late 1990s. Among the components of protection for regular employment, difficulty of dismissal is the third strictest among OECD countries. Even though only a few requirements for dismissal are set in the law, the courts request firms to justify the fairness of redundancies by demonstrating appropriate past efforts to avoid the action (*e.g.* through in-house transfers or

Box 8. Labour market institutions and growth

Innovation and productivity growth might be directly driven by the degree of competition and by the value of the property rights created by IPRs, but the actual process is likely to be intermediated by labour market institutions and by technology. For example, in some industries technological change or innovations might require downsizing so that the strategy chosen by the firm will be influenced by the cost of labour adjustment (determined by the *de facto* stringency of EPLs) and by its ability to use the internal labour market. The latter will in turn be influenced by the nature of the technology. In a cross section study of R&D intensity in 18 OECD countries (including Japan) covering 18 manufacturing industries, Bassanini and Ernst do not rely on direct proxies of competition but make use of the cross-country comparable indicators of the regulatory framework maintained by the OECD (including tariffs and non-tariff barriers to trade, inward oriented economic regulation and state control, administrative barriers on enterprise start-ups and regulation of intellectual property rights). Labour market indicators, which were developed for the Jobs Study, include measures of *de facto* EPL and whether the industrial relations system is characterised by co-ordination or not.* Japan is characterised as co-ordinated although this year's wage round (see Chapter I) was accompanied by greater wage variation than usual, both within and across sectors. The key results of the study are:

- There is an unambiguous negative association between R&D intensity and indicators of non-tariff barriers and inward oriented economic regulation.
- Stronger protection of IPRs is positively associated with higher R&D intensity although there is a problem in interpreting the causality.
- Some aspects of labour market flexibility are positively associated with R&D intensity in low tech industries and in all industries in countries with decentralised wage bargains with little co-ordination.
- Conversely, in countries with a co-ordinated system of industrial relations (which includes Japan) there seems to be a negative association between labour market flexibility and R&D intensity in industries with a more cumulative knowledge base (*e.g.* auto production). With such technology, employment protection and co-ordinated industrial relations regimes encourage the formation of firm specific competencies allowing firms to exploit the potential of the internal labour market. This appears to characterise Japan well.
- By contrast, where the technology appears to be less incremental (entrepreneurial in the terminology of the authors) labour market flexibility appears to be necessary to maintain R&D intensity and productivity gains. It follows that to the extent the old labour market institutions are carried over to these new sectors, Japan would suffer a comparative disadvantage in such industries.

* An industrial relations system can be said to be co-ordinated when: *i)* the wage bargaining process is centralised or co-ordination among employers and/or trade unions sets a uniform band of wages; *ii)* employers and trade unions co-operate as regard to decision making inside the firm; and *iii)* business associations (and/or a tacit code of conduct concerning firm behaviour) have an active role in solving free-rider problems across firms (training, standard-setting, basic research).

Source: A. Bassanini and E. Ernst, "Labour market regulation, industrial relations, and technological regimes: a tale of comparative advantage", CEPREMAP *Working Paper*, 2001-17. S. Scarpetta, *et al.*, "The role of policy and institutions for productivity and firm dynamics: evidence from micro and industry data", OECD *Economics Department Working Paper*, 329, 2002.

Table 24. **Japan has relatively strict employment protection**

	Score for Japan[1]	Highest countries	Lowest countries	Rank of Japan
Regular employment				
Regular procedural inconveniences	2.0	3.8 (Korea)	0.0 (US, Canada)	12
Notice and severance pay for no-fault individual dismissal	1.8	5.0 (Portugal)	0.0 (US)	16
Difficulty of dismissal	4.3	4.5 (Portugal, Norway)	0.3 (UK)	25
Overall strictness of protection	2.7	4.3 (Portugal)	0.2 (US)	20
Temporary employment				
Fixed term contract	1.5	4.3 (Italy, Turkey)	0.0 (US, Canada, UK, Ireland)	13
Temporary work agency	2.8	5.5 (Turkey)	0.5 (US, UK and others)	18
Overall strictness of protection	2.1	4.9 (Turkey)	0.3 (US, Canada, UK, Ireland)	17
Collective dismissals	1.5	4.5 (Sweden)	0.4 (New Zealand)	2
Overall EPL strictness[2]	**2.4 (2.3)**	**3.7 (Portugal)**	**0.2 (US)**	**17 (14)**

1. Higher score suggests stricter EPL measures.
2. Figures in brackets are based on the weighted average of three components.
Source: OECD *Employment Outlook* 1999.

retraining) and by showing that the procedures are reasonable.[112] However, many observers feel that the courts' requirements for justifying dismissal are too strict, virtually prohibiting firms from dismissing staff for economic reasons. As a result, they make widespread use of early retirement programmes, which means that adjustment is confined to older workers. Recruitment is also usually cut and any openings filled by short-term contracts. The current system which is based on the courts' judgement is also thought to be unproductive and also unfair as firms are not able to know *ex ante* whether their dismissal decision is acceptable or not. Responding to these critics, the Council for Regulatory Reform has recommended that the Ministry start discussions for legislating specific criteria to judge whether a dismissal is acceptable.

There has been some progress in the deregulation of temporary work agency employment (dispatched workers) and fixed-term contracts. Lifting the ban on having dispatched workers in manufacturing plants is under consideration, though the ban still remains in some other areas such as health care, ports, construction and security services.[113] The maximum term for middle-aged and elderly dispatched workers has also been extended from one year to three years, but only as a temporary measure for the period 2002 to 2005. However, the contract term for others is still limited to one year. An extension of the maximum duration from three to five years for fixed-term labour contracts for those who have special skills and knowledge or for those over age 60 (often the mandatory retirement age for companies) is under consideration and needs to be introduced.

The unemployment benefit scheme is well designed to prevent moral hazard and to maintain incentives for job search by limiting the duration of benefits to a maximum of 330 days and through a re-employment bonus. However, coverage is narrow with only 40 per cent of the unemployed receiving benefits. The scheme has been expanded to cover more temporary workers since FY 2001 by abolishing the minimum requirement for annual income and monthly days of work. The duration of benefits has been effectively extended by allowing a maximum 2 year extension of benefits for middle aged unemployed who participate in public training schemes. The government has also expanded the safety net for the unemployed not covered by unemployment benefits such as self-employed, and for those whose unemployment benefits have run out by introducing a loan scheme for these people. Although there is some rationale for expanding the unemployment benefits scheme, more attention should be paid to reviewing the strict eligibility for welfare benefits and the weak protection for individuals from bankruptcy, both of which cause serious social problems.

The introduction of work sharing to avoid job cuts by reducing work hours has now entered into the public debate. However, since many firms suffer from excess employment and low productivity, the introduction of work sharing in such conditions could end up depressing productivity even further. In March 2002, the government, representatives of labour unions and the employers' association agreed how to introduce work-sharing arrangements in Japan. The type of work sharing recommended is the promotion of flexible work styles such as part-time work, rather than the uniform reduction of work hours for all workers. Although they do not exclude the possibility of forcing a uniform cut in work hours and a compensating wage reduction at the time of economic recession, they also agreed that such an arrangement should be temporary. However, it is hard to see how such a major move could be reversed once already in place.

Active labour market policy – recent progress and remaining problems

Public expenditure on labour market policy is quite low, amounting to only 0.8 per cent of GDP, which is slightly higher than the US but significantly lower than in many other OECD countries (Table 25). Spending on active labour market measures amounts to 36 per cent of these expenditures, which is also relatively low among the OECD countries.[114] As for the components of active labour market measures, the emphasis is on spending for job creation in the public sector training and subsidies for private sector employment. However, facing a continuous increase in the unemployment rate, which reflects both weak economic growth and a rising mismatch between job offers and applicants, the

Table 25. **Expenditures on labour market policy are much lower than in Europe**
Expenditure as a per cent of GDP[1]

	Japan	United States	France	Germany	Sweden
1. Public employment services	0.2	0.04	0.18	0.23	0.25
2. Labour market training	0.03	0.04	0.25	0.34	0.31
3. Youth measures	–	0.03	0.42	0.08	0.02
4. Subsidised employment	0.08	0.01	0.37	0.32	0.27
5. Measures for the disabled	0.01	0.03	0.09	0.27	0.52
6. Unemployment compensation	0.55	0.30	1.38	1.89	1.33
7. Early retirement	–	–	0.27	0.01	–
Total	**0.86**	**0.45**	**2.96**	**3.14**	**2.70**
Active measures (1-5)	0.31	0.15	1.31	1.24	1.37
Passive measures (6 and 7)	0.55	0.30	1.65	1.90	1.33

1. All figures are those in 2000 (fiscal year for Japan and United States).
Source: OECD *Employment Outlook*, July 2002.

government has expanded active labour market measures by introducing a series of employment packages since 1998.

Better job matching

Job-search assistance is the least costly active labour market programme and many evaluation studies indicate that it is also the most cost-effective. It is also generally accepted that private placement agencies should co-exist with the public employment service to improve the cost efficiency of their programmes through competition.[115] Regulations covering private placement services have been eased recently, and private agencies are now allowed to offer job placement services for most job categories. Since February 2002, private agencies have also been allowed to charge client job seekers in the field of management and technology, whose annual income is 12 million yen or above. The restriction on the maximum commission which private agencies are allowed to collect from client firms has been abolished. However, to start a profit-making job placement service, permission by the authorities is still required.[116] Abolition of the requirement to obtain permission to start a non-profit-making job placement service is under consideration in line with the recommendation by the Council for Regulatory Reform. Despite the recent progress in this area, resistance to the greater use of private agencies still exists with some concerns about their impact on equity. However, part of the social function of the public employment service can be delegated to private agencies by, for instance, paying fees to them to place long-term unemployed or disadvantaged groups.[117] The quality of the public employment service also needs to be improved. Recent steps in this direction are the introduction of "career consultants" (career counsellors) and the attempt to provide one-stop service at the public employment service, including job placement and training.

Grants for job creation

Among the various measures taken by the government, particular emphasis has been placed on subsidies to firms that hire workers. These measures include employment and training subsidies for firms in 15 new and growing sectors (Special grants for creating employment in the New and Growth sectors), employment subsidies for firms that hire middle aged workers from 45 to 60 years old (Special emergency grants for job creation), and employment subsidies for firms that accept transfer of workers from other firms (Special subsidies for the transfer of human resources). Table 26 shows the utilisation of these three measures. Although eligibility for these schemes has been subsequently relaxed, take-up has so far remained very low.[118] However, there is a difficult trade-off for policy makers. If eligibility is eased further in order to encourage firms to participate in the programmes, then more abuses could be generated, resulting in smaller net gains in employment due to increased dead-weight costs and substitution effects.[119] Indeed, many evaluation studies outside Japan show that subsidies to private-sector employment yield only small net employment gains due to such effects.[120] As stressed in previous Surveys, *ex ante* and *ex post* analysis of these schemes remains wholly unsatisfactory, despite the administrative reforms which have set up a policy evaluation unit.

Table 26. **Grants for private sector employment remain underutilised**

As of August 2002

Measures	Budget and targeted increase in jobs	Actual results	Ratio of target achieved
Special grants for creating employment in the New and Growth sectors (August 1999-July 2002)	Approx. ¥ 109 billion, 168 000 jobs	69 866 people (subsidies applied for: 70 098)	Ratio to targeted numbers: 41.6%
Special emergency grants for job creation (January 1999-July 2002)	Approx. ¥ 60 billion, 200 000 jobs	18 197 people (subsidies applied for: 20 585)	
Special subsidies for the transfer of human resources (January 1999-March 2001)	Approx. ¥ 29.8 billion, 70 000 jobs	13 729 people (as of March 2001)	Ratio to targeted numbers: 19.6%

Source: Ministry of Health, Labour and Welfare.

Public employment programmes

Although spending for public employment programmes has been traditionally very small, it has expanded substantially due to recent employment measures. A fund was set up for local governments in 1999, financed by a special grant from the central government, to promote employment in such public projects whose implementation is entrusted to private companies and non-profit organisations (NPO). Initially, a 200 billion yen special grant was made available, aimed at creating 300 000 jobs in such areas as computer instructors at schools and assistants for elderly care. The public employment programme was expanded substantially by the FY 2001 first supplementary budget, which introduced a new scheme and allocated an additional 350 billion yen to the programme with a view to creating 500 000 jobs in the public sector. In the new scheme, the labour intensity of the projects has been increased and the contract term, which was limited to 6 months in the old scheme, can be extended up to 12 months. Although this kind of temporary employment programme in the public sector can be used as a means of helping the unemployed maintain contact with the labour market, particularly during a recession, the experience in OECD countries suggests that such measures have been of little success in helping unemployed people get permanent jobs in the open market. In this regard, it is important to ensure that they do not become a permanent employment subsidy scheme.

Despite unemployment, more should be done to stimulate labour supply

Although increasing the labour force participation of women and the elderly is very important since the population is projected to decline from 2007, progress in this area has been limited. Even though women's educational achievement is well above the OECD average, their participation rate has considerable scope for rising. At around 55 per cent it is almost in line with the average of the OECD countries, but much lower than those in Nordic and Anglo-Saxon countries. The particularly low female participation rate for the age group 30 to 40 years suggests that careers for women might have been disrupted by childcare. This is partly explained by lack of childcare facilities. To alleviate the situation, the government plans to expand facilities by 50 000 places in FY 2002 and by 100 000 in FY 2004. More importantly, the social security system tends to discourage labour supply by a spouse by waiving contributions to the pension and health insurance systems up to a threshold number of hours and income.[121] Women may also be adversely affected by being less well placed to put in the traditionally long working hours that are necessary for promotion to higher managerial levels.

As noted in last year's *Survey*, the difficulty in hiring older workers arises from their high wages due to the seniority-based wage and promotion system relative to their actual productivity. However, shifting the seniority wage system to a flatter wage profile based on performance pay would require the specification of tasks and responsibilities of individual workers within firms and would also need strict performance assessment. Both of these would require major changes to the management systems currently in place. A third of large companies have already adopted re-employment schemes for workers who have reached mandatory retirement age. In these cases salaries are much lower than before, often only around 50 per cent. However, with unemployment benefits based on pre-retirement wages (available for one year) and with the replacement rate around 60 per cent, such workers might be discouraged from accepting employment. A wage profile that better reflects productivity prior to mandatory retirement is necessary. The desirability of maintaining high labour force participation and employment rates of the elderly is also due to the gap between the mandatory retirement age set by firms (usually 60) and the eligibility age for public pensions, which is being raised gradually from 60 to 65.

To deal with the situation of older workers, it is sometimes argued that effective age discrimination legislation is necessary. In principle, one could even call for ending the system of mandatory retirement. Such changes would be counterproductive in the present structure of the labour market with age and seniority based wages and strict employment protection.[122] As already discussed above, since firms are virtually prohibited from dismissing employees for economic reasons under the current implementation of EPL, mandatory retirement is crucial for firms as a means to adjust staffing levels. And rising wage costs are also capped by mandatory retirement. To maintain employment of the elderly, an easing of the court's interpretation of EPL is important and laws and regulations should be carefully adjusted so as to encourage changes in labour market institutions.

Improving the fundamentals: an overall assessment of structural policy

The key issue facing the government is not only how to bring the economy out of a protracted recession but also how to place it on a secure path for adequate future growth, even at a time when the population will start to decline. For this to take place, productivity growth must be improved, especially in the under-performing sectors, and resources will need to be shifted from them to more productive activities. Administrative guidance and overall direction of financial flows might well have worked in the past – although this is still arguable – but for the future, market incentives should drive the way. Foremost among these will be the process of competition, although the impact on growth will also depend on corporate governance arrangements and the operation of an external labour market. A general summary of recent developments of structural policy and recommendations for measures which are needed to move the economy in this direction is given in Table 27.

Table 27. **Recommendations for structural reform and assessment of progress**

Based on previous and current Surveys and the Review of Regulatory Reform

Previous Survey's recommendations	Action taken since 2001 Survey	Survey assessment/recommendations
I. Reform the financial sector		
i) Recapitalise the banking system	For new bad loans, major banks are requested to write off 50 per cent in a year and 80 per cent over two years so as to eliminate them within three years. A share-purchasing corporation has been established to assist banks in reducing their equity holdings. Greater flexibility has been given to the Resolution and Collection Corporation (RCC) in deciding the purchase price of bad debts to increase purchases from sound banks.	Raise pressure on banks to improve loan classification and establish appropriate provisions. Speed NPL disposal. Force bank restructuring including closure of banks. Bid price of the RCC should not include a subsidy to banks.
ii) Shore up the life insurance sector	A proposal to allow a reduction in the guaranteed return on policies before the failure of insurers is under discussion.	Need to review the process of de-mutualisation of life insurers as only a few have been incorporated. Create flexibility to lower guaranteed returns. Caution on deeper capital links between banks and insurance.
iii) Tighten regulatory oversight and boost transparency and disclosure	Special inspection for major banks focusing on large borrowers has been introduced. The first result was published in April 2002. Protection of time deposits over 10 million yen per depositor has been lifted since April 2002. Planned abolition of the remaining restriction postponed until April 2005.	Introduction of the special inspection is good progress, though tighter loan classification is still needed. The re-introduction of such a scheme is important to address the risk of moral hazard facing both banks and depositors, and the pressure for bank restructuring needs to be strengthened.
iv) Review the role of state-owned financial institutions	The government housing loan corporation will be abolished by FY 2006. Reform plans for the other major public financial corporations are under discussion.	Reform of public financial corporations and postal saving should be dealt with immediately. Postal savings should be obliged to pay deposit insurance and to introduce a fee on all deposits to reflect the costs, while the cost from universal service obligations should be compensated in an explicit and transparent manner.

Table 27. **Recommendations for structural reform and assessment of progress** (*cont.*)

Based on previous and current Surveys and the Review of Regulatory Reform

Previous Survey's recommendations	Action taken since 2001 Survey	Survey assessment/recommendations
II. Enhance product market competition		
i) Accelerate deregulation	The Council on Regulatory Reform has adopted a comprehensive deregulation programme for the next three years. Proposed introduction of special zones for structural reform attracted more than 400 proposals by local governments and private sector.	The planned special zones for regulatory reform should be introduced with local initiative respected. It is a first step to nation-wide reform.
ii) Further strengthen competition policy	A government council has proposed to strengthen competition policy by raising fines and expanding the scope of FTC's investigation.	Strengthen enforcement activity by giving FTC coercive investigative power and by raising fines to at least the value of the violation. Need more professional economists in FTC. Make secretariat of FTC independent.
iii) Take steps to encourage competition in network sectors	Asymmetrical regulation of telecommunication and the disputes settlement commission were introduced by new telecommunication law in 2001. The regulator and the FTC have issued competition guidelines for telecommunication business including rules governing the operation of the incumbent. Discussions underway for further liberalisation of the electricity market. The Diet passed new bills, which established an independent agency for postal and related services and defined conditions for the entry to mail delivery service. New agency is allowed to enter or remain in competitive markets.	Set-up independent sector regulators. Need more effective enforcement of pro-competition policy to counter the abuse of market power by the dominant player. Greater use of *ex ante* prohibitions and stronger powers of investigation are needed. Increase interconnection and transmission capacity and separate transmission from generation. The entry requirements for basic postal services appear to be restrictive and the regulatory system needs to be clarified. Clearly define the extent of universal service obligation of postal banking and postal insurance services provided by the new corporation and compensate directly in an explicit and transparent manner.
iv) Eliminate use of supply/demand adjustment mechanisms	The entry restrictions due to supply/demand adjustment were removed for taxis in February 2002. Such restrictions still remain for port transporters except major 9 harbours.	Emergency market excess clause for taxis should be applied with prudence.

Table 27. **Recommendations for structural reform and assessment of progress** (*cont.*)
Based on previous and current Surveys and the Review of Regulatory Reform

Previous Survey's recommendations	Action taken since 2001 Survey	Survey assessment/recommendations
III. Promote industrial restructuring and boost technology and innovation		
i) Update the Commercial Code and ease restructuring	The Diet has passed the revised commercial code, which allows firms to adopt a US-type management system. Replacement of statutory auditors by an audit committee including outside directors is optional with alternative of maintaining improved statutory auditors system comprising outsiders who are at arms-length to the enterprise.	Outsider influence should be increased further not simply by having more outside directors but by enforcing shareholder rights. Lowered quorum requirements for extraordinary resolutions such as mergers could weaken the power of a number of shareholders to defend their interest.
ii) Revise the patent law	Revised law for patent attorneys has been in force since January 2001.	Monitor new system.
iii) Increase emphasis on basic research and improve efficiency of public technology spending	The basic plan adopted in March 2001 envisages allocating 24 trillion yen over the next five years to four areas: IT, environment, biotechnology and nanotechnology.	Continue university reform. Get the university structure and incentive right to improve the efficiency of spending. For allocation of R&D look at companies own priorities first and allocate spending accordingly.
iv) Encourage more start-ups and venture business	Support for start-ups including management training, loans, subsidies and special tax treatment is provided by the government. NASDAQ Japan, one of the three major venture capital stock markets, closed in August 2002.	Reduce regulatory barriers to entry in goods and service markets as well as in the professions. The special zones for structural reform could be an important step forward to lower entry barriers.
v) Streamline bankruptcy procedures	The guidelines for debt forgiveness based on the London condition (by INSOL) were agreed in September 2001 but little used. Corporate restructuring law (Kaisha kosei) is planned to be revised in 2003 to bring the restructuring provisions closer in line with those of Civil Rehabilitation law (Minji saisei).	Legal and regulatory changes are required to facilitate the use of debtor in possession financing (DIP). Support the greater use of the London rules.
IV. Liberalise the agricultural sector	Provisional safeguard measures introduced on three agricultural commodities lapsed in November 2001. A restriction on agricultural land area for rice producers is to be replaced by production quota by regions in order to encourage enlargement of production scale per unit. Additional measures for easing the entry of corporations into agriculture are under discussion.	Promote competition and encourage larger-scale operation.

Table 27. **Recommendations for structural reform and assessment of progress** (*cont.*)

Based on previous and current Surveys and the Review of Regulatory Reform

Previous Survey's recommendations	Action taken since 2001 Survey	Survey assessment/recommendations
V. Use market-based instruments to improve environmental outcomes	The Recycling law in which consumers shoulder costs of recycling some electrical goods, is in force since April 2001.	Monitor new system.
VI. Boost public sector efficiency		
i) Introduce multi-year budgeting and a medium-term fiscal plan	The government adopted a medium-term economic and fiscal perspective in January 2002.	Spell out specific policy requirements that should guide current and future policy decisions. Include short-term real expenditure targets.
ii) Give greater responsibility to local governments for spending decisions	A part of matching grant has been replaced by a consolidated subsidy. Reform in transfer system between central and local governments is under discussion.	Improve allocational efficiency in local government budgets by reforming transfer system and shifting tax revenue to local governments.
iii) Reduce importance of earmarked funds	A part of the revenue from a road-related earmarked tax has been allocated to other purposes in FY 2002 budget, though the basic framework has remained unchanged.	Promote de-earmarking of revenues.
iv) Increase use of user charges and vouchers	No progress.	Use more vouchers in job training and vocational education.
v) Promote greater use of cost-benefit analysis	Policy cost analysis was extended to 31 major FILP public corporations.	Need proper *ex ante* cost benefit analysis to prevent inefficient infrastructure construction by government and public corporations, especially in road construction.
vi) Improve the bidding system especially at local level	A law to prevent the involvement of government officials in bid-rigging was rejected in 2001 in favour of warmings from FTC.	Review the tendering system which favours local SMEs and leads to higher prices. Bring officials under the enforcement of the FTC.
VII. Reform the pension system		
i) Overhaul the public component to put it on a sustainable basis	The next periodical pension reform is planned in 2004.	Source of government financing from 2004 needs to be settled. Avoid the gradual, parameter oriented approach to the reform.
ii) Ensure the corporate pension system is adequately funded	New laws were passed in 2001.	Move to support implementation of a new system of corporate pension funds, which allows firms and employees to choose either a defined benefit or a defined contribution scheme. Firms are required to take steps to ensure future benefit payments.

Table 27. **Recommendations for structural reform and assessment of progress** (*cont.*)

Based on previous and current Surveys and the Review of Regulatory Reform

Previous Survey's recommendations	Action taken since 2001 Survey	Survey assessment/recommendations
VIII. Reform the health care system		
i) Health insurance funds should be integrated to form a larger unit	Integration of health insurance funds is under discussion by a government council but no specific plan has been proposed so far.	This would not only reduce the horizontal inequity of finance through a more effective risk pooling, but also help strengthen their role as agents for patients.
ii) The payer role of health insurance funds should be strengthened	The service of reviewing bills submitted by doctors, which was monopolised by a public corporation, plans to be opened to private agents.	The governance mechanisms of health insurance funds should be strengthened to make management accountable for its performance.
iii) Payment system needs to move further away from fee for service	The official fee schedule has been revised to reduce some distortions between treatments. Trial of the DRG type system for particular cases has been introduced in 10 hospitals. Inclusive payment type system is to be introduced in hospitals specialised in particular functions.	The official fee schedule should correct the existing biases towards hospitalisation and high technology medicine, while moving towards inclusive payments of various kinds.
iv) Regulatory reform of health service provision is necessary	Restrictions on advertisement of medical services have been eased.	Entry restrictions should be eased to promote the restructuring of supply, and so should be restrictions on information dissemination by health service providers. Third- party evaluation of hospitals should be made compulsory.
v) Balance-billing restriction should be eased with prudence	Balance-billing has been allowed for additional 4 cases since April 2002.	A gradual expansion of the list of allowable services should be envisaged in tandem with the formation of consensus on the minimum package of socially-financed services, advances in the practice of informed consent and the development of private health insurance.
IX. Increase the flexibility of employment and improve active labour market policies		
i) Allow temporary employment agencies to play a larger role	Lifting the ban on having dispatched workers in manufacturing plants is under consideration. Maximum term for middle-aged and elderly dispatched workers has been extended to three years for the period 2002 to 2005.	Liberalise dispatched employment in more areas. Extend the one-year limit on fixed-term contracts further.

Table 27. **Recommendations for structural reform and assessment of progress** (*cont.*)

Based on previous and current Surveys and the Review of Regulatory Reform

Previous Survey's recommendations	Action taken since 2001 Survey	Survey assessment/recommendations
ii) Make corporate pensions portable	See the reform in corporate pensions.	Reform important to promote labour mobility.
iii) Permit private job placement firms to play a more important role	Private job placement agents are allowed to charge job seekers under a certain condition.	The exclusion of port and construction workers is not justified. Use more private agencies for job placement service.
iv) Evaluate the effectiveness of all active labour market policies	Number and size of training programmes increased.	Need to investigate the productivity of the projects and the improvement in the employability in the training programme. Subsidies for employment need to be reviewed for displacement effects and dead weight costs. *Ex post* performance evaluation is poor and needs to be improved.
v)	The unemployment insurance scheme has been expanded to cover more temporary workers by abolishing the minimum requirement for annual income and monthly days of work.	Extend and widen the coverage of unemployment insurance scheme.
X. Increase labour force skills		
i) Improve the quality and availability of training outside of firms	Establishment of one-year vocational education courses at professional graduate schools was allowed in March 2002.	Subsidies for training need to be available for those who do not join the employment insurance scheme. Need *ex post* analysis to check the efficiency of the subsidies.
ii) Improve the education system	10 to 20 universities are to be selected as centres of excellence (COE) in 10 research areas. Competition among national universities is to be enhanced by their corporatisation.	Monitor how these plans will be implemented and whether selection is at arm's length.

Source: OECD.

Competition in wide areas of the economy must be fostered

In promoting the further development of an efficient market environment, competition policy should play a key role. Greater efforts are needed to reinforce the operations of the Fair Trade Commission, especially in the area of investigation and enforcement where it has been relatively weak. Moreover, it should pursue the prevention of bid rigging by civil servants and monitor the actions of other public organisations, which might remain poorly oriented to stimulating a competitive economy. To carry out its work effectively, staffing policies will need to be re-examined and attention given to hiring sector specialists. Without such resources, the FTC will be poorly placed to deal with the technical issues which will come to dominate the development of competition-oriented regulation in the network and transport sectors. In order to underline the government's commitment, consideration needs to be given to making the secretariat of the FTC independent and not attached to a ministry.

The regulatory system needs to be improved to ease barriers to entry and exit

Regulatory quality and efficiency is particularly important in the key areas of incentives and barriers to entry and exit from economic activities. With respect to entry, there are numerous governmental programmes including incentives to create high technology start-ups. Deregulation measures, however, are much harder to find. In this context, the proposal to create "special structural reform zones" (by which selected regulation which is judged to be a key barrier to growth by the local authorities is waived) constitutes a pragmatic step forward that would finally empower local government to take responsibility and which could counterbalance the political power of vested interests. The reform needs to be implemented as envisaged and not captured by central government bureaucracy. But it should remain the first step to regulatory reform nation-wide. With respect to exit, a great deal has been achieved by the government with more flexible restructuring and bankruptcy laws and institutions. How these will work in practice will depend to a great extent on the will of the banks to force the pace of enterprise restructuring.

A great deal of progress has been made in recent years to improve the quality of the regulatory system. Administrative procedures have been established in many areas, public comment periods for legislation have been introduced, and the principles for no-action letters put in place. However, there is some way to go for these initiatives to become the culture of government. Public comments have sometimes been treated in a perfunctory fashion and no-action letters have been very limited and are in any case not legally binding, while some ministries do not even propose to publish them. Moreover, the test proposed in the *Regulatory Reform Review of Japan* that regulation be necessary and efficient appears to be far from being realised.

Reforms to the commercial code have now given firms a great deal of freedom to establish their own board arrangements and has also lifted restrictions on their capital financing arrangements. Whether the new code will result in better governance and an improvement in the rate of return on capital will depend on changes in corporate behaviour and that of shareholders including investment funds through a proper exercise of their fiduciary responsibility. Effective shareholder pressure is much more important than the presence of "outsiders" on the board. It will also be important how commercial pressures develop, both from the side of bank lending and bank's activity as "stable" shareholders, and from the side of competition including improved government tendering practices.[123]

Labour markets need to support mobility and increased labour supply

Barriers to improved resource allocation include labour market institutions. If resources are to be reallocated to more productive uses, serious reforms are required in the direction of developing a more active and deeper external labour market. Non-portable pensions, seniority-based wages and strong *de facto* EPL all prevent the development of an external labour market to redirect labour and to provide signals for human capital formation. There is a limit to what policy can do. Employment protection legislation needs to be placed on a more rational basis by the Diet specifying clearly the criteria to be used by the courts. Current moves to increase the flexibility of fixed-term contracts and other forms of temporary work should also be continued. On the other hand, the social safety net needs to be reformed, which means that the eligibility criteria for social benefits should be eased and unemployment insurance widened. Public employment programmes do not appear to be efficient and need to be assessed rigorously, something advocated by OECD *Surveys* for quite some time now.

Japan faces a severe problem with re-employment of older workers, especially for those over 60 years which is the usual age for mandatory retirement. The current system is already evolving in the direction of a steep fall in wages after mandatory retirement and this development will need to be supported by further moves to establish flexible fixed-term contracts for these workers. But in the longer run private arrangements, which have encouraged a very steep age/wage profile, will have to adapt in the direction of more performance-based pay. The profile leading up to retirement would then be flatter and the disincentives to employ older workers less. The guideline covering age discrimination gives an exemption to companies if setting an age limit is necessary to avoid negatively affecting wage payments to existing workers. Consideration needs to be given to removing this exemption.

Labour supply by spouses is still discouraged by the social security system. Reform in this area is urgent and should be accompanied by the development of more childcare facilities. In addition, a more flexible style of employment, such as part-time and fixed-term contract work, should be encouraged by further deregulation.

Notes

1. The government adopted a substantial revision to the method of estimating QNA at the time of the release of the second quarter QNA in August 2002. The revised method utilises more supply side statistics for the estimation of consumption and investment with less weight on the household and corporate surveys. According to this revision, GDP growth rates from the second quarter in 2001 to the first quarter in 2002 have been revised substantially. Above all, the unreasonably high GDP growth in the first quarter of 2002 (5.7 per cent, s.a.a.r.) was revised down to 0.0 per cent, which seems more reasonable, compared with other indicators such as industrial production.
2. Although a sharp increase in exports to Asia partly reflects the recovery of exports by those countries to the US and other areas, the increase in exports of final consumption goods to Asia such as home electronics and vehicles outweighed the increase in exports of electrical parts and other intermediate goods. This could suggest that the Asian countries might become more important as a final destination of Japanese exports.
3. Since the March Tankan showed no improvement in business sentiment, the gain in the June survey might include a degree of catch up.
4. See, Matsuoka, "Capital investment outlook: Will cashflow and capex remain decoupled?", September 2001, Deutsche Bank Security.
5. This is partly because the full mark-to-market accounting has not been introduced for the real assets held by firms for the purpose of fixed investment. However, an increasing number of firms have started evaluating their real assets at market value with a view to adapting to the international accounting trend (*i.e.* asset impairment).
6. See, for example, Cabinet Office, Annual Report on Japan's Economy and Public Finance, 2000-2001.
7. Some argue that the massive increase in the monetary base may stimulate consumption, as some part of the increase in money holdings by households could flow into consumption. The possible shift to consumption from bank accounts due to the removal of blanket deposit insurance is also suggested to have some effect, but such an impact is thought to be small, if any.
8. For a review of some of these programmes see *Regulatory Reform in Japan*, Chapter I, OECD, 2000.
9. See the OECD *Survey of the United Kingdom*, 1985, and Lewis Evans *et al.*, "Economic Reform in New Zealand 1984-95: The Pursuit of Efficiency", *The Journal of Economic Literature*, Vol. XXXIV, No. 4, December 1996.
10. Although net lending in CY 2000 is slightly larger than in CY 2001, the difference can be explained by a one-off capital transfer in CY 2000, which amounted to 4.5 trillion yen.

11. Funds in a special account obtained from selling shares in Nippon Telecom and Telegraph (NTT) several years ago were transferred to a special account of the central government (*Sangyo toushi tokubetsu kaikei*) that provides interest-free loans to local governments and public corporations to finance construction of infrastructure and public facilities. To give local governments a strong incentive to implement the planned public works, the central government also made a commitment to giving grants to local governments to cover most of the repayment cost of the loans provided by the special account over the next several years. Consequently, transparency of the budget has been further eroded.
12. Consolidated tax accounting has been introduced with limitations: the consolidation is only for domestic subsidiaries, 100 per cent of whose capital is owned by parent companies; the loss carry-over generated before the introduction of this scheme is only for parent companies; and the special losses due to the creation of reserves for company pension payments are excluded for all companies.
13. The LAT special account has accumulated 42.6 trillion yen of debt as of March 2001. The BOJ has placed the lending by financial institutions to the LAT special account on the approved list of collateral for discounting.
14. Moody's and Standard and Poor's downgraded their rating of JGBs in the spring of 2002 from Aa3 and AA to A2 and AA minus, respectively. Fitch also downgraded JGBs in November 2001 from AA plus to AA. The government's questionnaire included the following questions: what kind of risk is contemplated as default for local currency denominated debt; how the world's largest current account surplus (or domestic saving) and foreign exchange reserves are evaluated; and why a country whose per capita GDP is one third of that of Japan with a large current account deficit is rated higher than Japan. The government sent letters several times to those companies and, in one letter, it explicitly stated that it believes to possess the right to claim compensation if any government or corporation suffer unwarranted damage by the rating. The dispute is ongoing.
15. However, long-term interest rates recorded their largest monthly increase (105 bps) in the past 20 years in December 1998, when the Ministry of Finance announced the reduction of JGB purchases by the Trust Fund Bureau.
16. As of March 2002, the share of long-term bonds (10 year and more) was around 65 per cent, while that of medium-term bonds around 27 per cent.
17. To give some order of magnitude, the decline of interest rates since 1990 has saved the budget some 43 trillion yen cumulatively.
18. The stock of foreign assets is also important. See Matsuoka, *Iron hexagon: Japan's ponzi scheme keeps going*, Deutsche Bank Security, August 2001.
19. Under the past scheme, the Trust Fund Bureau (TFB) collected funds from postal saving and public pension funds and invested in a number of public corporations as well as purchased JGBs. Some of the funds at the TFB were reallocated to the postal saving and the public corporation for pension reserves, both of which also invested a certain portion of their funds in JGBs.
20. See M. Shirakawa, "The reform in the Japanese government securities market", Bank of Japan, Note to Roundtable on Capital Market Reforms in Asia, April 2000.
21. Pursuing these two objectives together could reduce risk aversion by the public financial sector, possibly raising bond prices, which could send wrong signals to the private sector. See Ihori, Katoh, Nakano, Nakasato, Doi, Kondo and Sato, "Public bond

management and the role of public financial institutions", Chapter 6, *Budget deficit and economic activity*, Economic and Social Research Institute, Cabinet Office, March 2002.

22. One such mechanism is that as inflation returns, investors will see the danger of the government reducing the real burden of public debt on the budget by a period of unexpected inflation. They will consequently demand a risk premium and could shift funds off-shore.

23. The debt dynamics is derived as follows, $b_t = d_t + (1 + r)/(1 + g)\ b_{t-1}$, where b is the debt-to-GDP ratio; d is the primary-balance-to-GDP ratio; r is the nominal interest rate; g is the nominal growth rate. The required primary surplus to stabilise the debt-to-GDP ratio at time t is calculated as $d_t = (g - r)/(1 + g)b_t$.

24. The size of saving is calculated by the OECD based on the National Accounts. Government investment, and wage and non-wage consumption (excluding health care) are assumed to be cut by 3 per cent, 0.5 per cent and 7 per cent, respectively. A 700 billion yen saving in health care is also assumed.

25. These principles include: reducing public investment to the level prior to the introduction of stimulus packages; a steady reduction in the number of central government employees; social security spending to be limited and; non-wage expenditure should focus on reallocation.

26. The primary deficit for central and local government projected in the government's medium-term perspective is smaller than that for general government because the social security fund runs a primary deficit. However, the primary deficit in social security funds may not result in an increase in gross debts as it has accumulated net assets of 200 trillion yen (40 per cent of GDP). The gross debt projected in the government's perspective is also smaller than those on a national account basis as it excludes debts held by some special accounts of the central government, which amount to more than 50 trillion yen.

27. See page 78 of the OECD *Survey of Japan*, 2001. See also Giavazzi, F. and M. Pagano (1995), "Non-Keynesian effects of fiscal policy changes: International evidence and Swedish experience", NBER *Working Paper* No. 5332, Bertola, G. and A. Drazen (1993), "Trigger points and budget cuts: explaining the effects of fiscal austerity", *American Economic Review*, 83, and Alesina, A. and R. Perotti (1996), "Fiscal adjustments in OECD countries: composition and macroeconomic effects", NBER *Working Paper* No. 5730. Moreover, the fiscal theory of the price level would suggest that demand for money may, under such circumstances, fall, thereby stimulating consumption.

28. See, Ihori, Katoh, Nakano, Nakasato, Doi, Kondo and Sato, "Review of non-Keynesian effects in fiscal policy", Chapter 2, *Budget deficit and economic activity*, Economic and Social Research Institute, Cabinet Office, March 2002.

29. The past major tax reductions include: a special reduction in personal income tax (5.5 trillion yen) in 1994; advanced tax reduction in personal income tax (3.5 trillion yen) in 1995 and thereafter; a temporary cut in personal income tax (2 trillion yen for both 1995 and 1996, and 4 trillion yen for 1998); reduction in corporate tax rate from 37.5 per cent to 34.5 per cent in 1998 and thereafter; proportional tax cuts for personal income (4.1 trillion yen) and corporate income tax (2.5 trillion yen) in 1999; and a reduction in corporate tax rate from 34.5 per cent to 30 per cent in 1999. On the other hand, VAT was raised from 3 per cent to 5 per cent in 1997 (including 1 per cent local VAT).

30. The government's tax commission has opposed the suggestion of lowering the corporate tax rate. While keeping the marginal rate of corporate tax of the central government constant, it proposes to introduce a corporate tax based on sales as an

alternative to the existing local business tax, which taxes corporate profits. Since the introduction of a new tax would enable local governments to raise tax revenues from more firms including those making losses, this would lower the effective corporate tax rate including central and local taxes by 3 percentage points.

31. However, even in the early 1990s when the economy was booming, 48 per cent of firms reported that they were making losses. This might say a lot about the ability of small firms to understate business earnings.
32. See, page 171, Chapter 4, 1999 *Survey*, OECD.
33. See, OECD Directorate for Financial, Fiscal and Enterprise Affairs, "Tax and the economy: a comparative assessment of OECD countries", OECD *Tax Policy Studies*, 2001. See also P. van den Noord and C. Heady, "Surveillance of tax policies: a synthesis of findings in economic surveys", OECD *Economics Department Working Paper*, 303, 2001.
34. See, Doi, T. and T. Hoshi, "FILP: How much has been lost? How much more will be lost?", March 2002.
35. This in fact happened in the period just before the collapse of Mycal in September. The main bank assumed loans granted by other banks thereby increasing its exposure. This case is now the subject of a shareholders law suit, which might lead other main banks to curtail their implicit commitment.
36. See OECD *Survey of Japan*, 2001, Annex I for a review of private sector estimates of NPL.
37. The evidence (anecdotal as well as based on company reports) is that bad borrowers can pay lower rates than prime borrowers.
38. For an example see M. Fukao, "Barriers to financial restructuring: Japanese banking and life insurance industries", in *Structural Impediments to Growth in Japan*, NBER, 2002.
39. In the case of one large company the banks tried to avoid the guidelines and arrange matters between themselves and the company. After dissatisfaction among other creditors became more pronounced, the company finally agreed to work under the INSOL guidelines.
40. The criteria even extend to supporting a supermarket chain.
41. For a sense of the tone of the debate see Y. Fuchita, "Recent developments concerning Japan's bad loan problem and the outlook for its financial system", *Capital Research Journal*, Vol. 4, No. 4, 2001.
42. As part of the sale agreements for two large nationalised banks the RCC has agreed to repurchase loans which have lost more than twenty per cent of their value within three years. This clause was intended to compensate the purchaser for not being allowed to conduct a due diligence audit. The RCC is now declining to repurchase some of these loans and the cases may be taken to court.
43. Standard and Poor's, *Unsustainable revenue growth at major Japanese banks*, Tokyo, July, 2002.
44. See Fukao *op. cit.* who also concludes that the current solvency ratio might over-state the financial strength of life insurance companies.
45. See Fukao *op. cit.*
46. See Fukao *op. cit.* 2002.
47. Some 6½ trillion yen of core capital is also in the form of preferred shares bought by the government during the re-capitalisation of the banks. Formally speaking it will need to be repaid but there is nothing to prevent the government from simply selling its shares to the public.

48. For an insider's view of the crisis during the 1990's and of the lessons learned see H. Nakaso, "The financial crisis in Japan during the 1990's: how the Bank of Japan responded and the lessons learned", BIS *Papers*, No. 6 , 2001.
49. Foreign banks obtained yen funds in exchange for providing dollar funds to Japanese financial institutions for a certain period. Because the cost of obtaining yen funds (the yen swap rate) was negative, foreign banks were more or less guaranteed a profit margin even though the interest rate on yen investment was virtually zero. See M. Shirakawa, "One year under 'Quantitative easing'", IMES *Discussion Paper*, 2002-E-3, Tokyo, 2002.
50. The pattern of repatriation of foreign assets in the run up to the end of the financial year followed by an outflow afterwards is a well established pattern in Japan, although the period of outflow seems to have become more spread-out in recent years.
51. On one day the Ministry of Finance used the Federal Reserve Bank of New York and the European Central Bank as its agent.
52. The Tankan Survey includes sales price forecasts which have been negative for some time. Moreover, they actually deteriorated as the economy slowed in 2001 but as monetary policy eased. For a review of composite measures see Chapter I.
53. For example, M. Matsuoka, *Monetary policy, wealth effect and private consumption*, Deutsche Bank Economic Research, Tokyo, May 2002.
54. This methodology uses both the output gap and the price gap to explain price level movements. The latter is the deviation of the current price from the long run equilibrium price called P-star, which is supported by the current money supply level. This in turn is governed by the velocity gap. For estimates for Japan see M. Matsuoka, *Will inflation be back? Analysis from the P-star model*, Deutsche Bank Group, Economic Research, Tokyo, 3 June 2002.
55. A more controversial approach would also see a role for future tax liabilities arising from the build-up of debt.
56. The company bond market has been expanding by some 3 per cent per annum since 1998 which is about the same pace as the decline in bank lending. However, the size of the market is much smaller amounting to only 20 trillion by mid 2002.
57. Growth is driven not only by increased inputs of factors but also by technological progress, one aspect of which is summarised by multifactor productivity (MFP). Although MFP is a well defined theoretical concept, calculation is far from easy and small changes in the period considered and in smoothing procedures to account for business cycles can lead to large changes in estimates. Moreover, the measurement of capital stock by the statistical authorities is very imprecise with major problems arising in allowing for scrapping and depreciation, in particular, in periods when these rates are likely to be changing. The difficulties are even more severe in the case of Japan where technical progress over the catch-up period might have been incorporated in new capital stock (*i.e.* embodied technical progress) which would usually lead to an overestimate of MFP. Labour productivity (corrected for hours of work) is easier to calculate but is also subject to problems noted in the text. It is therefore important to consider broad tendencies over time and not to put too much weight on small differences in estimates unless underpinned by other information. For a detailed discussion of the issues involved, see P. Schreyer and D. Pilat, "Measuring Productivity", OECD *Economic Studies*, 33, 2001.
58. For a detailed account of MFP developments and of labour productivity in the convergence period see R. Katz, *Japan: The system that soured*, Eastgate, 1998.

59. For the derivation of this relationship and the construction of an empirical model examining the path to a new lower steady state rate of MFP growth see F. Hayashi and E. Prescott, "The 1990s in Japan: A Lost Decade", *Review of Economic Dynamics*, 5, 2002.
60. Another reason for care in using MFP estimates is that capital stock estimates are unreliable.
61. The *Growth Project* focused not on growth but on growth per head of working age population which slowed continuously from the 1970s to the end of the 1990s. See *The sources of economic growth in the OECD countries*, OECD, 2002, forthcoming.
62. See for example M. Baily and R. Solow, "International productivity comparisons built from the firm level", *Journal of Economic Perspectives*, 15, 3, 2001.
63. See Katz *op. cit.* Figure 2.2 who shows that the globalisation index for the weak sectors in Japan is much less than in Germany or the United States. There is also a wider spread between the weakest and strongest sectors.
64. McKinsey Global Institute, *Why the Japanese economy is not growing: micro barriers to productivity growth*, Washington, 2000.
65. See M. Porter, H. Takeuchi and M. Sakakibara, *Can Japan Compete?*, Macmillan, 2000.
66. Net assets left by senior citizens as a proportion of annual disposable income is around 2 200 per cent in Japan and 660 per cent in the United States.
67. For correlations which make the relationship even more apparent than in the figure, see S. Scarpetta *et al.*, "The role of policy and institutions for productivity and firm dynamics", OECD *Economics Department Working Paper*, 329, 2002.
68. For a comprehensive review of the development of competition policy in Japan see OECD, *Regulatory Reform in Japan*, Chapter III and background report, 1999.
69. Two distinct forms of bid rigging need to be dealt with: one between firms (*dango*) and the bureaucratic-led bid rigging (*kansei dango*) which is equally damaging to the economy.
70. The Ministry of Land, Infrastructure and Transport has a long history of limiting entry into air transport and failing to promote competition among airlines. Two small airlines which were established in 1996 – one has now gone bankrupt – were allocated very few slots at the beginning and ticket counters and gates were inconveniently located. Moreover, the various authorities involved have been extraordinarily slow in increasing capacity at Tokyo's crowded domestic airport.
71. From the work conducted by the OECD *Growth Project* and the empirical literature more generally there appears to be a strong causal relationship between increasing openness (as measured by the trade/GDP ratio) and growth in the OECD area.
72. The high share for the euro area is distorted somewhat by the exclusion of the UK, which has been a rapidly growing market for Europe.
73. H. Wall, "Has Japan been left out in the cold by regional integration", *Monetary and Economic Studies*, Vol. 20, No. 2, April 2002.
74. The agreement with Singapore covers a wide range of areas including market access for goods and services, mutual recognition of standards, ICT, competition policy and financial services.
75. The producer support estimate (PSE) for Japan is 59 per cent for 2001 while the average for the OECD area is 31 per cent. *Agricultural Policies in OECD Countries: Monitoring and Evaluation* 2002, OECD, 2002, Table III.3.
76. Study undertaken by the Japan Centre for Economic Research using the GTAP model.

77. Japan maintained extensive controls on inward foreign direct investment based on domestic industrial policy concerns until 1967 when greenfield foreign establishment was freed in a number of sectors designated as liberalised. Subsequently, the ceilings imposed in non-liberalised sectors were gradually lifted, but complete abolition of the cumbersome approval and notification procedures imposed on foreign investors came only in 1998, much later than in most other industrialised countries. At present, reservations maintained by Japan under the OECD Code of Liberalisation of Capital Movements in respect of inward FDI concern the following sectors: primary industry related to agriculture, forestry and fisheries, mining, oil, leather and manufactured leather products, air and maritime transport.

78. See Katz, *op. cit.*, for examples of how cartels set up to protect industries that were not competitive and to sustain high domestic prices were mutually supporting and prevented new entrants (including FDI). They also served to reduce imports and in some cases increased exports.

79. K. Fukao and K. Ito, "Foreign direct investment and service trade", in A, Kreuger and K. Ito, *Barriers to trade in services in the Pacific region*, NBER, 2001. See also K. Ito and K. Fukao, "Foreign direct investment in Japan: Empirical analysis based on establishment and enterprise census", RIETI *Discussion Paper Series*, 01-E-002.

80. It is a moot point whether this particular restriction is covered by the reservation lodged by Japan under the OECD Code of Liberalisation of Capital Movements with respect to investment in "primary industry related to agriculture…".

81. For a review of the trade and income effects of China's entry into the WTO see Annex II "Summary of studies of the impact of WTO on China", in *China in the World Economy*, OECD, 2002.

82. For a more extensive discussion see Y. Nakamura and M. Shibuya, "The hollowing out phenomenon in the Japanese Industry", *Studies in International Trade and Industry*, 19, REITI, Tokyo.

83. For estimates based on US import data (HS 10 digit classifications) see C. Kwan, *Complementarity and Competition between China and Japan*, REITI, *www.rieti.go.jp/en/index.html*

84. The study shows that 50-85 per cent of total productivity growth in five countries (excluding Japan) is driven by what happens in existing companies. Entry and exit of firms can account for 20-40 per cent of productivity growth with entry more important in high tech sectors. See S. Scarpetta, *et al.*, "The role of policy and institutions for productivity and firm dynamics: evidence from micro and industry data", OECD *Economics Department Working Paper*, No. 329, 2002.

85. Recession cartels and agreed capacity cuts during this period often led to proportional cuts across enterprises that bore no relation to productivity and also led to gaming outcomes on the part of firms which sought to increase capacity and market share to put them in a better bargaining position at a later time. See Katz *op. cit.* and also Porter *et al.*, *op. cit.*

86. Audretsh and Thurik (2001) have demonstrated that an increase in entry rates tends to result in higher subsequent growth rates and a reduction of unemployment. D. Audretsch and R. Thurik, "Linking entrepreneurship to growth", OECD STI *Working Papers*, 2001/2, 2001.

87. From K. Komoto, "Economic impact and policy implications of the long-term decline in Japan's business start-up rate", NLI *Research Institute*, 2002, No. 161.

88. One of the model cases assumed by the Council for Regulatory Reform is a set of exemptions concerning port services, including facilitation of custom procedures, abolishment of additional charges at night, easing the qualifications for issuance of tourist visas, and the allowance of legal and accounting services provided by foreign lawyers and accountants. Another important model case assumes easing regulations in agriculture, which limit the size of agricultural land holdings and restrict the entry of corporations into many agricultural businesses.

89. To give an idea of the costs of the present system, advisors have estimated that reforms could lead to over 5 million new jobs in the service sector in five years.

90. See J. Peek and E. Rosengren, *Have Japanese banking problems stifled economic growth?*, mimeo for a study based on a unique data set which traces the link from individual firms to their main bank. They also discover no evidence of a credit crunch. Hayashi and Prescott *op. cit.* also find no evidence that potentially profitable investments lacked finance during the 1990s. A study by the IMF also indicates that balance sheets of both banks and enterprises contributed to the decline of credit. See IMF Article IV Consultations, Japan 2002.

91. Although hard data are not available, firms are known to have cut back activity in some areas as part of their debt reduction strategies. Industrial processes and even whole factories have been moved abroad, a process which also took place in the 1980s following the appreciation of the yen. At the other end of the scale, older firms are now increasingly failing: companies with a history of 30 years or more accounted for a record quarter of the bankruptcies in 2001 and this pattern has continued into 2002.

92. The criteria even extend to supporting a supermarket chain.

93. There is a certain guarantee that loans will be repaid since they are classed as common interest claims which have priority over any claims (general claims) originating from pre-petition causes. However, the protection is not strong. See M. Iwatani, "Issues surrounding debtor in possession financing in Japan", *Capital Research Journal*, Vol. 4, No. 2, 2001.

94. Y. Seki, "The use of debt equity swaps by Japanese companies", *Capital Research Journal*, Vol. 5, No. 2, 2002.

95. For a description of the Japanese bankruptcy framework in an international perspective see OECD *Economic Survey of Japan*, 2000, Box 6.

96. In addition, it is also proposed to ease the condition that all directors must resign to cover the case where some directors are brought in to help solve a deteriorating situation.

97. For a review of the impact of corporate governance arrangements on performance focusing on shareholder rights, see S. Johnson and A. Shleifer, "Privatisation and corporate governance", forthcoming in T. Ito and A. Kreuger (eds.), *Privatisation, Corporate Governance and Transition Economies*, University of Chicago Press. They find that various dimensions of shareholder protection do affect performance, not only at the corporate level but also when a cross-section of countries is examined, although their sample is heavily weighted to Asia.

98. Foreign holdings have now risen to around 18 per cent. Financial institutions continue to hold around 40 per cent despite the reduction of holdings by banks.

99. For a general overview of the new code see S. Osaki, "Corporate governance and reform of Japan's commercial code", *Capital Research Journal*, Vol. 5, No. 2, 2002.

100. The new committee will have similar responsibilities to the "operating committees" and "management committees" that exist already. Unlike these unofficial committees, the new one has powers and responsibilities clearly defined in the law.
101. The Tokyo Stock Exchange survey of corporate governance in 2000 covered 1 310 firms and arrived at somewhat different results. 60 per cent replied that they had taken measures to strengthen the board. Of these, 33 per cent said that they had nominated outsiders, 46 per cent said that they had reduced the number of board members, and 35 per cent that they had introduced executive officers. See K. Nitta, "Corporate governance rating", NLI *Research*, 02/06/13.
102. The reason for reducing the size of the board of directors is less concerned with efficiency than to lower the total cost of shareholder law suits. These have now been capped at six years annual income of a representative director.
103. At municipal level they are 70 per cent and 45 per cent, respectively. The ratios are better at prefectural level but still below those of the central government.
104. For example, in one case a Ministry received 301 comments in the period 25 July to 27 August. The final version of the bill was published only 13 days later raising doubts about the sincerity of the procedure. The bill was virtually unchanged.
105. While on mission the Secretariat was given numerous examples of contradictory action by customs and tax officials; in one case a submission for a license was initially rejected, even though the relevant Ministry had no right to do this, and subsequently reversed its decision.
106. Population estimates in the past have failed to anticipate the fall in the number of children per couple so that population growth has been overestimated. The most recent projection appears to have reacted to widespread criticism and is based on the assumption that a couple born after 1985 will have only 1.72 children in their lifetime. The current post-50 age group had an average of 2.14 children.
107. Ono and Rebick calculate that a male employee with 30 years of tenure would lose 30 per cent of his earnings by leaving his current job. Such a loss should not be attributed to the loss of firm specific capital since there is little evidence that the wage profile reflects productivity rather than other more sociological factors. H. Ono and M. Rebick, "Impediments to the Productive employment of Labour in Japan", in M. Blomstrom *et al.* (eds.), *Structural Impediments to Japan's Economic Growth*, NBER, 2002.
108. The loss of pension rights can be very substantial: 10-20 million yen for an average pension of 35 million yen depending on the age of separation. For this reason, firms offer lump sum payments to individuals who leave under early retirement plans or who are transferred, often permanently, to other companies. Ono and Rebick, *op. cit.*, report that additional lump sum payments amount to between 5 and 10 million yen but do not cover all the losses in pension value. Overall losses of up to 100 million yen may be realised by workers who lose their jobs at large firms at age 40.
109. For example, promotion in a US company often occurs immediately after entry into a firm but in a typical Japanese firm is non-existent for the first 12 years (see Ono and Rebick and references therein). In these circumstances, bringing in older workers disrupts the system.
110. This is the main conclusion of Kato who also shows that restructuring and downsizing have depended on early retirement and transfers of employees to subsidiaries (often to sales subsidiaries) and related firms and hiring cuts. T. Kato, "The end of lifetime employment in Japan? Evidence from national surveys and field research", *Journal of the Japanese and International Economies*, 15, 2001. With respect to the ability to transfer to

smaller firms his results might be somewhat misleading since Fujiki *et al.* (2001) have shown that the smaller firms are no longer characterised as in the past by a shortage of labour. H. Fujiki *et al.*, "Structural issues in the Japanese labour market", *Monetary and Economic Studies*, 19, 2001.

111. For more detail, see "Employment protection and labour market performance", Chapter II, OECD *Employment Outlook*, 1999.
112. Redundancy dismissals require urgent business reasons for reducing the number of staff, reasonableness of selection criteria, and reasonableness of procedure.
113. The change in the law in 1999 opened up most areas to dispatched workers except those mentioned in the text.
114. The relatively high proportion of spending on unemployment benefits reflects in part the recent rise in the unemployment rate.
115. See R.G. Fay, *Making the public employment service more effective through the introduction of market signals*, OECD, 1997 and OECD, "Labour market policies that work", *Policy Brief*, July 2001.
116. If the requirement would be strictly adhered to, it could prevent the headquarters of a holding company from recruiting employees on behalf of their group companies. See Ohtake, *Discussion in Economics*, Spring 2000, Toyokeizai.
117. For example, the Australian government has introduced a competitive framework in job services by contracting public employment services to private and community placement organisations while the functions of registration and eligibility assessment were amalgamated with the administration of income support in social security.
118. The eligible age for employment grants in the new and growth sectors has been expanded to unemployed between 30 and 60 years who are on public vocational training. Initially, to get those grants, firms were required to hire unemployed through the public job placement offices. Now firms can receive the grants when they employ workers through private job placement agencies licensed by the government. One of the reasons for low utilisation of these schemes could be the economic downturn since late 2000, which might constrain employment by firms even with public grants.
119. Dead-weight costs arise from the situation where many of those for whom the subsidy is paid would have been recruited anyway: money paid for those recruits is dead-weight and has no effect at all. The substitution effect means that some of those recruited merely replace others who the firm would have recruited instead. See R. Layard, S. Nickell, R. Jackman, *Unemployment: Macroeconomic performance and the labour market*, Oxford press, 1991.
120. J. Martin (2000) summarises the effects of various active labour market measures. Evaluations of wage subsidies in Australia, Belgium, Ireland and the Netherlands have suggested combined dead-weight and substitution effects amounting to around 90 per cent, implying that for every 100 jobs subsidised by these schemes only ten were net gains in employment. See J. Martin, "What works among active labour market policies: Evidence from OECD countries' experiences", OECD *Economic Studies*, No. 30, 2000.
121. Among the mechanisms involved, contributions to health insurance and public pensions are exempt for spouses provided that their employed hours do not exceed a certain level and annual income does not exceed 1.3 million yen. Contributions to unemployment insurance are exempt for spouses whose annual income does not exceed 900 000 yen. There is evidence that these factors influence hours of work. C. Horioka, "Japan's public pension system: What's wrong with it and how to fix it",

Japan and the World Economy, 11, 1999. For details of how the income tax system influences the return to work decision see OECD *Economic Survey of Japan*, 1999.

122. The guidelines covering age discrimination are effective only to some extent and age requirements are still usually associated with job offers. For example, one of the exceptions is related to seniority based wages: "Cases where recruiting or hiring is intended for workers under a certain age in situations where in order to make wage payments regardless of age to new employees, companies will be required to revise present regulations determining wages mainly in accordance with age in such a way that it will have an adverse effect on the wage payment to existing workers."

123. A great deal will also depend on how corporate groups (*i.e. keiretsu*) evolve. For an analysis see Y. Yafeh, "Japan's corporate groups: Some international and historical perspectives", in M. Blomstrom *et al.*, *Structural Impediments to Japan's Economic Growth*, NBER, 2002.

124. Figure 28 converts yen prices to dollars using the exchange rate for August 2002. The MPHPT makes its calculations using purchasing power parity which has the effect of lowering prices.

125. For example, the regulator in Britain has the power to impose fines of up to 10 per cent of UK turnover for up to a maximum of three years.

126. Long run incremental cost (LRIC) has been adopted as the methodology for determining interconnection prices although the precise form of the technique is still under discussion. See *Survey* 2001 for a discussion of LRIC A and B methods.

127. An example of bundling would be combining new products, which are subject to competition, with the existing local exchange business, which is not subject to competition.

128. The logic here is that the right to place poles was given free by the authorities to the electricity companies so they should not be left in a position to extract scarcity rents from telecommunications operators. Charges related to operations are permitted.

129. See "Corporate IT investment and internet usage gain momentum: The NLI Survey of Business conditions", NLI *Research*, No. 140, 2000.

130. H. Joffe, "Japanese business models for electronic commerce–laying the foundation of a ubiquitous networking infrastructure with mobile phones and convenience stores", *Vierteljahrsheft*, 4-2001, DIW. Berlin.

131. More recently, ADSL (asynchronous digital subscriber line) and DSL have been spreading due to lower prices following local unbundling and better access to facilities (colocation).

132. For highly qualified engineers, treaties have been signed with India, Korea and China which should allow work permits to be granted more readily.

133. This was the recommendation of the 1999 *Regulatory Reform Review of Japan*.

134. Competition will be allowed in express mail delivery services where the mail item is charged 1 000 yen or above; items weighing 4 kg or more or with a combined length, width and depth of more than 90 cm and; where the delivery time does not exceed 3 hours.

135. See OECD *Survey*, 2001 Table 6 which is in turn drawn from CAO, *The economic impact of recent regulatory reform*, Tokyo, April 2001.

136. At present 96 per cent of slots on the longer runway are subject to coordination rules set down by IATA. However, raising slots by some 4 per cent would still be a significant change for an airstrip which is already suffering from capacity constraints.

137. Students invest a great deal of money and effort to pass difficult entrance exams for prestigious schools and the investment does pay. Employers, however, do not assess graduates on the basis of their university performance but on the basis of being at a given university. See H. Ono, "College quality and earnings in the Japanese labour market", SSE/EFI *Working Paper*, 395, Stockholm, 2002.

138. Blondal, Field, Girouard and Wagner (2001), estimate that the private rate of return to tertiary education in Japan, which is based on pre-tax earnings and the length of study, is around 8 per cent. This is below the average of sample countries but higher than in Germany and Italy. The social rate of return to tertiary education in Japan is 5½ to 6½ per cent. Private rates of return to tertiary education for men 45 years and older are negative as is the case in other non-Anglo-Saxon countries. This reflects the high opportunity cost for older workers due in part to the steep age/wage profile in Japan.

139. The ratio of post-graduates leaving universities each year to normal graduates is a little over 10 per cent.

140. Ministry of Labour, *Minkan kyoiku kunren jittai chosa*, Tokyo, 1993, 1997.

141. Arnal *et al*. suggest that employment tenure can be affected by two conflicting forces: a change in industrial structure towards low tenure industries and an increase in tenure within industries. E. Arnal, W. Ok and R. Torres, *Knowledge, work organisation and economic growth*, OECD, Paris, 2001.

142. Ministry of Labour, *White Paper on Labour*, Tokyo, 1996.

143. Y. Higuchi, *Koyo to Sitsugyo no Keizaigakn*, Nikkei press, Tokyo, 2001.

144. Ohtake, 2000, "Special Employment Measures in Japan", *Japan Labour Bulletin*, December 2000.

145. For example, seven of the top ten companies by patent applications in the United States in each of the last five years were Japanese. US patents are used because of a break in the Japanese patent series after 1988. Since then more patents are required to protect the same intellectual property. Patents have been adjusted for quality by measuring the number of citations received by a patent from subsequently granted patents over four years, information that is available in the US data bank. See, L. Branstetter and Y. Nakamura, "Has Japan's innovative capacity declined", Forthcoming in M. Blomström, J. Corbet, F. Hayashi, A. Kashyap (eds.), *Structural Impediments to Growth in Japan*, NBER, 2002.

146. Porter *et al.*, *op. cit.* Underpinning this conclusion is econometric work which suggests that co-operative R&D projects did not yield productive outcomes when they involved close competitors (who presumably use a similar technology).

147. D. Guellec and B. van Pottelsberghe de la Potterie, "The internationalisation of technology analysed with patent data", *Research Policy*, 2001, 30.

148. *Gijutsu Yoran*, Tokyo, 2000.

149. M. Sakakibara and L. Branstetter, "Do stronger patents induce more innovation? Evidence from the 1988 Japanese patent law", RAND *Journal of Economics*, Vol. 32, 2001.

150. For a discussion as well as estimates of the value of R&D tax measures in the OECD see *Tax Incentives for Research and Development: Trends and Issues*, OECD, 2002.

151. An earlier study of marginal effective tax rates indicated much the same pattern and noted that short run R&D projects were more favourably treated in Japan as elsewhere. K. Gordon and H. Tchilinguirian, "Marginal effective tax rates on physical, human, and R&D capital", OECD *Economics Department Working Papers*, No. 199, 1998.

152. For a discussion of the advantages and disadvantages of various measures to support R&D, see OECD, *op. cit.* Although it is often claimed that tax measures are ineffective in raising R&D, this is not supported by more recent empirical evidence which suggests a short term elasticity of 0.16 but a long run elasticity of 1.1. See OECD, 2002, for references and N. Bloom, R. Griffith and J. van Reenan, "Do R&D tax credits work? Evidence from an international panel of countries 1979-1994", *The Institute for Fiscal Studies Working Paper*, W99/8.

153. The statutory business profits tax is 30 per cent for the central government and 9.6 per cent for local government. There is also a local residential tax amounting to 17.3 per cent of the corporate tax payments, but which is tax deductible. This leaves the effective statutory tax rate at 40.87 per cent.

154. The number of joint research projects between industry and universities increased by 29 per cent in FY 2000 to 4 029 while research commissioned by companies grew by 8 per cent to 6 368. However, the sums involved were not large.

155. For a summary see "Industry-science relationships in Japan", in *Benchmarking Industry-Science Relationships*, OECD, 2002.

156. Since April 2001 the NRIs have become administrative legal entities which will increase management flexibility. University reform is to be implemented from 2004.

157. 1 007 venture firms (42 per cent) replied to the questionnaire. A venture firm is defined as: introducing a unique technology or know how; achieving high growth in recent years; being relatively young or having recently changed its line of business.

158. The policy is meant to also cover private universities. However, a fundamental problem has not been addressed, namely, unlike public universities they are taxed on private research contracts.

159. Geographical agglomeration is important in most countries but Japan appears to be highly concentrated. In the United States, a much larger country, 380 local clusters are reported to produce approximately 60 per cent of the country's output. Opening speech by Donald Johnston, Secretary General of the OECD, at the World Congress on Local Clusters in 2001.

160. For a description of the local political dynamic which is oriented to obtaining central government projects regardless of how they could be used locally see A. Kerr, *Dogs and demons: The fall of modern Japan*, Penguin, 2001. The major deficiencies of the fiscal transfer system are documented in OECD, *Economic Survey of Japan*, 2000, Chapter III.

161. The new theories of growth and trade also point to the importance of geographical agglomeration. Knowledge spill-overs are often restricted geographically, leading to the spontaneous development of clusters around the world. This has led to numerous policy initiatives to create clusters.

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Annex I

Assessment of the government's structural reform programmes

This Annex reviews the government's reform programme in detail so as to support the overall assessment in the *Survey*. The measures of particular importance are discussed further in the text. Conversely, a number of less important measures are not covered in the text but are taken into account here. Tax reform measures are not considered due to their highly specific nature. The programme is assessed from two perspectives: the progress in implementation which simply checks what has and has not been done and; the degree to which the measures serve original policy goals. As for the *stage of implementation* (column "Progress"), the rating is 0 for the discussion stage, 1 for having a concrete plan, 2 for a preparatory stage of necessary legislation, and the maximum 3 for the passage of legislation. As for *fulfilling policy objectives* (column "Quality"), it is measured against the deviation from the objectives set in the June 2001 programme. The rating hence ranges from 0 for plans and legislation that are not compatible with original goals (all reforms at a discussion stage are automatically rated zero) to the maximum 3 for those that broadly meet original objectives. The ratings of 1 and 2 respectively represent large and small deviations from the June 2001 objectives. The distinction between 1 and 2 is inevitably somewhat arbitrary in some cases.

Reform objectives	Action	Progress	Quality
1. Privatisation and corporatisation of public service			
1. Review the roles of postal savings, insurance and mail-delivery services including the possibility of privatisation.	*a)* Laws for establishing public postal corporation passed the Diet. The entry barriers to mail delivery market are very high. The role of postal saving and insurance remains unchanged.	3	1
	b) There is no consensus on privatising this corporation, though the discussion continues.	0	0
2. Promote privatisation of public corporations and reduce subsidies to them.	Of 163 special-status public corporations, 17 are to be abolished, 45 to be privatised, and 38 to be made independent agencies. Specific reform plans are still under discussion. FY 2002 budget cut subsidies for public corporations by 1 trillion yen.	1	2
3. Review the function of public financial institutions.	*a)* The Government Housing Loan Corporation is to be abolished by FY 2006.	2	3
	b) Reform in other major public financial institutions is under consideration.	0	0

Reform objectives	Action	Progress	Quality
4. Enhance competition among the national universities through corporatising them and introducing private management technique.	National universities are to be corporatised in 2004 (see Chapter 4).	2	2
Comments: Reform of public corporations including financial institutions and privatisation of postal services should be accelerated. The entry requirements for basic postal services appear to be restrictive and the regulatory system needs to be clarified so as to limit the potential for the postal corporation to distort competition. The reform of public corporations should aim to reduce the scope of public intervention.		Average score: 1.3	Average score: 1.3
2. Deregulation			
1. Promote deregulation in general.	A revised three-year timetable for regulatory reform was adopted in March 2002.	3	2
2. Revitalise urban areas and improve commuting.	A new law is in force to allow private developers to manage city planning for designated sites regardless of existing regulations in urban areas. A quality assessment system for second-hand houses is to be introduced. Regulation requiring residents' unanimous support for rebuilding condominiums has been eased. Some public infrastructure projects in urban areas such as a new fast railway to Narita airport and an extension of circular roads are planned.	3	3
3. Encourage competition in non-profit areas including medical services and nursing care.	Private corporations are allowed to manage nursing homes and nurseries. Assessment by a third party is to be introduced for providers of elderly care and nursery services. Restrictions on advertisement of medical services have been eased. The review service of bills submitted by doctors has been opened to the private sector.	2	2
New measures announced in the June 2002 programme (too early to be assessed).			
4. Introduce "Special zones for structural reform" which allow local governments to ease regulations and to design their own reform measures.	A unit in charge of promoting special zones for structural reform has been established in the Cabinet Office.		
Comments: Deregulation for redevelopment in urban areas is a good move. The new proposal to allow "structural reform zones" is promising and needs to be developed quickly. But it should be seen as a first step to nation-wide regulatory reform.		Average score: 2.7	Average score: 2.3

Reform objectives	Action	Progress	Quality
3. Entrepreneurship, competition and openness			
1. Strengthen the Fair Trade Commission to enforce competition policy more vigorously.	*a)* Additional 40 staff are appointed by the FTC.	3	1
	b) Independence of the FTC secretariat from the Ministry is still under discussion.	0	0
2. Encourage competition in telecommunications sector by imposing asymmetric regulations on NTT. Promote open bidding for electromagnetic spectrum and for other public assets.	Asymmetric regulation on dominant career has been introduced. The law covering the electromagnetic spectrum has been revised to allocate frequencies more efficiently.	3	2
3. Open up unutilised capacity of optical fibre owned by the public sector and disclose information about the utilisation of cables owned by the private sector.	Unused optical fibres located under roads and rivers are opened up. Information about the utilisation of optical fibres owned by electric companies and railways has been disclosed.	3	3
4. Review commercial code so as to strengthen corporate governance	The diet has passed the revised commercial code, which allows replacing statutory auditors by board committees (audit, compensation, personnel), with the majority comprising outside directors.	3	1
5. Revise relevant laws for judicial system reform within 3 years. Revise bankruptcy and corporate restructuring laws by 2003.	*a)* Headquarter for judicial reform has been established at the cabinet. A plan for judicial reform has been proposed by the council.	1	2
	b) A draft of revised corporate restructuring law is to be discussed by the Diet by the end of 2002.	2	3
6. Review the system of rice production and distribution. Promote the entry of corporations into agricultural business.	A restriction on agricultural land area for rice producers is to be replaced by a production quota for regions in order to encourage enlargement of the production unit. Additional measures for easing the entry of corporations into agriculture are discussed.	1	2

Reform objectives	Action	Progress	Quality
New measures in the June 2002 programme (too early to be assessed).			
7. Promote FTA and inward FDI: – Standardise institutions and rules to establish East Asia Free Business zone. – Facilitate the entry and employment of foreign engineers in strategic areas. – Restrictions on co-operation between foreign and domestic lawyers are to be eased by 2003. – Promote one stop service at the government to facilitate inward FDI.	Although some of its components have already been planned as part of the judicial reform and the regulatory reform programme, the proposal for a Free Business Zone in East Asia is a new initiative and the details are as yet unknown.		
8. Ease barriers for start ups: – Ease the minimum requirement for capital. – Review the coverage of personal guarantees.			
Comments: FTC should be encouraged to pursue criminal penalties and be given more investigative powers. Abuse of dominant power of NTT should be checked effectively. To extend FTA to Asian countries other than Singapore, it is important to reform the agricultural sector by promoting competition and by encouraging larger-scale operation.		Average score: 2	Average score: 1.8
4. Health care reform			
1. Improving efficiency in health care services: – Set a target on the growth of medical care expenditure. – Standardise medical services including greater use of payments based on diagnostic related groups (DRG). – Disseminate information and establish informed consent. – Differentiate functions of hospitals and reduce excess beds. – Modernise and improve the efficiency of health care provider management system. – Strengthen the role of insurers.	A new health care reform plan has been adopted: – The eligibility age for the elderly insurance scheme is to be raised to 75 and above. – Co-payments are to be raised (10 per cent for elderly and 30 per cent for SMEs employees). – Medical service fees for doctors have been reduced by 2.7 per cent. – Restrictions on advertisement of medical services have been eased. – By FY 2004, more than 50 per cent of bills in all hospitals are encouraged to be submitted in electronic form. – The role of insurers as agents for patients is to be strengthened by asking private companies to check bills submitted by doctors.	3	2

Reform objectives	Action	Progress	Quality
Comments: Progress has been made in health care reform, though measures for improving supply-side efficiency should be strengthened.		Average score: 3	Average score: 2
5. Pension and social security reform			
1. Establishing a sustainable pension system: – Review the current pension system to make it compatible with greater diversity of work arrangements and life styles. – Ensure intergenerational equity and balance of benefits and burden. – Decide specific measures to raise the tax financing of basic pensions to 50 per cent to ensure stable revenues. – Lift temporary suspension in raising pension contributions.	Pension reform measures are to be decided during the periodical review planned in 2004.	0	0
2. Introduce social security numbers and individual social security accounts.	A study of the experiences of other countries about social security numbers and individual social security accounts has been conducted.	0	0
Comments: The agenda for next pension reform should go beyond changing parameters and include ambitious measures to ensure the viability of the system in the face of changes in demographic and economic conditions.		Average score: 0	Average score: 0
6. Human capital and labour market			
1. Introduce competition among universities to foster world-class universities.	10 to 20 universities are to be selected as centres of excellence (COE) in 10 research areas to promote competition by allocating funds based on their performance.	3	1
2. Promote retraining of unemployed at universities and graduate schools.	The scope of subsidies for training has been expanded to cover vocational training courses at university and graduate schools.	3	2
3. Establish one-year courses at graduate schools and strengthen vocational courses at colleges (community schools).	Establishment of one-year vocational education courses at professional graduate schools was allowed in March 2002.	2	2
4. Increase labour mobility through: promoting training; easing restrictions on flexible work styles such as temporary work and fixed-term contract; enhancing job matching functions; and eliminating discrimination in employment by gender and age.	Lifting the ban on having dispatched workers in manufacturing sector is under consideration. Maximum term for middle-aged and elderly dispatched workers has been extended temporarily to 3 years. Private job placement services are allowed to collect charges from some job seekers.	2	2

Reform objectives	Action	Progress	Quality
5. Alter focus of taxation and social security system from families to individuals.	Tax reform planned in FY 2003 will reduce allowance for dependent spouses.	0	0
6. Boost measures to eliminate waiting list for nurseries to support working women.	Child care facilities are to be expanded to accept 50 000 more children by FY 2002 and 100 000 more by FY 2004.	3	2
Comments: More emphasis should be put on enhancing research capacity at universities and reducing barriers to collaborating with foreign institutions and individuals. The regulation which requires universities to hold open land should be eliminated. Although some progress has been made in labour market regulations, remaining restrictions on dispatched workers should be eased further. The use of private agents in job placement should be encouraged. Elimination of social security disincentives for spouses to increase their labour supply should be implemented as soon as possible.		Average score: 2.2	Average score: 1.5
7. More responsible local governments			
1. Promote mergers of local governments in order to improve efficiency.	Mergers of local government are promoted by some financial supports of central government such as: financing a part of initial costs arising from mergers; allowing the merged local government to receive lump sum grant from central government at the same level as before the merger; and allowing local governments to issue additional bonds to finance merger costs.	3	2
2. Allocate a local allocation tax (LAT) to local governments by setting objective standards.	Complex adjustment system for allocating LAT to local governments is to be streamlined gradually by FY 2004.	3	1
3. Review central government's share of contribution to local government administrative costs. Consider shifting tax revenues from central to local government and adopting a corporate tax based on sales and other factors to deal with low tax revenue facing local governments.	Introduction of a local corporate tax based on sales and other factors is discussed. The government is reviewing the revenue structure of local government including state subsidies, LAT and the allocation of tax resources between the central and local governments with a view to establishing a concrete plan by June 2003.	0	0
Comments: Huge transfers from central to local governments, which distort incentives for local government spending, need to be changed. The discussion about the reform of subsidies and grants from central to local governments should be accelerated.		Average score: 2.0	Average score: 1.0

Reform objectives	Action	Progress	Quality
8. Fiscal reform			
1. Aim at primary surplus as a medium-term goal. Prepare medium-term fiscal consolidation plan.	Medium-term economic and fiscal perspective aimed at achieving fiscal surplus by early 2010s has been adopted, though how to limit spending as a proportion of GDP is not specified.	3	2
2. Change budget formation process. Council for Economic and Fiscal Policy (CEFP) to propose broad direction of budget plan, while specific components of budget plan to be decided by Ministry of Finance.	CEFP has played the expected role in budget formation.	3	3
3. Reallocate spending to priority areas.	FY 2002 budget plan has allocated 2 trillion yen to priority areas, while 5 trillion yen was cut in general spending. FY 2003 reallocations not yet clear.	3	2
4. Review long-term public works projects. Lower public works spending in proportion to gross domestic product in the medium term.	*a)* FY 2002 and FY 2003 budgets have cut spending on public works by 10 per cent and by 3 per cent.	3	2
	b) Long-term plans for public works are being reviewed.	0	0
5. Reallocate earmarked road taxes.	A part of the revenue from road related taxes is now used for other purposes than road construction. Reallocation of earmarked revenue is being discussed in the context of a broader reform including public works and taxation.	1	1
Comments: The budget formation process and the outcome of FY 2002 budget are satisfactory though the 30 trillion yen ceiling on public bond issuance involved creative accounting. The medium-term economic and fiscal perspective is not sufficiently ambitious and lacks specific measures for containing spending to achieve a primary surplus. It needs to make use of shorter run real spending targets to improve credibility. The discussion about reallocating road taxes and reducing the size of road construction needs to be brought to a swift and successful conclusion.		Average score: 2.2	Average score: 1.7

Reform objectives	Action	Progress	Quality
9. Financial sector reform			
1. Dealing with non-performing loans (NPLs): – Remove existing NPLs from balance sheet within 2 years and new ones within 3 years. – Encourage Resolution and Collection Corporation (RCC) to purchase NPLs by adopting fair value for purchasing price. – Request the Development Bank of Japan (DBJ), private investors and RCC to set up and/or participate in funds for corporate reconstruction. – Introduce a special inspection for major banks	Financial revitalisation law was revised in December 2001 allowing RCC to participate in open bidding and to have flexibility in purchasing price. RCC has been permitted a trust banking licence. 100 billion yen has been funded by DBJ to set up funds, which purchase shares issued by restructuring companies. The funds will also purchase shares which banks obtained from borrowers through debt-equity swaps. Special inspection for major banks was conducted and the result was published in April 2002.	3	1
2. Encourage individual investors to participate in stock market by reviewing tax system.	Tax on capital gains has been based on self-assessment rather than a withholding system, and its rate has been reduced. Capital losses can be deducted from asset incomes for three years.	3	1
Comments: See Chapter II for the assessment of the measures to deal with NPLs. New tax measures for capital gains are too complex to be used.		Average score: 3	Average score: 1
10. Others			
1. Focus funds on four areas in allocating budget: life sciences, information technology, environment and nano-technology.	Supplementary budget for FY 2001 and budget for FY 2002 have allocated more funds to these four areas. Funds are also allocated to promoting knowledge-intensive clusters and fostering venture business at universities and technology licensing organisations (TLOs).	3	1
2. Encourage the use of ICT for administrative procedures.	A new law which promotes electronic submission of administrative documents has been prepared.	2	2
3. Reduce waste and create environmentally friendly society.	Private agents who have advanced skills in recycling and waste disposal are supported by subsidies and public loans. Government procurement favours environmentally friendly goods. Residents and NPOs are encouraged to promote waste reduction and recycling by disseminating information about the necessity to do something.	3	1

Reform objectives	Action	Progress	Quality
New measure in June 2002 programme (too early to be assessed).			
4. Promote tourism and longer vacations			
Comments: Ensure appropriate economic incentives in pursuing waste and recycling targets. Streamline government in order to allow effective use of ICT.		Average score: 2.7	Average score: 1.3

Source: Assessment by the OECD.

Annex II

Chronology of main economic events

2001

November

The Diet passed the first supplementary budget for FY 2001, which included 1 trillion yen (0.2 per cent of GDP) of additional spending for employment measures and subsidies to public financial institutions for lending to SMEs.

The government decided to abolish seven major special-status public corporations including Japan Highway Public Corporation, the Government Housing Loan Corporation, and the Japan National Oil Corporation.

December

The Bank of Japan (BOJ) raised the target for the outstanding balance of the current accounts at the Bank from 6 trillion yen or above to 10 to 15 trillion yen and to increase outright purchase of long-term government bonds from 600 billion yen to 800 billion yen per month.

A framework for the consolidation of 163 special status public corporations was adopted by the government, of which 17 are to be abolished, 45 are to be privatised and 38 are to be made independent agencies.

The government adopted the second supplementary budget for FY 2001 including 2.6 trillion yen of additional spending for public works. The supplementary budget is financed by revenue which was obtained in the recent past by selling NTT shares held by the government.

The government adopted the draft initial FY 2002 budget, envisaging general expenditure (*i.e.* total expenditure less debt servicing and transfers to local governments) of 47.5 trillion yen, down from 48.6 yen in the previous initial budget, with new public bond issues limited to 30 trillion yen.

2002

January

Japan and Singapore signed a FTA treaty (the Japan-Singapore Economic Agreement for a New Age Partnership).

Prime Minister began talks for a comprehensive tax reform in FY 2003.

The government adopted the *Structural Reform and Medium-term Economic and Fiscal Perspective for* FY 2002 *to* FY 2006, which illustrated the medium-term economic prospects and fiscal consolidation paths, including the introduction of a cap on spending as a proportion to GDP.

The government submitted the draft FY 2001 second supplementary budget and the draft initial FY 2002 budget to the Diet.

February

The Diet passed FY 2001 second supplementary budget.

The BOJ raised its outright purchase of long-term government bonds from 800 billion yen per month to 1 trillion yen.

The government adopted an anti-deflation package, which includes measures for accelerating disposal of non-performing loans and stabilising financial system as well as those for strengthening the security market regulations to curtail short-selling.

March

The Diet passed FY 2002 initial budget.

Council of Regulatory Reform adopted the regulatory reform plan for the next three years, which covers broad areas including social welfare, health, urban revitalisation, and education.

April

Protection on time deposits restricted to 10 million yen per depositor per bank since 1 April.

Financial Service Agency (FSA) published the result of the special inspection of large borrowers at major banks.

May

The government announced in its monthly economic report that the economy had reached the bottom of the cycle.

June

The government adopted a second anti-deflation package, proposing a reduction in inheritance tax and tax credits for business investment and R&D.

The government adopted the *Basic Policy for Economic and Fiscal Policy Management and Structural Reform* 2002, to update and revise the structural reform plan adopted in June 2001.

July

The Diet passed the laws for establishing a public postal corporation and setting the conditions for the entry of private agents into mail delivery services.

The Diet passed laws for reforming the health insurance system, which include measures such as a rise in the eligibility age for the elderly insurance scheme and an increase of co-payments (10 per cent for elderly and 30 per cent for SMEs employees).

August

The FSA announced the "Programme for Promoting Security Markets Reform" in order to encourage the participation of a wide range of investors.

The cabinet approved the guideline for FY 2003 budget requests, setting general expenditures at 48.1 trillion yen, slightly higher than in FY 2002 budget.

The committee for privatisation of road construction public corporations released its interim report, proposing a separation into several road operating companies and a road maintenance company.

September

The BOJ announced that it will purchase shares held by banks at market prices to help them reduce their holdings of shares to the level equivalent to their tier I capital.

Prime Minister Koizumi reshuffled his cabinet members and appointed Minister for Economic and Fiscal policy, Takenaka, as Minister for Financial services.

October

The FSA announced the postponement of the introduction of a cap on deposit guarantee until April 2005.

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BASIC STATISTICS OF JAPAN

THE LAND

Area (1 000 sq. km), 1995	377.8
Cultivated agricultural land (1 000 sq. km), 1995	51.3
Forest (1 000 sq. km), 1994	251.4
Densely inhabited districts[1] (1 000 sq. km), 1995	12.3

Major cities, October 2000 estimate (10 000 inhabitants):	
Tokyo (23 wards)	813
Yokohama	343
Osaka	260
Nagoya	217
Sapporo	182
Kobe	149
Kyoto	147

THE PEOPLE

Population, October 2001 estimate (1 000)	127 210
Number of persons per sq. km in 2001	337
Percentage of population living in densely inhabited districts in 1995[1]	64.7
Net annual rate of population increase (1995-2000)	0.2

Labour force in per cent of total population, October 2001	53.1
Percentage distribution of employed persons, 2001:	
Agriculture and forestry	4.5
Manufacturing	20.0
Service	61.2
Other	14.3

PRODUCTION

Gross domestic product in 2001 (billion yen)	506 111
Growth of real GDP, 2001	–0.2
Gross fixed investment in 2001 (per cent of GDP)	25.7

Growth of real gross fixed investment, 2001	–1.9
Net domestic product of agriculture, forestry and fishery, at producer prices, in 2000 (billion yen)	5 092
Growth of industrial production, 2001	–7.5

THE GOVERNMENT

Public consumption in 2001 (in per cent of GDP)	17.5
Current public revenue in 2000 (in per cent of GDP)	29.4
Government employees in per cent of total employment, 2001	8.4
Outstanding long-term national bonds in per cent of GDP (FY 2001)	78.1

	House of Representatives	House of Councillors
Composition of Parliament, October 2002:		
Liberal Democratic Party	239	113
Democratic Party	124	60
Peace and Reform (*Komei*)	31	24
Liberal Party	22	15
Communist Party	20	20
Others	38	12
Vacancy	6	3
Total	480	247
Last elections	June 2000	July 2001

FOREIGN TRADE AND PAYMENTS

(2001, billion yen)

Commodity exports (fob)	46 584
Commodity imports (fob)	38 056
Services	–5 315
Investment income	8 401
Current balance	10 652
Exports of goods and services in per cent of GDP	10.4
Imports of goods and services in per cent of GDP	9.8

	Exports	Imports
Percentage distribution:		
OECD countries	58.7	45.0
of which: North America	33.0	21.1
Far East	34.0	37.5
Other	7.3	17.5
Total	100.0	100.0
Crude material and fuels (SITC 2, 3, 4)	1.2	26.8
Semi-manufactured goods (5, 6)	17.8	15.9
Machinery and transport equipment (7)	67.3	27.3
Other (0, 1, 8 ,9)	13.7	30.0
Total	100.0	100.0

THE CURRENCY

Monetary unit: Yen

Currency unit per US$, average of daily figures:	
Year 2001	121.5
September 2002	120.8

Note: An international comparison of certain basic statistics is given in an annex table.

1. Areas whose population density exceeds 5 000 persons per sq. km.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of Member countries.

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The economic situation and policies of Japan were reviewed by the Committee on 14 October 2002. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 30 October 2002.

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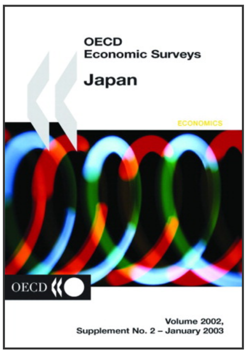
The Secretariat's draft report was prepared for the Committee by Grant Kirkpatrick and Hideyuki Ibaragi under the supervision of Yutaka Imai.

•

The previous Survey of Japan was issued in December 2001.



From:

OECD Economic Surveys: Japan 2002

Access the complete publication at:

https://doi.org/10.1787/eco_surveys-jpn-2002-en

Please cite this chapter as:

OECD (2002), “Improving the Sources of Growth and Higher Living Standards”, in *OECD Economic Surveys: Japan 2002*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/eco_surveys-jpn-2002-5-en