The Sad Tale *of* Japan

New Prime Minister Fumio Kishida has caved in and given up.

By Richard Katz

Had new Japanese Prime Minister Fumio Kishida actively pursued the two economic goals he declared during his rise to the top last fall—a restoration of Japan's past entrepreneurialism and ensuring that households get their fair share of national income—he'd be sending Japan well on the way to recovery. Unfortunately, like so many of his predecessors, he has failed to back his lofty goals with the measures needed to reach them. On the contrary, he quickly caved in the face of opposition and now retains only hollow slogans—like "a new form of capitalism"—plus a few leftover measures that have proved futile.

This creates the risk that Japan's three "lost decades" could add a fourth. If so, living standards for a large share of the population will continue to stagnate or decline. Over the past three decades, subpar productivity has kept Japan's per capita growth at just 0.6 percent per year, the third lowest rate among thirty-one countries in the OECD. Meanwhile, even this meager level of growth is failing to benefit so many households. From 1995 to 2018, median disposable income plummeted 11 percent for the seniors who now comprise nearly a third of the population. Even though the average Japanese worker produced 30 percent more GDP per workhour in 2019 than in 1995, real wages per hour dropped 1 percent. This is the worst productivity-wage gap in the entire OECD.

Kishida was accused of preaching socialism for saying, "If the fruits of growth are not redistributed, consumption and demand will not increase." In reality, this is a longstanding finding of textbook growth theory called the Uzawa

---

Richard Katz, Senior Fellow at the Carnegie Council for Ethics in International Affairs, is writing a book on how to nurture new, high-growth companies in Japan.

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

theorem. That theorem has played out in spades in Japan. Not only is Japan's potential growth low, but despite decades of big budget deficits and near-zero interest rates, actual GDP has fallen short of potential by an amount averaging 1.2 percent of GDP over the past thirty years (see Figure 1).

One reason is that Japan's economic weakness makes it very susceptible to economic shocks. Even though Japan played little role in the widespread malfeasance that produced the frightening global cataclysm of 2007–2009, its GDP fell twice as much as the rest of the OECD. Covid caused relatively few cases and deaths in Japan. Yet, due to Covid and two hikes in the consumption tax (2014 and 2019), Japan's real GDP in January–March 2022 was only 2 percent higher than it was almost nine years earlier during calendar 2013. Consumer spending was 3.4 percent lower than in 2013. This pattern bodes ill for Japan if the world enters a new recession.

On the security side, economic weakness is causing Japan to lose influence in Asia to an increasingly bellicose China. In terms of "the capacity to exercise influence and leverage through economic interdependencies" within Asia, like trade, investment, and technological leadership, the Asia Power Index reported that Japan's score fell from 56 in 2018, when the index was launched, to only 40 by 2021. China's score rose from 96 to 99.

CAVING IN TO PRESSURE

For six long months, the Kishida administration, aided by reform-minded outsiders from new companies and academia, toiled to translate the mantra of "a new form of capitalism" into concrete policies. The rather vacuous end product approved by the Cabinet on June 7 disappointed many of those participants. It's top-heavy with rhetoric but very weak on substance.

Kishida's surrender began just after his October 4 inauguration due to a so-called "Kishida shock" when stock prices fell in response to his call for higher capital gains and dividend taxes on the very few Japanese earning more than ¥100 million ($745,000) per year. A cowed Kishida quickly withdrew the proposal. The backpedaling continued, said an insider, when Kishida decided that he could not afford to offend any important business or political interest groups on the eve of the July 10 Upper House election. With Kishida's faction within the ruling Liberal Democratic Party so small, he needed a solid victory to consolidate his clout and overcome the resistance of larger, more conservative factions, like that of the assassinated former Prime Minister Shinzo Abe.

That left Kishida with nothing more than a rehash of failed measures laid down by predecessors like Abe. He repeated past futile pleas for companies to raise wages by 3 percent per year. He also repeated the twelve-year-old raising

For six long months, the administration of Prime Minister **Fumio Kishida**, *aided by reform-minded outsiders from new companies and academia, toiled to translate the mantra of "a new form of capitalism" into concrete policies. The rather vacuous end product approved by the Cabinet on June 7 disappointed many of those participants. It's top-heavy with rhetoric but very weak on substance.*

the minimum wage of ¥1,000 ($7.25) per hour but offered no timeframe. Finally, he suggested a bit higher temporary tax breaks to companies that raise wages by a certain increment, even though history shows companies do not grant permanent wage hikes to get temporary tax breaks.

Regarding a key component of the growth strategy—a ten-fold increase in startup companies over the next five

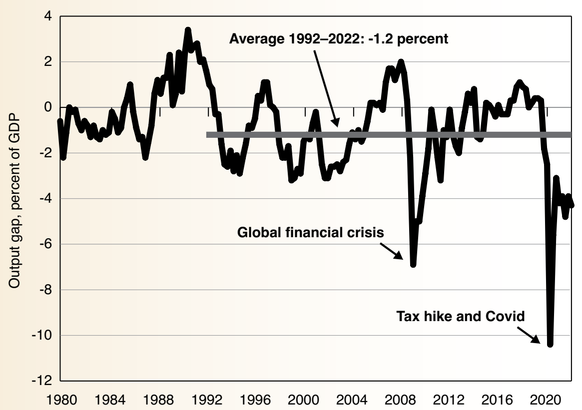
> *Kishida quickly caved in the face of opposition and now retains only hollow slogans.*

years—reformers were even more frustrated. A team under the aegis of the Council for Science, Technology, and Innovation produced a first-rate analysis of many of the key impediments that keep the startup rate so low. However, the team was ordered not to offer any specific remedies because of disagreements among key players. For example, the Ministry of Finance has repeatedly vetoed the kind of tax breaks needed to nurture new startups. The Prime Minister's office promised that, by year's end, it would present a "five-year plan" loaded with powerful specifics. However, participants in the deliberations expressed little confidence in that promise.

DEFICIT-FINANCED CONSUMER SPENDING

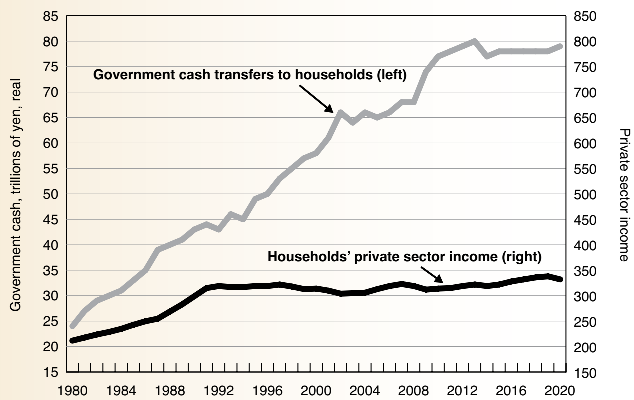
As the Uzawa theorem states, for an economy to avoid instability, its growth must be "balanced," that is, in the long run, GDP, personal income, consumption, and investment must grow more or less at the same pace. In Japan, however, personal income began lagging behind GDP in the

Figure 1 Japan Can't Reach Its Potential GDP



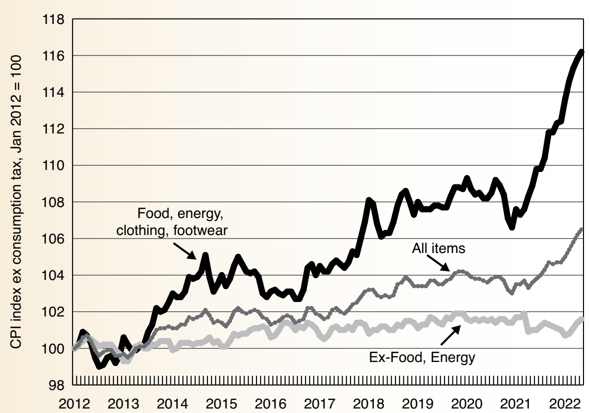
Source: Cabinet Office

Figure 2 Government Cash Replaces Private Sector Income



Source: Cabinet Office

Figure 3 Yen-Created "Bad Inflation"



Source: Statistics Bureau

1980s. While other rich countries suffer from the same imbalance, Japan's syndrome is the most severe.

The predicted instability has manifested itself in Japan via massive government debt as well as decades of near-zero interest rates. The latter have enabled zombie firms to survive at the expense of healthier ones. Because growth in private sector income decelerated, consumer spending has increasingly depended on deficit-financed cash transfers from the government. Back in 1980–1992, 85 percent of the growth in household income came from the private sector: wages, self-employed income, rents, dividends, interest, company pensions, and insurance annuities. Only 15 percent came from government money, such as social security and other social assistance.

Then came a big reversal. From 1992 onward, real private sector income grew only 4 percent, a negligible 0.1 percent per year. By contrast, government cash transfers more than doubled (see Figure 2). As a result, 72 percent of the entire growth in household income was supplied by government cash. Only 28 percent came from growth in private sector income. Without massive budget deficits—now being monetized by the Bank of Japan—Japan would have suffered even weaker consumer spending and GDP growth. After 2012, cash transfers stopped growing due to social security benefits being made less generous so as to induce seniors to work longer. This was a factor in the decline in seniors' median income.

WEAK YEN AS TRICKLE-UP ECONOMICS

Shinzo Abe hoped that driving the yen downward would catalyze a trickle-down benefit via increased exports and corporate profits. Instead, it has worsened the macroeconomic imbalance. As of June 2022, the purchasing power of the yen in international trade is the lowest on record since measurement began a half-century ago.

Nearly 40 percent of consumer spending is accounted for by import-intensive items such as energy, food, clothing, and footwear. Not counting the consumption tax hikes, prices of these items have risen 16 percent since 2012, the year before Abe took office. By contrast, prices for all other items edged up just 1.5 percent. In short, 93 percent of the entire rise in consumer prices was driven by import-heavy items (see Figure 3).

A weaker yen transfers income from Japanese households to foreign producers as well as to Japan's big multinationals. A policy advertised as trickle-down has proven to be trickle-up.

WHAT COULD BE DONE ON INCOME DISTRIBUTION?

The primary culprit in the maldistribution of national income is the gap between corporate and household incomes. Corporations are hoarding "retained earnings," *Even though the average Japanese worker produced 30 percent more GDP per workhour in 2019 than in 1995, real wages per hour dropped 1 percent. This is the worst productivity-wage gap in the entire OECD.*

that is, profits not plowed back into the economy via wage hikes, investment, dividends, or taxes. Worse yet, over the past couple of decades, Tokyo has repeatedly shifted income by raising the consumption tax to help finance tax cuts for companies. The top corporate tax rate on large companies was slashed from 52 percent of profits in 1998 to 30 percent at present.

The claim was that companies would use the tax cuts to hike wages and investment. This never happened. As aides informed Kishida's New Capitalism Council, between 2000 and 2020, the profits of Japan's few thousand largest corporations almost doubled, but their compensation to workers fell 0.4 percent and capital investment fell 5.3 percent (all in nominal terms). As a result, cumulative retained earnings soared by an amount equal to almost a third of a year's GDP. The same pattern prevailed at small and medium-sized corporations.

If corporate income tax cuts are worsening Japan's growth and its budget deficit, why not roll them back? Why not use the resulting revenue gains to reduce the consumption tax? That would help living standards and aggregate demand in a deficit-neutral manner. The Council never discussed this option.

Japanese law already mandates equal pay for equal work between regular and non-regular workers and between men and women. Yet no agency of government is mandated to investigate violations and penalize offenders.

Raising the minimum hourly wage—now at ¥930—elevates not only the income of those below the minimum wage but also those earning 15–20 percent above it. Since the average wage of Japan's fifteen million part-time workers is just ¥1,100 ($8.20), the boost to living standards and consumer demand would be dramatic. To match the OECD standard of the minimum wage relative to the median wage, Japan would have to reach ¥1,145.

ENTREPRENEURSHIP

For decades, Japan's corporate giants and their political allies feared that powerful entrepreneurs could disrupt them. Their obstruction has hurt Japan since entrepreneurship is indispensable to a good rate of potential growth.

The good news is that digital technology is changing corporate sentiment. Toyota, for example, has been compelled to contract services from hundreds of new software companies because software now makes up 10 percent of a car's value, and the automaker and its traditional suppliers lack the required skills. Cases like this have driven the normally conservative Keidanren business federation to call for a ten-fold increase in venture capital funding for startups, and 100,000 new dynamic companies over the next five years.

This is just one of the factors creating the best political opportunity for entrepreneurship in a generation. Many feasible measures could provide a significant economic payoff with relatively little budgetary impact or political-social disruption. Success via such measures would build up a constituency for more difficult steps.

The first step is to think beyond glamorous Silicon Valley-type firms. There are just two thousand high-tech firms in Silicon Valley. By contrast, America hosts more than fifty thousand innovative, high-growth enterprises, most of whom are outside of high-tech. During the 1980s and 1990s, American firms less than five years old supplied a stunning 60 percent of the growth in factory output per worker. The comparable numbers for high-growth enterprises are sixteen thousand in South Korea, thirteen thousand in the United Kingdom, and ten thousand in France. By contrast, Japan's small and medium-sized enterprises suffer poor productivity and the lowest rate of growth in the OECD.

The single biggest obstacle in Japan is the dearth of financing. Startups that are not suitable for venture capital and are too young for bank loans rely on "business angels." In 2019, American angels invested $24 billion in 64,000 companies. That's twenty times the number of superstars who received venture capital money. In several countries, tax incentives have created a boom in angel investment. Unfortunately, Japan's tax break is tiny: a maximum income tax deduction of ¥8 million ($58,000) for total investment in all companies under three years old. In the United Kingdom, by contrast, angels can deduct 30 percent of their investments up to £1 million ($1.2 million) and twice as much for "knowledge-intensive" companies. The Ministry

Continued on page 63

Continued from page 43
of Finance's Tax Bureau has blocked efforts by the Ministry of Economy, Trade, and Industry to improve the tax break. This is shortsighted knee-jerk thinking since more high-growth enterprises mean better growth and therefore more tax revenue.

New companies in Japan have trouble finding customers. So, it would help if they could sell to the national and local governments, whose spending adds up to 16 percent of GDP. Traditionally, the government's procurement preferences for small and medium-sized enterprises have shored up older firms with little prospects for growth or innovation. In 2015, the government finally added a provision for companies under ten years old. However, its purchases from them in 2021 were a trivial 0.8 percent of national procurement. A more meaningful level would not only provide more revenue but also help startups get bank loans and win increased sales to private firms.

Like other rich countries, Japan subsidizes research and development, but only 8 percent of its aid goes to companies with fewer than 250 employees, the lowest share in the OECD.

Japan's economic weakness makes it very susceptible to economic shocks.

The Kishida team wants the enormous Government Pension Investment Fund to invest more in venture capital funding. That would be terrific, as long as the GPIF does not invest on its own, but through independent (not corporate) venture capital funds, foreign or domestic.

It is not difficult to come up with feasible steps to improve both productivity and distribution. The difficulty lies in the lack of political will to implement them. ◆