Policy Brief

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Summary

The overall assessment is certainly more favourable than the gloomy judgement issued in the previous Survey. The economy has probably turned the corner on the worst recession of the last quarter century. The banking system has been recapitalised and is now reorganising, and financial supervision has been improved, leaving financial markets more buoyant than at any time in recent years. Consumer and business sentiment have bounced back. Output growth looks set to be around potential rates for both this year and over the projection horizon, even though the recovery is still tenuous. Fiscal stimulus should therefore not be withdrawn until private demand-led growth is solidly in place, and, in the context of the zero-interest-rate policy, ample liquidity should be provided until deflationary concerns are dispelled. But the needed fiscal consolidation should be sought as soon as possible once the economy is on a clear recovery path. Progress has also been made in taking some of the key structural reform decisions and implementing others that will no doubt serve the country well in the future by bolstering the role of markets rather than government in allocating resources. There should be no let-up in this process: the ability of the nation to revitalise its economy in the new decade depends on it. ■

This Policy Brief presents the assessment and recommendations of the 1999 OECD Economic Survey of Japan. The Economic and Development Review Committee, which is made up of the 29 Member countries and the European Commission, is responsible for these Surveys.The starting point for the Survey is a draft prepared by the Economics Department, which is then modified following the Committee's discussions and issued under the responsibility of the Committee.

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How solid is the recovery?

It now looks likely that the recent downturn in the Japanese economy has ended and that some modest yet fragile recovery is underway. This survey reviews the evidence for this improvement and examines the risks and uncertainties still evident and the short-term policy requirements to ensure a durable recovery. The recovery has been prompted by policy measures in the monetary and financial sphere as well as by significant fiscal stimulus. However, the massive build-up in public-sector debt will require significant fiscal consolidation over the medium-term, necessitating both spending cuts and revenue increases. Achieving the latter in the most efficient way will entail a major overhaul of the tax system. More generally, the authorities should pursue a broad range of structural reforms in order to revitalise the economy in the medium term.

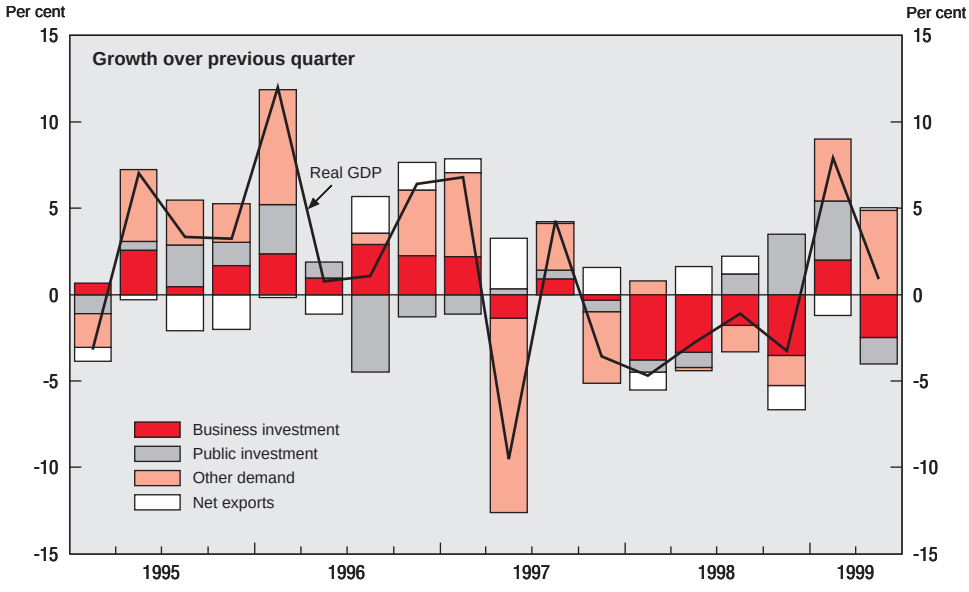
The worst of the 1997-98 downturn apparently ended at the close of 1998, even if the turn-around in the situation passed generally unnoticed until late in the spring of 1999. This was indeed a welcome change for an economy that was mired in a slump throughout 1998 as a result of a combination of earlier negative shocks – foreign, financial and fiscal. The cumulative loss in output by year-end of around 5¼ per cent since the peak seven quarters earlier was the most severe since the 1970s. Businesses sought ways of cutting spending to maintain cash flow in response to plunging sales. Other than outright dismissals, which are not as rare as they used to be, this inevitably led to reduced overtime, lower regular wages and diminished bonuses, all of which cut into disposable incomes and household expenditure. Householders' anxieties about their jobs mounted, as they observed increasing numbers of workers involuntarily dismissed and the inexorable rise of the unemployment rate, which surpassed its US counterpart for the first time in post-war history. This amplified the weakness in households' expenditure, as did the uncertainties surrounding the future path of their health care costs and the value of their pensions and tax liabilities in view of the increasingly severe public finance situation. Even the external sector provided little buffering of the downturn in the domestic economy: exports fell despite a small rise in overall trading partner imports.

Indicators through 1999 to date now suggest a modest pick-up even though there remain reasonable doubts about its sustainability. However, it is not unusual for economic data to provide conflicting evidence early in a recovery. Labour market indicators in particular are still flashing red – the unemployment rate has risen to nearly 5 per cent and may well stay around that level for some time yet, but the unemployment rate always lags behind output in the business cycle. There can be no doubt that the upturn owes much to earlier policy easings. Unsurpassed amounts of budgetary stimulus applied over the past year and a half, combined with the world's first attempt to run a zero-interest-rate policy, an effective stabilisation of the banking system, at least for now, and lavish amounts of new public loans and credit guarantees finally proved sufficient to convince both consumers and investors that an implosion would be avoided and that a turn-around was at hand. With a return of confidence, financial markets rebounded, and private spending immediately picked up. Once the resulting sales cleared away the last vestiges of the inventory overhang, moderate growth in industrial production was set to resume as from the summer.

Modest growth may have settled in during the second half of 1999. It looks like households continued to increase their spending, cutting their saving rates, as they have remained fairly confident that management of the economy is being handled prudently, both for the short and longer terms. And while business may not have jettisoned earlier plans to cut back on investment this year, the size of that retrenchment will surely be revised down, reflecting the new more optimistic mood observable in each of the political, financial and economic spheres. Housing construction should remain active in view of the strength in starts thus far this year. Exports too could pick up somewhat, despite the strength in the yen, in view of the robust recovery that appears to be underway in the economies of Japan's Asian neighbours, signs of a pickup in Europe and continued strong demand for imports in the United States.

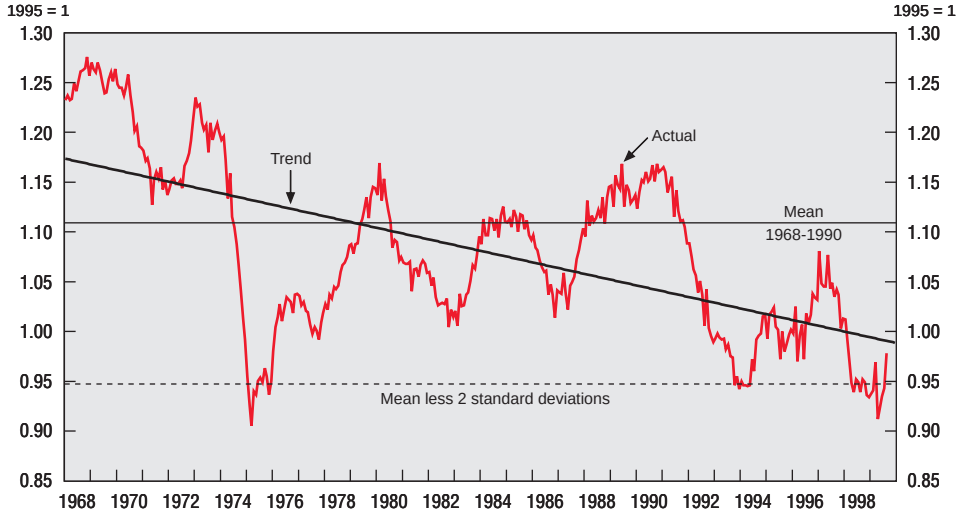
Overall, real GDP growth on both a calendar and a fiscal year basis may be of the order of 1½ per cent in 1999, a figure that does not excite, but one which should be compared with earlier predictions. Last year's Survey, for example, projected growth for 1999 would be barely positive, and forecasts made earlier this year were almost universally for yet another year of falling output. ■

Contributions to real GDP growth
Seasonally adjusted annual rates



Source : OECD.

Capacity utilisation in manufacturing



Source: OECD.

What is the outlook?

It is the outlook for the year 2000 and beyond that is more difficult to ascertain because of the unusual difficulty of assessing the strength of contractionary and expansionary factors. As to the former, the major influence is from corporate-sector restructuring. The need to engage in such measures is not new: it is one of the legacies of the 1980s asset price bubble. But it is only fairly recently – when finally confronted with the unsustainability of their imbalances in personnel, fixed capital and financing – that firms have begun to take it seriously. They have been adjusting their labour inputs downwards, but no more than in past recessions of this magnitude and

largely by the same means (mainly by shrinking the workweek), although recourse to redundancies has been on the rise. Nonetheless, if prevalent estimates of the size of the imbalance (upwards of 2¼ million workers or 3½ per cent of employment) are reliable, downward pressure on total labour compensation will be more severe than in previous recovery periods, delaying the pickup in employment and restraining gains in real compensation per head. Similarly, low capacity utilisation in manufacturing, an investment share of GDP more appropriate for an economy whose trend growth is 4 per cent per year than 1, and unusually rapid declines in capital productivity point to the existence of excessive amounts of capital in a wide variety of sectors. Again the estimates are worrisome: they are centred on a range from 40 to 60 trillion yen (roughly 3 to 5 per cent of the capital stock), once cyclical effects are removed.

Because this unnecessary capital was largely financed by external funds, it is no surprise that the corporate sector's balance sheet is loaded with excessive amounts of debt and that financial returns have been inadequate to remunerate shareholders properly. While deleveraging has been underway for several decades already, it has been insufficient to offset the long-term slowdown in sales growth, especially for non-manufacturing firms. Since firms have allowed both personnel and sales and administrative costs to rise unremittingly in relation to sales, their profitability has dropped to extremely low levels. In many cases, that has resulted in bankruptcy, the frequency and average size of which soared in the recession. Surviving companies have begun to respond to financial market pressures by cutting back on investment more savagely than at any time in the post-war era, by engaging in rationalisation of their business through mergers, plant closures and asset sales and by promising to boost returns on assets and equity in the coming years towards western norms. To achieve those profit goals will require a combination of increased sales and enhanced margins well beyond what can be expected from cyclical recovery. This could be facilitated by ongoing corporate governance and pension management changes that would concentrate managers' minds on profitability, as will the expected move to consolidated accounting and taxation and the planned easing of rules applying to corporate divestiture. Bankruptcy reform could also help free up resources currently tied to their present uses. In macroeconomic terms labour's share of income and output may have to fall by around 3 percentage points beyond cyclical changes. That will be challenging, but, since the adjustment phase is likely to take at least three to five years, not so formidable as to abort the recovery, assuming the policy environment is sufficiently supportive. ■

What factors favour expansion?

Fortunately, there are some expansionary factors as well. First, it must be recognised that most of the restructuring will be done by existing large firms who employ less than 20 per cent of the work force. A similar process of shedding workers by large established firms has been underway in the United States for nearly 20 years, and that has not prevented economic growth from occurring, even if it did slow it down when it initially got underway. The basis for economic expansion in the future must be the ability of the economy to spawn new firms and to generate growth at existing smaller firms in more dynamic sectors. Many of the necessary conditions for such a transformation are gradually falling into place, as was discussed in more detail in the previous Survey. In addition, the government has just made a number of changes that will ease corporate restructuring, promote technological innovation and encourage the private sector to take more business venture risks by, for example, facilitating mergers and acquisitions and employee buyouts, handing back intellectual property rights to private researchers sponsored by the government, and providing loans and credit insurance to start-ups and venture firms. This should be useful in stimulating economic activity, even if it proves insufficient to jump start the small-business sector without stepped-up regulatory reform. Second, following such a severe and lengthy recession, there may be a substantial backlog of pent-up household demands that, along with the healthy state of household finances, could sustain consumer spending for some time to come. Third, there is some chance that foreign market conditions will be more favourable than in the past few years: for the first time in a decade all the major regions of the world look set to be growing at or above potential.

Assuming the current fiscal and monetary policy settings remain unchanged over the next year or so, the economy is judged to be able to withstand the adjustment burdens resulting from restructuring without falling back into recession. There is little doubt, however, that the recov-

ery will not match that of 1994-96 in terms of its robustness. At that point it was still widely believed that the economy could grow its way out of most of its problems, and therefore adjustment was postponed. A moderate increase in real GDP is about all that can be expected in the environment projected for next year: something similar to this year's figure of 1½ per cent would be most likely. But there exist important risks of an even less satisfactory outcome, based, for example, on a faster pace of restructuring or on a relapse in confidence, possibly resulting from an excessive rise in the value of the yen or renewed financial instability. This could entail a further sharp cutback in business investment plans and a dangerous setback to the income-generating process. But the scenario in the centre of a wide range of possible outcomes involves growth continuing to be led by household spending, with both private consumption and residential investment retaining some of the momentum built up in recent quarters, despite the lack of much growth in disposable income. A rebound in export growth may also help sustain demand, as may a deliberate attempt to restock by manufacturing firms. Some time next year, despite a heavy rate of scrapping, especially by large firms in the traditional sectors, greater risk-taking in various forms could take hold, so long as the easy monetary policy persists and the balance sheets of financial institutions continue to improve, allowing an incipient rebound in capital formation. This could boost business investment in more dynamic sectors and overall. The projected reduction in public investment, especially in 2001, is unlikely to have more than a limited restraining effect. In such a scenario the output gap – the aggregate amount of capacity under-utilisation – would shrink very slightly, even though the unemployment rate would at best stabilise at a high level (due to ongoing labour shedding). Accordingly, moderate downward pressures on prices would persist, and labour's share would fall a little more, after a sharp drop in 1999. Assuming a further supplementary budget the general government deficit could be stable in 2000 in both actual and cyclically-adjusted terms before falling modestly in 2001 but would remain large by any standard of comparison. Finally, despite an oil-related deterioration in the terms of trade over the next year (under the assumption of an unchanging nominal exchange rate), the current account surplus is projected to edge up to 3 per cent of GDP once again mainly because of faster export growth to Asian markets. ■

What about monetary policy and the banking sector?

With such a scenario in view the current monetary policy settings still seem broadly appropriate. The concerns that have confronted the monetary authorities should be only slightly alleviated over the projection horizon. Prices may still be edging down, and the yen may be well supported by renewed confidence and persistent capital inflows. Projected rises in long-term rates reflect expectations that the zero-interest-rate policy would eventually no longer be necessary, and the resulting steepening of the yield curve would be entirely consistent with normal cyclical developments. But the debate about whether sufficient stimulus is being provided in what had appeared to be a "liquidity trap" has given way to redoubled efforts by the Bank of Japan to ensure its monetary easing fully permeates the financial markets. Financial market stability has largely returned, as reflected in the resurgence in the prices of equities and of the yen, as well as the disappearance of the infamous "Japan premium" on loans to Japanese banks, even if their lending has continued to shrink slightly. The major remaining questions are how long to maintain the current zero-interest-rate policy and whether anything would be gained by adopting an explicit inflation target. The former is a function of what happens to budgetary policy and to the banking system. But if and when recovery proceeds and the credit mechanism gradually returns to normal – next year in the central scenario – the Bank of Japan might do best to no longer try so hard to hold rates further out on the yield curve near zero, even if overnight rates remain there. Setting an inflation target could potentially help in attaining price stability by enhancing the Bank's communications with outsiders once the zero interest rate constraint can be abandoned, but this is not likely to be possible at least for the time being.

Monetary policy has been ably assisted in supporting real activity by increased lending by public financial institutions at modest interest rates and by an expanded system of credit guarantees. Under normal conditions neither of these measures would be called for, but in the context of a dysfunctional banking system in the midst of a severe downturn, they were justified. However, private-sector risk should be assumed by the public sector only in extraordinary circumstances because of the longer-term moral hazard implications. Thus, with the banking system recapitalised and a

more suitable regulatory system put in place, once private financial intermediaries regain strength these programmes would best be progressively scaled back in order not to have further permanent increases in the public sector's share of lending and in its role in the financial system more generally.

The last year has marked a watershed in the government's handling of the evolving financial system crisis. Two large banks have been effectively nationalised, most others have received a further and larger dose of public capital in order to resolve their non-performing loans problem, regulatory powers have been transferred to a new agency that has quickly gained credibility, and provisioning standards have been tightened. No longer will "window dressing" or even fraudulent operations be able to conceal financial losses with impunity, even though that lesson has been a costly one for the Japanese taxpayer. The two failed long-term credit banks alone had over 6 trillion yen ($55 billion) in capital deficits, much more than had been known as late as the moment of their closure. In total, the final cost to the government will probably surpass the 7 trillion yen authorised in the 1998 legislation. The result is that the government is expected to have to return to the Diet to seek authorisation for more funds to finish the job of cleaning up the banks' balance sheets. But in recapitalising the solvent large banks the opportunity seemed to have been missed of implementing more of the changes that will surely be required in order to put the industry on a footing that will be sustainable in the global marketplace. While foreign operations are being downsized, director numbers slashed and operating expenses reduced, incentive compensation for executives was not introduced, and a reduction of capacity through mergers was not insisted on. Fortunately, a significant realignment now seems more likely, and this should allow the new bigger banks to undertake the key investments in technology that have been in too short supply heretofore. But cutting operating expenses cannot play much of a role, given their already low levels. Rather, unless more revenues can be generated from existing assets through greater securitisation, for example, and unless credit risk is henceforth assessed and priced properly (and there are as yet no signs of improvement), the banks will fail to meet their profit commitments, and the government's stake will have to remain of indefinite duration. Furthermore, while the government seems to have finally dealt with some of the banking sector's problems, there remain some bankruptcy risks among life insurance companies, which are now attracting increased regulatory attention. The gap between the actual rates earned and the rates these firms promised their policy-holders ("negative spread") has caused their financial conditions to deteriorate. In short, the financial sector has been stabilised, but there is still a long way to go before it is fully transformed. ■

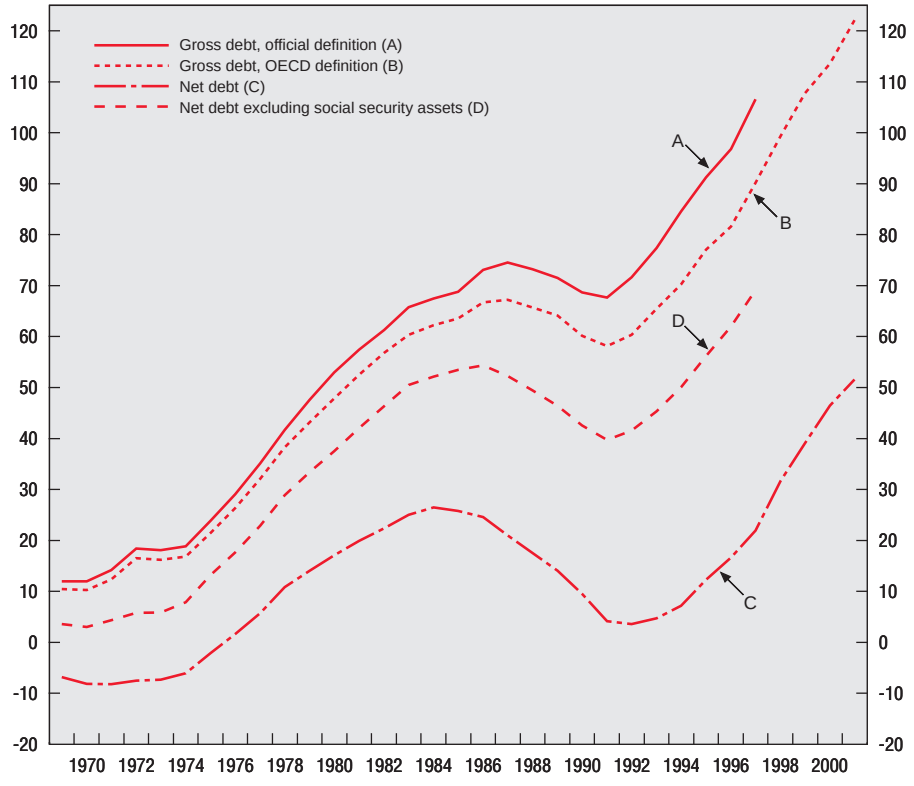
And fiscal policy?

The more controversial question is what should happen to budgetary settings. The government seems intent on keeping its foot all the way to the floor so as to ensure that the economy does not stall in a repeat of what happened in 1997. While the present circumstances are not those of that earlier period, the current recovery is still tenuous, with a fine balance between positive and negative forces. Implementing a programme of fiscal consolidation now might well tip that balance unfavourably. Indeed, the limitations on available policy tools with which the authorities could confront any renewed weakness in private spending and the persistent risks of deflation are reasons to seek the added assurance of sufficient public demand. Thus, a carefully designed supplementary budget is justified in order to signal the priority placed on maintaining the recovery. In that regard, heightened attention should be paid to the variable quality of public spending, and greater focus should be put on areas where returns are likely to be highest.

But longer-term considerations cannot be ignored. Already in last year's Survey the Committee warned that the nation was not far from the point when counter-cyclical fiscal policy would no longer be available because of the deterioration of the public finances and that aiming for a deficit on central and local government account of 3 per cent of GDP in FY 2005 was not sufficiently ambitious. Since that time fully 38 per cent of the national budget has had to be bond financed. Local government finances have worsened further, even abstracting from the notorious "third sector" companies, over which they have joint responsibility and about which there is shockingly little information. And the underlying situation of government institutions, albeit opaque, has undoubtedly deteriorated to the point where their indebtedness recently amounted to some two-thirds of GDP. Thus, overall gross public sector debt (leaving out public financial institutions) reached 129 per cent of GDP in March 1998, even excluding contin-

gent liabilities in the pension, banking and credit guarantee systems. For the narrowly defined general government sector debt is set to reach 114 per cent of GDP in gross terms (and 45 per cent in net terms) next year, and Japan is set to become the OECD country with the highest gross debt-to-GDP ratio by 2001. Although there are substantial measured government-held assets, their worth is difficult to assess, and the trend in net indebtedness is just as worrisome.

Various definitions of Japan's government debt
FY 1969-2001,[1] per cent of GDP



1. The data for FY 1998 to FY 2001 are OECD estimates.
Source: Economic Plannig Agency and OECD.

To make the situation sustainable (as determined by a stabilisation of the government debt ratio) over a horizon as long as 10 years, even taking the recently announced pension reform on board, will require a massive consolidation. As stressed in the previous Survey, as much of that as possible should be carved out of spending. It seems as though public investment could yield much in the way of savings. But slowing the rate of increase in health care expenditure and shrinking the size of the civil service are other avenues that will surely also have to be included. Yet even after these moves, as well as assumed increases in social security contributions, there will probably remain a large portion to be made up by other revenue increases. To accommodate the need to increase the tax-to-GDP ratio substantially will require major changes to the tax system. The challenge – daunting, to be sure – will be to increase revenues sufficiently while at the same time avoiding raising economic distortions or compromising distributional objectives unduly. ■

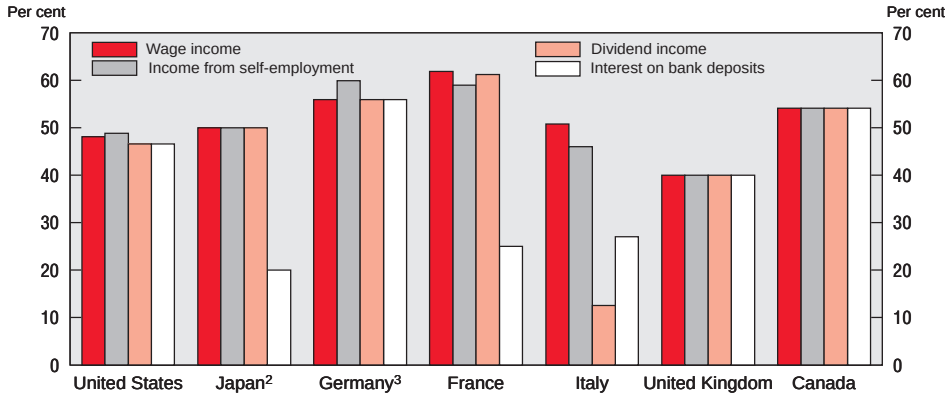
Is the tax system in good shape?

Up to this point, the tax system appears to have worked reasonably well overall. Relatively low marginal income tax rates for the vast majority of economic agents, in combina-

tion with moderate tax elasticities of the bases, indicate that the overall distortion is probably modest compared with that of most other OECD countries. In particular, it appears that neither the labour force potential, including human capital formation, nor aggregate savings and investment decisions are unduly hampered by taxation. This feature has recently been strengthened further by the reduction of the top marginal tax rate on labour income from 65 to 50 per cent (including local taxes), bringing Japan broadly into line with the other major countries. The tax-exempt threshold is among the highest in OECD, and since the brackets are also wide, around 95 per cent of all personal income earners pay less than 20 per cent of their income in taxes and social security contributions. The effective tax rate on labour is thus at a level that is comparable to those of the United States and the United Kingdom at the bottom end of the OECD range. Previously fairly high effective corporate rates have recently been reduced by 9 percentage points and are now in line with, or only slightly above, those of many other OECD countries. As well, corporations will be assisted in their restructuring by improved loss carry-forward provisions and the planned introduction of consolidated taxation. The value-added tax (VAT) applies the lowest standard rates among those OECD countries with VAT and is broadly based in terms of the goods and services it covers.

It has also been a success in terms of its effectiveness in raising revenue and in contributing to balancing revenues from different bases.

Highest all-in tax rates for top income earners[1]
1998



1. The all-in rates include central and sub-central government taxes as well as social security contributions where these are not capped.
2. Japanese data are for FY 1999. Tax on dividends depends on the size of payment. Tax credit not included.
3. Income from self-employment applies only to business income which is subject to the local business tax ("Gewerbesteuer").

Source: OECD Tax Database.

The Japanese tax system is, however, not problem-free. The need for its improvement will increase with the prospect of having to raise tax revenues substantially in relation to GDP. Tax bases are narrow in some parts of the system, and significant non-neutralities exist in other parts. The allowances and tax credits given in the personal tax system dilute the base and hence revenues, contribute to horizontal as well as vertical inequity and distort incentives for labour market participation for some groups, in particular dependent spouses. The potential for base broadening, though more limited, also exists for social security contributions, where bonuses are only partially included, and in the VAT system, where the tax-exempt threshold for small retailers is much higher than elsewhere in the OECD. Non-neutralities are present in the incentives for corporate financing – where the tax advantages to debt relative to retained earnings and new equity are even larger than in other countries – and in the taxation of land and property. The inheritance tax distorts market prices for land, especially agricultural land, largely to the benefit of a small number of

urban farmers, but the tax on holding property as well as the capital gains taxes and transaction taxes also contribute to inefficient land use. The tax treatment of personal savings, in particular pension savings, appears to be relatively lax compared with other major countries, especially considering the generational imbalances in Japan. On the administrative side, Japan stands out as one of the few OECD countries not applying a taxpayer identification number system.

A key conclusion which follows from the analysis of the Japanese tax system presented in is that a significant part of the required revenue increase should come from broadening the personal income tax base, reversing the tendency in recent years. Although precise estimates are not readily available, it is not unrealistic to assume that the revenue shortfall from these tax preferences could amount to as much as 10 per cent of GDP. Eliminating only half of them would thus contribute significantly to closing the financing gap. Even though exemptions can serve some economically and socially legitimate goals, these can generally be attained more efficiently through targeted transfers, and an alternative way of increasing revenues by raising rates would have large harmful effects on the economy as distortions tend to rise disproportionately with rates. Another important recommendation is to exploit more fully the potential for taxing consumption through an increase in the VAT rate and, to a lesser extent, a widening of the base. This tax has several attractive features in terms of horizontal equity and neutrality with respect to decisions to save and invest. Both an increased consumption tax and reduced personal allowances would spread the burden of population ageing and of servicing the existing government debt more evenly across generations. Successful implementation of a meaningful tax reform requires that a broad range of measures be applied all at once so that the burden of higher taxes is widely shared and the perceived sense of unfairness minimised. The introduction of a sufficiently extensive information system, including taxpayer identification numbers, could improve the accuracy of data on individuals' income status – thereby raising the efficiency and effectiveness of administering the tax and transfers systems. It could also contribute to the alleviation of the widespread sense of unfairness, notably between wage earners and the self-employed. Even with improved transparency and enforcement, however, some degree of horizontal inequity is likely to persist between capital and labour incomes in an increasingly globalised environment, which puts a limit on taxing mobile resources at rates significantly above those prevailing elsewhere. ■

What is the public sector reform agenda?

The need for increasing tax revenues will be lessened by stepped-up efforts to reform the public sector. Enhanced transparency is acknowledged to be necessary, and to this end access to information legislation has been passed and a system of public comment procedures on regulatory changes is being instituted. This, along with increased internal assessment and evaluation of policies and actions, should serve to increase the quality of the government's economic management. The now-decided reorganisation both of the ministries and of various other institutions may also augment efficiency, but only if real public-sector cost savings result. More broadly, the government's reforms are predicated on a desire to reduce its role in the economy and to allow a greater role for both markets and lower levels of government, even though progress here has been limited and public ownership in the economy has continued to trend up to surprisingly high levels. Some privatisation has taken place, but no clear strategy has been worked out, and thus it has appeared haphazard and revenue-driven. For example, there appears to be little justification for continued government ownership of NTT. The Private Finance Initiative scheme, as appropriately modified by the Diet to reduce moral hazard, may lead to fewer poor-quality public works projects. Similarly, the forthcoming reform of the Fiscal Investment and Loan Programme is intended to move to a more market-based allocation of funds among competing public institutions. The additional financial discipline should boost the average quality of their outlays. In addition, the central government will have to accept a smaller role if decentralisation is to lead to decision-making at the most appropriate level, as in the "subsidiarity" principle espoused earlier in the European Union context. In any case, the current system of inter-governmental relations seems to be excessively paternalistic, which results in serious incentive problems in local government financing.

The government's social security policies are also under review, largely because they are not sustainable as the population ages. The recent draft law to reform the public pension system represents a reasonable compromise designed to ensure long-term actuarial balance. By gradually rais-

ing the retirement age as from 2013, making a small cut in benefits and indexing to prices rather than wages, the plan allows a delay in the schedule of contribution increases and a moderate reduction in future peak rates from what they otherwise would have been. In addition, consideration is being given to increasing the funding from general revenues from one-third to one-half (at a cost of around ½ per cent of GDP). But progress in designing the intended overhaul of the health care system has been disappointing. Few important decisions have been taken, even though the intention was to implement the reform next April. The government has not yet persuaded doctors of the desirability of changes, despite evidence of unnecessary diagnostic testing and excessive consumption of drugs. On the other hand, next spring's introduction of long-term care insurance should move the elderly who presently occupy acute-care beds into more appropriate structures at significant savings.

Corporate pensions also have major under-funding problems, estimated by some to be as much as 80 trillion yen (around $700 billion or 14 per cent of GDP). The government has decided that funding shortfalls will have to be reported as from next year and then eliminated over 15 years. Companies will be allowed to contribute cross-held shares to their pension plans – with potentially enormous corporate governance implications – but the call on profits will still be substantial. Another vastly important proposal that seems to have government support is to introduce a system of defined-contribution pension plans along the lines of the US 401 (k) scheme. If the annual ceiling on tax-assisted contributions is set as high as is being mooted – nearly $4 000 – the fiscal implications could be significant, although the benefit in terms of pension portability and thus deepening the mid-career job market would be immense. ■

And other structural reforms?

The authorities are engaged in planning and implementing a plethora of other structural reforms as well; some of the major ones are briefly reviewed below. Most are intended to revitalise the economy and enhance medium-term growth prospects, which have deteriorated because of well-known demographic changes. In view of the lengthy period required to reach consensus it would no doubt be best if agreed reforms were carried out as quickly as possible, so that the synergies among them can begin to work without delay. But in no case should reform be postponed by reopening the debate once decisions have been taken, nor should interest groups be accorded a right of veto. In the current circumstances it would be wise to put priority on those reforms that promise new entry in dynamic sectors, attenuate workers' income uncertainty and facilitate the mobility of resources to further the economic restructuring process.

Liberalisation of the financial markets forms the backbone of the structural reform efforts. Implementation of the Financial System Reform Law is proceeding on time, and, although many of the changes remain to be implemented between now and FY 2001, the effects are now easily seen. The transformation is comprehensive, and that is entirely welcome. The only part of the overhaul that still does not seem set on a sound footing is customer insurance: the securities industry has two rival funds that should eventually agree to merge to gain full risk-pooling benefits; the life insurance scheme is almost certainly underfunded; and the schedule for the normalisation of bank deposit protection is under attack, despite plenty of advance notice that full compensation would be available only during the intensive reform period. One general strategy that would be advisable in this delicate area is to move towards risk-based premia in order to reduce moral hazard problems.

Regulatory reform is another domain on which official attention has long been focussed because of its potential to both reduce costs and prices towards world levels and stimulate domestic demand, as indicated in the recent OECD Review of Regulatory Reform in Japan. The most important advance of late was the strategic decision to move towards a regulatory system based on retroactive supervision rather than on prior intervention. If fully and consistently implemented, this will be a far-reaching and beneficial change. Another significant move will be to modify public utilities' price-setting methods: price flexibility will be introduced, subject only to a cap, and information disclosure requirements will be introduced. Such a system has already been announced in the telecommunications sector (except for basic local services). In that industry competition will also grow as a result of several changes that will effectively boost foreign and new domestic firms' ability to challenge incumbents, such as a reduction in interconnection charges, even though the competitive effects of the recent split of NTT remain uncertain because of

the adoption of the holding company structure. Electric utilities have been benefiting from competitive tendering by independent power producers for several years, and now the largest users will be allowed to choose their suppliers as well. If these changes were supplemented by others put forward in the OCED Review – such as opening access to the transmission grid – the official objective of reducing prices to internationally comparable levels may be realisable. The various parts of the transportation sector have also been accorded increasing pricing freedom, and demand-supply adjustment regulation is on the way out. Overall, it seems fair to say that within a few years Japan's regulatory landscape may well have been radically transformed.

The government has taken a number of measures that mainly respond to the recent deterioration of labour-market outcomes: the rises in the overall unemployment rate, the average duration of spells and the share of involuntary joblessness in the total. While there has been some increase in the generosity of the long-standing Employment Adjustment Subsidy programme, that scheme has often been accused of preventing adjustment, rather than assisting it. Over the past year the government has been subsidising hiring at recent start-ups, job-related education and training at professional schools, local government temporary jobs, and employment of older workers, especially in high-unemployment regions or in new and growing fields. This would seem a better way of spending funds to deal with cyclical problems than would merely paying out more unemployment benefits. But to the extent that many of those involved, especially the elderly, may well be without jobs for a long time, outcomes may not prove as satisfactory as is hoped. It is therefore entirely appropriate that the unemployment insurance system be reviewed so as to determine whether there should be changes in the benefit structure, duration and targeting by age group. All workers are likely to benefit from the recent opening-up of the private job-placement business, but the parallel liberalisation of occupational limitations in the temporary-job-placement business should not be held up unnecessarily.

In agriculture there has been clear reluctance to allow markets a much greater influence. The recently adopted Basic Law on Food, Agriculture and Rural Areas makes no mention of competition among its guiding principles, citing the primacy of food security and the multi-functionality of agriculture and rural development. The cost of this approach is overall producer support levels that are high and that have shown little tendency to decline in recent years, leaving taxpayers and especially consumers with heavy financial burdens. An explicit target for food self-sufficiency is being developed, one that will likely try to reverse the long-standing trend decline. Such a policy would require producing more of what consumers want despite the relatively hostile environment. That would take either a great deal more intervention, with all its attendant costs to Japanese taxpayers, or a massive increase in efficiency, something that would necessarily entail substantial consolidation to reap available economies of scale. The latter strategy might be more easily adopted, given the concentration of elderly among the farming population, were it not for a variety of land and tax policies that impede new entry, rationalisation and shifting land to other uses.

The government has not seen fit to make much use of markets for meeting its environmental objectives either. The most important effort will be to meet the nation's commitment under the Kyoto protocol to cut greenhouse gas emissions by what amounts to over 13 per cent from 1997 levels through a reduction in energy demand growth – from changes in life style – and in emissions – from shifts in the energy mix mainly towards nuclear power and natural gas. The strategy to reducing emissions from mobile sources may include setting various taxes related to automobile usage based on emissions levels. But in the increasingly competitive marketplace it remains to be seen whether Japanese firms will respond sufficiently to moral suasion and other voluntary measures, without the adoption of a system of carbon-based fuel taxes, which would provide the necessary incentives for fuel substitution and conservation. Charging for disposing of household garbage by weight or by bag would also go some way to making consumers aware of the full costs of their buying patterns. ■

For further information

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- **OECD Economic Surveys:** Economic Surveys review the economies of Member countries and, from time to time, selected non-Members. Approximately 18 Surveys are published each year. They are available individually or by subscription. For more information, consult the Periodicals section of the OECD online Bookshop at www.oecd.org/bookshop.

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- **Additional Information**: More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's Web site at www.oecd.org/eco/eco/.

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