

# JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

## In Search Of A Grand Design For The Economy And Public Finance by Yoshio Nakamura, Managing Director, Keidanren

Recent data suggests that while the Japanese economy still is in the throes of a stock adjustment, there also is evidence that a self-sustaining recovery is gaining momentum. However, Japan's public finances are in very poor condition as a result of stimulative tax cuts and spending policies initially designed to jump-start an economy mired in recession after the bursting of the economic bubble.

Based on the initial FY 2000 budget, the combined long-term national and local government debt will be ¥645 trillion by March 31, 2001. This is equivalent to approximately 130 percent of gross domestic product. Moreover, the government has yet to undertake radical reforms of such key elements of the social security system as pensions and medical care, which raises questions about the future reliability of these programs. As Japan enters the 21st century, not only is its public sector burdened with massive debt for generations to come, but the government has also failed to establish a clear vision of the social security system.

The most frightening prospect for Japan in the new millennium is that its birth rate will continue to fall. The nation's population already is aging at a faster rate than in any other country on earth. The National Institute of Population and Social Security Research estimates that the ratio of the elderly population (65 years of age or older) to the working population (15 to 64 years of age)—also known as the Aged Population Index—will increase from 25.3 percent in 2000 to 46 percent in 2025.

These changes should be designed to accomplish the following goals:

- To maximize economic growth through more effective use of resources;
- To realize "small government" by applying public funds at both the national and local levels in a more rational, efficient, and focused manner and by optimizing social security benefits; and
- To develop a mix of tax policies and social security benefits that will not have a detrimental effect on economic growth.

"Our objective must be to limit the increase in the national burden rate by implementing various structural reforms."

The declining birth rate and the aging of the population will affect Japan's socioeconomic infrastructure in a variety of ways. However, analysts have been most concerned about the potential increase in the national burden rate—the ratio of tax revenue and social security expenditures to national income—implied by a slower rate of economic growth, a deterioration in public finances, and a growing social security burden. There is a strong possibility that an excessive increase in the national burden rate will lead to a decline in the savings rate, a contraction of the labor supply, and even more "crowding out" within certain sectors—all of which will sap the nation's economic vigor.

Thus, our objective must be to limit the increase in the national burden rate by implementing various structural reforms.

### Basic Direction of Structural Reform by Sector

Despite the continuing decline in the birth rate and the aging of the population, the Japanese economy could grow by 2.7 percent annually through 2025. But in order to realize this potential, the public and private sectors will have to work together to develop and implement a strategic game plan.

This comprehensive set of policies should aim to (1) increase job opportunities for women and senior citizens; (2) further expand the labor pool by actively recruiting foreign workers to fill specialist and technical posts; (3) promote capital investment by enhancing the efficiency of capital and improving the financial and capital markets; and (4) stimulate greater

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Total Factor Productivity (TFP), particularly in the non-manufacturing sector, through regulatory reform and the promotion of information technology (IT).

To limit national and local government spending, we must conduct a thorough, across-the-board review of all policies and systems to determine whether they are effective and efficient. At the same time, we should encourage privatization, outsourcing, and the computerization of administrative functions at both the national and local government levels to further streamline operations and reduce costs. In addition, money should be earmarked in the budget to underwrite policies and programs relating to the so-called IT revolution and other growth industries.

**Public Works.** The role of public works also must change to create a new foundation for growth and to maintain the existing stock of social capital. With this goal in mind—and to ensure that the public and private sectors share appropriate levels of responsibility for providing fixed social cap-

“Japan needs a fiscal framework that encourages local governments to be more independent and to initiate administrative and fiscal reforms on their own.”

ital—the Japanese government should be more selective and cost-conscious in managing public works projects. We should also use Private Finance Initiatives (PFIs) and other policy tools to ensure more efficient implementation of public works projects.

**Local Government Finance.** Japan needs a fiscal framework that encourages local governments to be more independent and self-reliant and to initiate administrative

and fiscal reforms on their own. This will require a comprehensive reorganization of local agencies to ensure that residents can effectively check and control operations. At the same time, we should clarify the social welfare responsibilities of the prefectural and municipal governments by expanding local sources of tax revenue and abolishing the local grant tax and national treasury disbursements.

## Reform of the Social Security System

Japan should overhaul its social security system so that it can withstand the pressures caused by the nation's declining birth rate and aging population while not overburdening the current working population or future generations. In order to realize these goals, the system must include an appropriate mix of self-help and social welfare assistance.

**Pensions.** The Japanese government must develop a plan that provides more reliable funding for pension benefits. One approach would be to limit the program to truly needy recipients by exclud-

ing people with incomes above a certain level from receiving pension payments, while at the same time steadily equalizing the burden between generations. Toward this end, we should limit basic benefits to a level that meets minimum living standards, while increasing the proportion paid from public funds.

Earnings-related benefits also should be thoroughly reviewed, with the ultimate

goal being to privatize this program in the future. In addition, it is important to reduce deductions for public pension benefits as a way of realizing a more equitable balance between generations.

To encourage people to adopt the sort of independent and self-reliant attitude that would support a private pension system, Japan should introduce defined-contribution pensions as soon as possible. This could be accomplished by redesigning the current defined-benefit pension system to be more flexible while abolishing the special corporation tax.

**Medical Treatment for the Elderly and Long-Term Care Insurance.** The main beneficiaries of a medical plan for the elderly should be determined by income. So-called social hospitalization, which has been quite wasteful, should be replaced by long-term health care insurance. In addition, the Japanese government should review the current program that provides benefits for terminal medical care.

Equally important, Japan should undertake a radical review of program funding with an eye toward using existing assets to increase the intra-generational insurance element. At the same time, an increasing proportion of public funds should be tapped to pay for health-care insurance, bearing in mind that the death-rate rises with aging. The proportion of medical costs for the elderly paid by the individual (out-of-pocket expenses) should be increased as soon as possible. In addition, assuming that a greater share is paid from the public purse, we should abolish contributions for elderly medical care currently supported by all age groups of the working population.

# In Search Of A Grand Design For The Economy And Public Finance

by Yoshio Nakamura, Continued

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## Tax Reform

To accommodate the aging population, Japan needs a tax system that combines the new principle of “vitality” with the existing principles of fairness, neutrality and simplicity. Generally speaking, funding for government programs and social security requires a suitable mix of various component taxes and social insurance premiums. The present system, however, leans too heavily on direct taxation and social security contributions. So we should try to achieve a more appropriate ratio of direct and indirect taxes—based on a suitable division between tax and social insurance premiums—by introducing an invoice-based tax system.

In addition, the “beneficial tax element” of the simplified consumption tax system should be eliminated, and multiple tax rates, tax-inclusive pricing, and other similar reforms should be developed and implemented. To enhance international competitiveness, the Japanese government should reduce corporate tax rates and, as for individual income taxes, ease the steep progressive structure of taxation while at the same time lowering the minimum taxable income.

## A Grand Design for Economic and Fiscal Policy

The above discussion provides a basic outline of structural reform in various sectors. The question left is how to realize these changes. Tokyo’s efforts three years ago to implement reforms in six major areas serve as a useful reference.

Some experts viewed the Japanese government’s 1997 plans to overhaul administration, fiscal policy, social insurance, the economy, the financial system and educa-

tion as pioneering reforms. Of these six areas, the Law Regarding the Preparation of Related Laws for Financial System Reform (Financial System Reform Law) that went into effect in December 1998 encompassed changes to the financial system. With regard to administrative reform, the complete reorganization of Japan’s ministries and government agencies will take place in January 2001.

Fiscal reforms have been more difficult to realize. Although the Diet passed the Fiscal Structure Reform Law in November 1997, Japanese policymakers twice changed the target year for implementation, finally suspending further consideration of the matter. They have yet to tackle drastic changes to the social security system.

An examination of the setback in fiscal reform reveals three main problems:

- Policymakers did not closely link fiscal reform to other areas targeted for change, such as administration, social security and the economy.
- Japanese legislators and bureaucrats did not give sufficient thought to the practicable potential of specific goals and schedules.
- The government could not foresee in 1997 the profound economic impact of the subsequent failures of major Japanese banks and the escalation of the Asian currency crisis.

Based on the 1997 experience, the “Grand Design” for structural reform must meet the following requirements:

- It must be comprehensive. In particular, the various systemic reforms must be consistent with the strategy for economic growth.

- It must be well planned. That is to say, the goals should be achievable and implementation clearly scheduled.
- It must be flexible. Policymakers should have the freedom to adjust the reforms to accommodate unforeseen economic and business developments.

Keidanren (Japan Federation of Economic Organizations) has estimated the extent to which structural reforms will affect economic growth and fiscal balance for the next 25 years. According to our simulations, the national burden rate could be held below 50 percent. Primary balance equilibrium—that is to say, the balance of “expenditures excluding national debt service payments” and “revenue excluding receipts from government bonds”—will be achieved in FY 2004 to FY 2005, and the “outstanding government debt/GDP” ratio will be reduced. Such conditions also will enable stable management of the social security system.

The new administrative structure that becomes effective in January 2001 calls for the establishment of the Economic and Fiscal Consultative Council in the Cabinet Office of the Prime Minister. This change will facilitate discussion of important economic and fiscal policy measures at the highest government levels. Under the leadership of the Prime Minister and with the cooperation and input of other relevant organizations, the Council should become the principal forum for the discussion and development of a Grand Design for economic and fiscal policy. Just as important, the Council will be able to periodically review its progress and recommend changes. ■

## Will Face-To-Face Communication Survive In The IT Age?

by Hideaki Tanaka, Director, Keizai Koho Center

The world economy is in the midst of the "IT Revolution." We can receive all kinds of information from around the world very easily and quickly via the Internet, satellite television and other high technology means. The media and other organizations post numerous reports, analyses and critiques about developments in Japan every day, which people from all walks of life and from all corners of the globe can readily access. Some people might even view the Internet as the only tool needed to understand world affairs. Will increasing use of the Internet eventually end "face-to-face communications?"

While the Internet is an important tool, it cannot provide insights into complex issues such as the differences between American and Japanese cultures and corporate behaviors, or the outlook for each

country's society and economy. To find answers to these and other complex questions, Japanese must assume personal responsibility that goes far beyond the Internet.

The Keizai Koho Center believes that town meeting-style conversations offer a useful way to expand and deepen people's understanding of current developments in Japan. In cooperation with the National Association of Japan-America Societies (NAJAS) and the Japan Center for International Exchange (JCIE), we dispatched the "Japan Caravan" to several U.S. cities October 23-26 to engage American businessmen, university faculty and graduate students in candid discussions. Caravan members included: Shinichi Goto, Vice President, Toyota North America, Inc.; Hiroyuki Fukui, Executive Coordinator, Toyota Motor

North America Inc.; and Masanobu Katoh, General Manager of the Washington, D.C. Office of Fujitsu, Ltd. They spoke to groups in Denver, Houston and Minneapolis.

The caravan was very successful, with speakers discussing how their companies are addressing issues such as environmental protection and IT promotion in ways that reflect Japanese cultural values. We intend to continue to promote these exchanges of views between leaders in both the United States and Japan.

In the following article, Patricia Kearns, NAJAS Executive Director, provides an overview of the first three-city caravan tour. An account of Mr. Goto's presentation in Washington, D.C. on October 27 also appears. ■

## First 'Japan Caravan' Completes Three-City Speaking Tour

by Patricia Kearns, Chairman, National Association of Japan-America Societies



The first town-meeting caravan of Japanese business executives successfully completed a three-city speaking tour October 23-26, visiting Japan-America Societies in Denver, Houston and Minneapolis. Three leading Japanese business officials in North America – Fujitsu's Masanobu Katoh and Toyota's Shinichi Goto and Hiroyuki Fukui—participated in animated

discussions with their audiences. Issues discussed ranged from e-commerce and the "IT revolution" in Japan to private sector efforts to address global warming and other environmental problems. Most importantly, the discussions revealed how policy issues are viewed differently by people working outside the "beltway" around Washington, D.C.

In addition to speaking to corporate audiences, the caravan group addressed graduate students at the University of Denver, the University of Houston, and the Hubert Humphrey Center at the University of Minnesota. All the students

at the three universities asked penetrating and important questions about Japanese business practices. At the University of Minnesota, however, Mr. Fukui responded by asking students to describe their own images of Japanese companies. Mr. Fukui admitted he was surprised by the responses that generally gave Japanese companies high ratings. All of the participants agreed that the relaxed and informal exchange between the speakers and the students served to improve American and Japanese understanding of one another.

Toyota's Shinichi Goto discussed how his company is coping with environmental

# First 'Japan Caravan' Completes Three-City Speaking Tour

by Patricia Kearns, Continued

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issues (a summary of his remarks follows.) Mr. Katoh delved into the unique ways in which telecommunications and the Internet have taken hold in Japan. He also examined the Japanese government's efforts to "wire" Japanese society and to educate the general public about Internet technology.

## Japan and the IT Revolution

Mr. Katoh contrasted the sluggishness of the Japanese economy over the last decade with the relative boom in the U.S. economy. American information technology, he pointed out, has served as the engine driving the expansion of U.S. gross domestic product. More than 50 percent of U.S. households have computers as compared with about 30 percent in Japan.

In cellular phone technology, however, the Japanese have far outpaced the U.S. According to recent statistics, there are more cell phones in Japan than conventional, home-installed telephones. Mr. Katoh also noted that cell phone Internet use, provided by NTT DoCoMo's i-mode technology, for example, is popular with Japanese teenagers and young adults. But cell phones provide only limited Internet access, he said.

## Challenges to E-Commerce in Japan

Mr. Katoh pointed out that cultural and language issues will challenge the development of e-commerce in his home country. Japan is a calligraphic society, not a keyboard society. And English is the language most often used on the Internet. This

poses a problem for many Japanese, especially because translation software currently is not accurate enough to help bridge linguistic differences.

Members of the audience asked whether English should be made the international language of the Internet. Mr. Katoh said that international standards are needed to avoid confusion not only with respect to language differences, but also concerning the sale of domain names. He cited as an example a "dot.com" company

"International standards [for the Internet] are needed to avoid confusion not only with respect to language differences, but also concerning the sale of domain names."

in Korea that selected a domain name identical to a "dot.com" company in another country. There needs to be a way, Mr. Katoh said, to review sales of domain names on a global basis.

Certain Japanese customs also make Internet e-commerce less attractive to the Japanese public. Mr. Katoh noted that in Japan neighborhood shopping is a social event. What's more, Japan is a cash-based society unlikely to move quickly to a credit-based Internet economy. These societal tendencies, plus the lack of public confidence in the security of online transactions, continue to inhibit Internet use. Nonetheless, the Japanese government continues to aggressively promote information technology.

"Japan is a cash-based society unlikely to move quickly to a credit-based Internet economy."

## New IT Ventures

Mr. Katoh said that Japanese society does not allow for second chances if a company fails. This attitude further hinders the development of IT because it discourages would-be e-commerce entrepreneurs from taking the plunge and starting a company. In America on the other hand, there has been sufficient venture capital to help failed start-ups try again. Japan is not lacking venture capital, but society's "no-fail" mentality has greatly limited investment opportunities.

Mr. Katoh was pessimistic about Japan's high tech future because the information technology industry changes so rapidly. He questioned whether Japanese companies are sufficiently creative and flexible to keep pace with industry innovations. When asked if the Internet discourages social interaction or is a tool to spread U.S. culture abroad, Mr. Katoh responded that the more important question is how we choose to use the Internet. Each of us—not the government—must decide how to use the Internet to present our respective cultures, he said. ■

## Japan Business Dialogue

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



### "How to Cope with Environmental Issues: A Company View"

Shinichi Goto,  
Vice President,  
Toyota North  
America, Inc.

Shinichi Goto, Vice President of Toyota North America Inc., discussed his company's efforts to address the effects of global warming and other environmental challenges at a special Japan Business Dialogue on October 27.

Mr. Goto outlined three environmental challenges that the auto industry faces—emission controls, global warming-related CO2 reductions, and recycling. Concerning emission controls, he said that Tokyo's rigorous enforcement of a 1973 emissions-reduction law actually benefited industry. Mr. Goto noted that in 1970, Japanese car companies sold only 380,000 cars in the U.S. market. By 1980, U.S. sales figures had jumped to two million. He attributed the dramatic increase to the fact that Japanese cars, unlike other imported models, met strict U.S. emissions standards.

Mr. Goto also noted differences in the approaches by the U.S. and Japan to global warming. He said that Japan has ratified the Kyoto Protocol on the environment, which sets goals for the reduction of CO2 emissions. The United States, on the other hand, has yet to ratify the treaty. Some Members of Congress have argued that it would be unfair for the United States to commit itself to ambitious CO2 reduction

goals in the absence of a comparable pledge from developing countries. Mr. Goto suggested, however, that the reluctance of American lawmakers to approve the Kyoto environmental accord might stem from the fact that their constituents are not overly concerned about global warming. In fact, he was skeptical that U.S. consumers would sacrifice the comfort and size provided by gas-guzzling Sport Utility Vehicles in order to protect the environment.

Mr. Goto discussed Toyota's effort to develop alternative, environmentally friendly automobiles. The Prius, a Super Ultra Low Emissions Vehicle (SULEV), gets about 52 miles per gallon in the city and 45 miles per gallon on the highway. The reason for this unusual flip-flop in city/highway mileage is because the technologies incorporated, such as a regenerative brake system, are innovative and unique. Mr. Goto noted that the different driving habits of Japanese and Americans, as well as other nationalities, has complicated the development of globally harmonized standards on fuel efficiency and emissions reduction.

Toyota also has been working on an electric vehicle. While the so-called EV is a zero emission vehicle, it has other problems that hamper its marketability. These include the EV's lengthy recharging period, its inability to go long distances without recharging, and the EV's high sticker price due to the high cost of its battery. Mr. Goto termed the Fuel Cell EV vehicle, which emits only water, the "ultimate Eco-car." However, it likely will not be commercially marketed much before 2010.

Concerning the third environmental challenge—recycling—Mr. Goto said that Toyota was trying to achieve the goal set by

the Japanese government that calls for recycling 85 percent of its vehicles by 2002. In Japan, nonmetallic residue of automobile scrap is reclaimed and used to produce new materials for automobiles. In the United States, by contrast, there is no comparable effort to recycle automobiles.

Next Japan Business Dialogue:

"Improving Financial Infrastructure in Japan"

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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.

The views expressed in this newsletter are of the contributors and do not necessarily represent those of the Keizai Koho Center.