

JAPAN

BUSINESS INSIGHTS A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

 KEIZAI KOHO CENTER
JAPAN INSTITUTE FOR SOCIAL AND ECONOMIC AFFAIRS

A “New Economy” For Japan? Yes, But With A Difference

by Douglas Ostrom

The past decade has not been kind to the world's second-largest economy, either compared to its own past or to that of the United States, the world's largest. Today, an ever-growing chorus of analysts on both sides of the Pacific proclaim that the American economy is not merely doing well—it has, in effect, been reinvented and become the “new economy.”

One might ask whether Japan, too, can give birth to a new economy. In short, the answer is “yes,” but Japan's version will look quite different. To the extent that Tokyo consciously sets out to create a new economy in the mold of America's, it is likely to do real damage to Japan's economy and prevent the new one from emerging.

The phrase “new economy” is used here in the narrow sense. An economy is always new in that it is continually shedding old activities and ways of doing things in favor of new innovations. Moreover, a growing economy is likely to be changing faster than a stagnant economy. Nevertheless,

the U.S. economy is “new” even after allowing for such changes.

Significantly, economists who are skeptical of popular economic fads are coming around to the view that something is different about the pattern of U.S. economic growth in the past five years. The key difference is that several measures of

may not seem like much, it is large enough to correspond to millions of additional jobs and significantly higher incomes over a period of years.

Japan so far has not benefited from the digital revolution nearly as much as the United States. Business-to-business Internet commerce, for example, is no

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productivity—the efficiency with which a society uses its human and non-human resources to produce goods and services that people value—have grown far faster and persistently than in the recent economic past.

Experts do not understand exactly why this has occurred, much as they were unable to comprehend the slowdown in productivity growth in the early 1970s. However, these analysts give the digital revolution at least partial credit for recent increases in the rate of productivity growth.

Computers enable valuable new goods and services to be produced and reduce the cost of providing existing products. In other words, the popular view that computers are changing our lives dramatically and—for the most part—for the better, is correct.

According to some estimates, the impact of computer technology on economic growth is as high as one percent per year, although other guesses are considerably lower. While a percentage point difference

more than one-fifth as large a component of the economy as in the United States, even though Japan's relatively high prices and complex distribution system would seem to make B2B commerce a highly attractive way to do business. If it took off in Japan, corporate relationships could change dramatically, with corresponding benefits for productivity generally.

Could Japan tap into the broad, efficiency-enhancing benefits of advanced technology that the United States enjoys? Of course. Japan has a highly educated workforce and a good infrastructure typical of an advanced industrial nation. It has world-class companies specializing in high technology. It has a long record of successfully incorporating technological advances developed abroad.

Yet, the Japanese economy also has many features that handicap efforts to reignite growth. It has a huge government deficit and an aging population that will place ever larger demands on the public

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sector. It has few young workers and in the coming decades will have even fewer, both in absolute numbers and as a percentage of the labor force.

Japan's fiscal stance and demographics alone imply that, absent some dramatic policy shift or new technology, the Japanese economy might very well begin shrinking within the next decade or so. This means that even if the digital revolution boosts the Japanese economy by as much as one percent, the nation still could have remarkably anemic, even negative, rates of economic growth. In other words, Japan would still be an economic underperformer.

Corporate Japan could make some changes that would alter the picture dramatically. If Japanese business would merely boost productivity in less efficient sectors to the levels that prevailed in the United States five years ago before the effects of the digital revolution were apparent, Japan could, over a period of 25 years, realize an additional two percentage points of growth per year. An improvement of this magnitude would probably be enough to restore Japan to at least the middle ranks of industrial nations in terms of economic growth.

Economic experts on both sides of the Pacific have suggested time and again how Japan can dramatically raise productivity. Not surprisingly, deregulation is the most important part of the strategy. Deregulation in a competitive environment would allow—indeed compel—Japanese firms to use resources more efficiently. If such a process spread throughout the economy, overall productivity would rise.

In some cases, corporations may use less-than-best practices for other reasons. Perhaps they are protected from corporate takeovers. Companies also may rely on collusive arrangements to shield them from competition. Mergers, the threat of mergers and a vigorous anti-monopoly policy therefore are strong antidotes to inefficiency.

Will official and corporate Japan make the changes needed? Surely the past 10 years provide evidence that progress is not inevitable. Yet, Japan is a more agile

“High technology could provide some increased growth, but not nearly as much as a sweeping program of deregulation...”

country than most people imagine. Some change is almost certain and far-reaching reform is not unimaginable. Even half-hearted reforms would introduce significant changes in Japan and represent a major break with the past. These measures would earn Japan the right to claim a “new economy”, even if the innovations had relatively little to do with advanced technology.

The Japanese government, however, seems bored by the years of deregulation talk. Moreover, mergers, while they have increased dramatically, still occur far less frequently than in most industrialized countries. Experts believe that mergers will increase further with new rules that ease the process, but still remain below U.S. levels. Thus, competition policy remains a question mark.

Conversely, high technology now is touted as the answer to years of subopti-

mal growth. For example, the July 21-23 summit of the Group Seven industrial nations plus Russia, which was hosted by Japan on Okinawa, highlighted the importance of the information technology revolution. Such high-level emphasis, were it to persist, implies that Tokyo might try to divert resources into specific activities. But bureaucrats, even Japan's reputed elite corps, generally guess wrong when they get into the game of choosing “winning” sectors. The result is a drag on productivity growth.

The trick for Tokyo is not to regard the development of high technology as a quick fix. High technology could provide some increased growth, but not nearly as much as a sweeping program of deregulation and other restructuring along more traditional lines. A focus on advanced technology could prove to be the opposite of what Japan needs—the encouragement of private decision-making through deregulation. This less sexy alternative would yield far greater returns. The result would be a new economy, not necessarily like the high-technology U.S. version, but a very real one nevertheless.

Douglas Ostrom is Senior Economist at the Washington, D.C.-based Japan Economic Institute.

How Will Japan's New 401(k)-Style Plan Effect Its Pension System Reform

by Hiroyuki Takahashi

JAPAN
BUSINESS
INSIGHTS

Japan's four major business chambers—Keidanren, Nikkeiren, Keizai Doyukai, and the Japan Chamber of Commerce and Industry—agreed on September 14 to urge the government and the ruling Liberal Democratic Party to pass legislation permitting Japanese companies to offer American 401(k)-style defined contribution (DC) pensions plans. The unanimous push for this legislation well illustrates the compelling need for reform of Japan's pension system.

A Troubled System

The most important characteristic of Japan's public and private pension systems is that they are all defined benefit (DB) plans. Workers who pay into a DB plan are guaranteed certain retirement benefits. For public sector pensions, this means that future pension premiums must be sufficient to meet future pension obligations. For private pensions, however, the return on investment for current pension premiums must be enough to pay for future obligations.

With the aging of Japan's population, fewer workers will be available to finance public pension benefits for increasing numbers of retirees. At the same time, Japan's recession has hurt the performance of private pension investments, and the nation now faces a crisis in both its public and private pension systems.

Japan's 34.5 million private-sector workers currently enjoy a two-tier system of public pension benefits. A fully-vested retiree receives about ¥67,000 (\$620) a month under the state's fixed basic pension. The

retiree also receives employees' pension insurance (EPI), which pays additional benefits based on contributions. When added together, the combined contribution to the basic pension and premium for EPI is 17.35 percent of the average worker's monthly salary. In fiscal year 1998, the average

“With the aging of Japan's population, fewer workers will be available to finance public pension benefits for increasing number of retirees.”

retiree's combined monthly income was ¥175,000 (about \$1,620), a sum which compares favorably with the \$813 per month average in the United States.

Approximately 16 million Japanese workers supplement their public pension income with a private corporate pension plan. Currently, the law permits two types of private DB pensions. Employee's pension fund (EPF) beneficiaries pay an EPF premium along with a reduced EPI premium, and receive benefits at least 30 percent greater than those under EPI alone under the regulation of the Ministry of Health and Welfare.

Another private corporate pension fund regulated by the Ministry of Finance—the Tax Qualified Pension (TQP)—is subject

“At the same time, Japan's recession has hurt the performance of private pension investments...”

to a special 1.2 percent tax on its assets. The employee pension fund is exempt from this tax. In the past the primary TQP advantage was that the Ministry of Finance imposed less stringent regulations. But a

government-mandated 5.5 percent return on EPF investments—guaranteed by employer contributions—has dampened employer interest in EPF plans and encouraged many employers to participate in TQP plans. While a TQP can be converted to an employee pension fund, the

opposite is unfortunately not permitted. Business leaders such as Seiko Epson President Hideaki Yasukawa have publicly criticized this inflexibility.

Pension Reform

Japanese industry understandably wants to switch from a DB pension plan to a DC plan. Japan's rapidly aging population and low fertility rates make the current public pension structure unsustainable. By 2025, one-third of Japan's population will be 65 or older. Funding public pension benefits will place an enormous tax burden on the dwindling number of workers. To address this problem the government is reducing benefits and gradually raising the minimum age for benefits from 60 to 65. Even so, the government expects pension fund contributions to rise from 17.35 percent of a worker's salary to 25.2 percent—a figure which includes the employer's pension contribution.

Many experts consider a 25.2 percent pension premium so high that the government would have to reduce benefits. In light

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of these public sector problems, industry leaders believe that Japan's retirees in the future will need to supplement their income through private DC plans.

During 10 years of post-bubble recession, many private pensions earned an abysmally low rate of return on investments when compared with an expected 5.5 percent rate of return. Because future benefits are fixed, the low return rate has produced a reserve shortfall. In 1998, 70 percent of Japan's 1,830 employee pension funds failed to meet their obligations. As long as interest rates remain low, private firms have only two alternatives, reduce benefits or contribute more money. For firms already struggling through a recession, neither choice is a good one.

Reforms to Japan's accounting standards exacerbated the reserve shortfall problem by forcing firms to disclose their reserve deficit. Beginning this year, each firm must deduct beneficiaries' claims from current reserves and include the figure on its balance sheet. Managers in the future will seek to avoid this problem by switching to defined contribution plans, which never pay benefits which exceed the retiree's share of existing assets, although the company still will need to offset the deficit caused by the service cost in the old DB plan.

These mounting problems have forced industry leaders to revamp their pension plans to make them more compatible with new hiring and employment patterns. Employers have increased the dynamism of

the workplace by changing the lifetime, seniority-based employment system to one rooted in merit-based pay and greater opportunity for talented workers to change jobs. Currently, workers must stay with a firm for as many as 20 years before quali-

“Managers have started...using increased pension benefits to reward more productive workers.”

ifying for a corporate pension. Even after the pension vests, many pensions are not portable, and this inflexibility continues to discourage job mobility. However, if more employers were to offer DC plans it would be much easier to move assets from one pension to another, and encourage more workers to change jobs.

Managers are also promoting the use of pension benefits to increase the productivity of workers. Historically, all workers in the same position with equal seniority received the same retirement benefits. Recently, however, managers have started tying pension benefits to performance, using increased pension benefits to reward more productive workers. A new DC plan could be an additional incentive.

The “Defined Contribution” Plan

Experts in Japan carefully studied the popular American 401(k) plan, and many concluded that Japan's DC plan should follow similar lines. But the version being considered in the Diet has sparked some criticism. The Diet's proposed solution

allows two approaches. The corporate plan would permit contributions only by an employer, with no employee-matching funds. The maximum amount of employer contributions is low and many experts strongly argue they should be raised and workers

should be allowed to make matching contributions.

In addition, the Diet's plan fails to address another

problem with Japan's pension system—the many tax exemptions available for retiree income. Japan's pension income, like income under a U.S. IRA, is not taxed until benefits are paid. Unlike the U.S., however, those benefits are eligible for a variety of deductions that enable

most retirees to avoid being taxed on about ¥3 million (\$ 28,000) in annual income.

“The Diet's proposed DC plan...will permit workers to play a greater role in shaping their retirement.”

Retirees strongly oppose abolishing these tax deductions, so the Ministry of Finance addressed this revenue loss by instituting a 1.2 percent tax on pension assets, leaving the deduction problem untouched. Keidanren supports repeal of the 1.2 percent tax, so that all private sector funds would be taxed equally.

Another shortcoming of the Diet's proposal is the inflexible criteria for drawing benefits. The Diet bill permits a participant to draw benefits at the age of 60, or after suffering a serious disability. These strict eligibility requirements emphasize the need to create income for elderly retirees but fail to account for other lifestyle choices.

Workers who retire early and take up second careers should be able to enjoy the benefits they've earned immediately.

Despite these concerns, however, the Diet's proposal should be applauded for breaking with the current single employer requirement. It allows full benefits for a person who works three years and permits the worker to carry his or her own account after that. Someone who works less than 10 years, however, receives reduced benefits and must wait longer to draw a pension. There is no good reason for this, and the 10-year period should be drastically shortened or abolished.

Next Steps

Industry leaders, including Hitachi Executive Director Kotaro Muneoka, say that despite its flaws, the Diet's proposed DC plan should be passed. Mr. Muneoka feels that any problems can be revisited after passage. He recently told labor groups, whose members must approve any changes to workers' pension benefits, that the DC plan will permit workers to play a greater role in shaping their retirement.

In addition, Keidanren is seeking a number of changes, including: the introduction of a cash balance plan; a reduction to one year of the minimum three-year amortization schedule for losses caused by pension fund reserve shortages; and making regulations and tax rules for all private pension funds more compatible. Japan's business leaders are aware of the difficulty in implementing these changes and are focusing on the current Diet bill. Unfortunately, the same bill died without deliberation in the last Diet session due to the general election.

Meanwhile, the Diet's members have turned to reform of the national health care system where a debate rages over proposals to raise the amount of health care costs borne by the elderly. Even though the target date for implementing the DC plan has slipped from January to March 2001, it is

unlikely that the Diet will resume deliberation in time to meet that date.

Hiroyuki Takahashi is Senior Representative of the Keizai Koho Center, Washington, D.C. office.

OUTLINE OF JAPAN'S PENSION PLAN FOR PRIVATE SECTOR EMPLOYEES

Proposed Defined Contribution

Existing Defined Benefit

| Personal Type (individual contribution only) | Corporate Type (corporate contribution only) |
|---|---|
| <p style="text-align: center;">If Employer has NO pension plan</p> <p style="text-align: center;">Max. annual contribution ¥180,000 = Apprx. U.S. \$1,651</p> | <p style="text-align: center;">If Employer has NO corporate pension plan</p> <p style="text-align: center;">Max. annual contribution ¥432,000 = Apprx. U.S. \$3,963</p> |
| <p style="text-align: center;">If Employer has corporate pension plans</p> <p style="text-align: center;">Max. annual contribution ¥216,000 = Apprx. U.S. \$1,982</p> | |

Private Corporate Pension Plan (*EPF, *TQP)

Apprx. 16 million subscribers

Employees' Pension Insurance (EPI)

Pays benefits relative to contribution (in proportion to salary)

Basic Pension (state's fixed pension)

Apprx. 34.5 million subscribers

*EPF=Employee's Pension Fund *TQP=Tax Qualified Pension
As of October 23, 2000 exchange rate of U.S. \$1.00 = ¥ 109.00

Japan Business Dialogue

KKC's monthly program featuring Japanese experts on the economy.



"What is Japanese News Media Carrying?"

Toru Takanarita,
Bureau Chief,
American
General Bureau,
*The Asahi
Shimbun*

Toru Takanarita, Bureau Chief of the American General Bureau of *The Asahi Shimbun*, discussed several differences between Japanese and American newspapers in terms of circulation and operations at the Japan Business Dialogue on September 20. Drawing on his experience as Economics Correspondent in the Washington, D.C. bureau from 1987 to 1990, Mr. Takanarita also provided insights into changes in Japanese media coverage of U.S.-Japan relations in the past decade.

One notable difference between U.S. and Japanese newspapers, according to Mr. Takanarita, is circulation. More than 8 million Japanese households receive *The Asahi Shimbun* daily. In the United States, by comparison, 1.1 million Americans subscribe to the *New York Times*, 1.2 million read the *Los Angeles Times*, 800,000 receive the *Washington Post* and 1.8 million get *USA Today*. Because of the breadth of *Asahi's* circulation, it has long been regarded as one of Japan's most influential disseminators of information.

U.S. and Japanese newspapers also approach advertising differently. In Japan, advertising provides about 50 percent of revenue, while another 50 percent comes from circulation. According to Japanese

regulations, if a publication derives more than 50 percent of its revenue from advertising, it cannot be considered a "newspaper." In the United States, however, newspapers rely primarily on advertising to finance their operations.

Mr. Takanarita said that the level of coverage of U.S.-Japan relations has changed as the bilateral relationship has evolved. For example, when he was stationed in Washington in the late-1980s, he wrote extensively about semiconductor trade-related sanctions, the dispute concerning joint development and production of the FSX fighter support aircraft, the Structural Impediments Initiative negotiations and the controversy concerning Japanese restrictions on rice imports, to name a few.

Currently, U.S.-Japan trade is not "big news." If U.S. Trade Representative Charlene Barshefsky issues a statement or testifies before Congress, most Japanese would now say, "So what?" Mr. Takanarita attributed this low-key reaction to the fact that the Japanese government and the public-at-large have more confidence in the U.S.-Japan alliance. They realize that longtime trade disputes or even the development of new disagreements will not necessarily hurt the bilateral relationship.

Japanese and American newspapers have very different conceptions of the "news scoop," Mr. Takanarita added. In the United States, newspapers rely on their journalists' investigative reporting skills to unearth important, undisclosed information. But in Japan, since most journalists belong to each of the government ministries' press clubs, the "scoop" usually amounts to a report of what the govern-

ment will do the next day. Mr. Takanarita said that the press club system, in fact, has enabled the Japanese government to manipulate the media.

Upcoming Japan Business Dialogues:

"The U.S.-Japan Relations After the Election-What's Ahead?"

Mr. Toshinori Shigeie
Minister Plenipotentiary and
Deputy Chief of Mission
Embassy of Japan

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Publisher, Keizai Koho Center

Director, Hideaki Tanaka
kkc1@kkc-usa.org

1900 K Street NW
Suite 1075
Washington D.C. 20006
202 293-8430

www.kkc.or.jp

Keizai Koho Center (KKC) is an independent, non-profit organization designed to promote the understanding of Japan's economy and society at home and abroad. Its financial resources are derived entirely from the private sector.

KKC offers numerous programs designed to create a favorable business environment within Japan and worldwide. Its efforts extend to promoting free and stable trade by eliminating sources of friction in the global economic community.

KKC fosters a deeper understanding of Japan's basic social structure. Furthermore, it conducts public affairs activities to improve the Japanese people's recognition of Japan's global role.

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