Global Growth *Headache*

By Tadashi Nakamae

Japan is an example of what happens when you ignore the little guy.

In 2018, a time of rapid technological innovation, decelerating productivity growth seems an unlikely source of economic worry. Technology has helped industries, especially manufacturing, become increasingly efficient. Unfortunately it has not boosted productivity across the board.

Amid a global trend in which households and industries are becoming increasingly polarized, big dominant companies with high productivity are boosting their share of the market, while their smaller brethren are squeezed and less able afford to raise productivity. In highly productive industries, the top companies cut jobs and become even more productive. Meanwhile, their less successful competitors have to lay off workers because business is down. The redundant workforce then moves (if lucky) to other industries (often in the services industries) that are not yet efficient enough to be caught up in this cycle. From a macroeconomic point of view, the ensuing rise in the number of workers in such industries pushes down productivity as a whole.

Thus the world economy is losing its ability to grow. Productivity growth has almost come to a standstill. Although the easy monetary policies of the past decade or so have helped to obscure this, the underlying structural problem has become too big to ignore. The economy will not grow as long as productivity growth remains close to zero and the number of employed workers barely increases.

This is not to say that technology and innovation are bad. Unfortunately, recent improvements in technology—and the ability to make them—have been concentrated in only a fraction of the economy.

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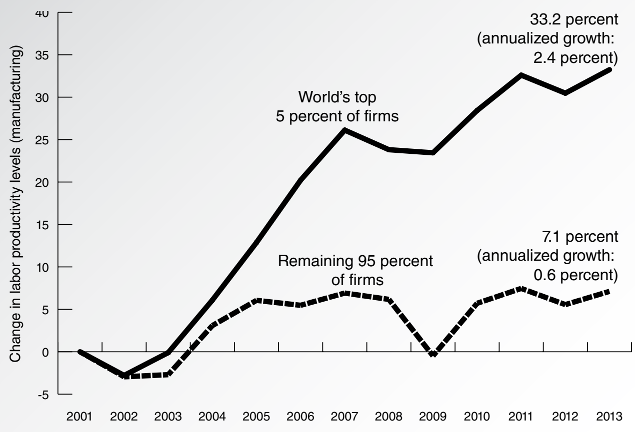
OECD data shows improving rates of productivity among manufacturers from 2001 to 2013 (Figure 1). The world's top 5 percent companies saw their productivity improve 33 percent (2.4 percent at annualized rate) during a period in which the remaining 95 percent experienced an improvement of only 7 percent (0.6 percent annualized). The service sector, which combines a variety of industries, saw the top 5 percent companies record a 44 percent (3.1 percent annualized) rise in productivity while the remaining the 95 percent saw only a 5 percent (0.4 percent annualized) gain.

Figure 1 Widening Disparities Among Companies



Source: OECD

The distribution of wealth is just as skewed. In the United States, the ratio of employee income to GDP has been falling sharply since the beginning of the 2000s. Even as technological innovations in information technology and artificial intelligence have accelerated, the share of employee income has declined. By contrast, corporate earnings as a whole have been trending upward.

Widening disparities in productivity have had negative impacts on macroeconomic numbers. Labor input, the amount of labor used to produce a good or service, has changed enormously since the financial crisis in 2008. The manufacturing industry's share of labor input declined sharply from 22.4 percent to 18.9 percent. By contrast, medical-and-welfare, restaurants and lodging, all low-productivity sectors in the services industry, saw their share increase from 20.2 percent to 23 percent. Overall productivity growth has slowed as high-productivity sectors continue to reduce, and low-productivity sectors boost, labor input.

This is bad for wages. Hourly wages in the manufacturing industry averaged $26 in 2016, while hourly wages in food services, typically one of the lowest-paying sectors, averaged around $15.9. Similarly, labor productivity (per-hour value-added output) was $73 in manufacturing and $18 in nursing care.

"Trickle-down" has proven to be a failure.

In the United States, the latest tax bill, passed late last year by the Republican Party, does little to help as its beneficiaries are mostly big companies that are already highly efficient. Smaller companies, confronted by increasing polarization and hampered by uncertainty within a regulatory framework that increasingly favors big, dominant companies, will probably continue to struggle to make the investments that would improve productivity.

The bill also relies on a dubious assumption that capital spending will increase as domestic consumption rises. This is unlikely to happen as the tax bill and its related measures will hurt many consumers. The cut in personal income tax is not only temporary (unlike the corporate tax cut, which is permanent), it disproportionately favors high-income earners.

LESSONS FROM JAPAN

These structural problems are painfully familiar to Japan. The country is an example of how a long-term trend of favoring the corporate sector in order to boost international competitiveness has come at the expense of households, the budget deficit, and the economy. These policies have stifled income and consumption, frozen productivity, and shrunk the domestic market.

It is no surprise that many of Japan's biggest success stories of the past couple of decades are big exporters who have increasingly concentrated their resources in overseas markets. This hurts companies in the services sector whose services and products are not (or cannot be) exported. Japan's tax system pampers companies that are not investing capital at home because the market is not growing. Workers are not benefiting from these companies' growing wealth as wage growth is weak.

Japan also provides an example of how official data can obscure statistical trends by over- and under-representing the performance of certain sectors by not explaining the details of what is included and excluded. Figure 2 explains why Japan's consumption remains sluggish. It should be noted thatsome items such as "imputed rent"—rent that owners of owner-occupied homes receive in theory but not in reality—need to be subtracted. Subtract another ¥28 trillion yen of indirect taxes such as Japan's 8 percent consumption tax from the official figure of ¥292 trillion, and real consumption was actually around ¥214 trillion in 2016, the latest year for which national income statistics are available.

Japan's nominal GDP growth peaked in 1997. Official data shows consumption increased from ¥280 trillion in 1997 to ¥292 trillion in 2016. But when imputed rent is excluded, consumption increased by ¥2 trillion from ¥240 trillion to ¥242 trillion. Exclude indirect taxes, and it turns out that consumption actually decreased.

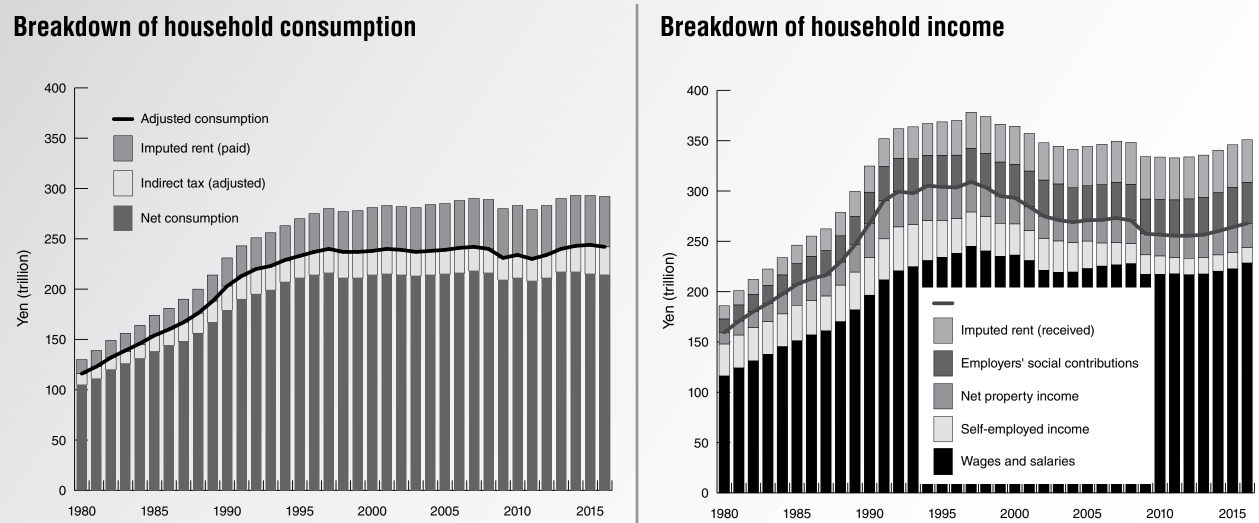
What about corresponding household income? After subtracting "imputed rent" and another ¥41 trillion yen in employers' social contributions that directly goes to the government, household income was ¥268 trillion, approximately 25 percent lower than the official figure of ¥350 trillion yen compared with ¥309 trillion in 1997. Wages, the biggest component of income, decreased from ¥245 trillion in 1997 to ¥228 trillion in 2016.

Official data also understates corporate income by not including social insurance contributions made from earned income to the government. Once these are included, corporate income rises from ¥130 trillion to around ¥163 trillion. The ratio of household income to the primary income balance in Japan declined from 69 percent in 1980 to 52 percent in 2016, indicating a sharp fall in the share of households. In the United States and Germany, these figures were 66 percent and 63 percent respectively. Japan saw a much sharper rise in the share of corporate income than in the United States or Germany.

One way to boost household income would be to repeal the consumption tax. Japan could make this budget-neutral by raising corporate taxes.

The tax system fuels this inequality. In Japan, households pay around ¥95 trillion in social welfare contributions, indirect taxes (primarily through a consumption tax), and income tax. The corporate sector pays some ¥52 trillion in taxes and social welfare contributions. Households are shouldering more of the tax burden: the

Figure 2 Japan: Household Consumption and Breakdown of Income



Note: Adjustment to indirect taxes: Taxes on domestic products and imports, divided by government, NPOs, and household final consumption expenditure (after deduction of imputed rent). The adjusted figure indicates the taxes borne by households.
Source: Cabinet Office. Recent data is for 2016.

ratio of household taxes to primary income has gone up from 28 percent in 1991 to 35 percent at present, while corporate taxes fell from 49 percent to 32 percent.

Japan's households are getting poorer. The savings ratio has come down from 25 percent in 1974 and 16 percent in 1991 to only 3 percent in 2017. Households had the most savings in Japan until the 1990s, but have now been overtaken by the corporate sector, which began registering a surplus in 1997. This is largely because companies have been reducing investments in plants and equipment as they believe there is not enough demand in Japan.

Since 1997, companies amassed savings of ¥395 trillion (¥21 trillion annually). Households accumulated ¥307 trillion and the government had a deficit of ¥623 trillion.

Japan needs to strengthen households' potential purchasing power. Companies across the world rushed to China in its nascent stage of growth because they believed that its potential purchasing power was strong. Japan needs to (re)create an economy with strong purchasing power to attract companies, both domestic and foreign.

One way to boost household income would be to reduce taxes, as it is hard for smaller companies, which account for 70.5 percent of workers in Japan, and where personnel costs average 69.7 percent of the value added, to raise wages. This can be best achieved by repealing the consumption tax. With consumption tax revenues totaling around ¥20 trillion and spending on goods and services at ¥215 trillion, abolishing the tax would boost consumption by nearly 10 percent, creating an appealing environment for new businesses. Lowering the consumption tax rate rather than income tax rates would help more people (such as retirees and the poor).

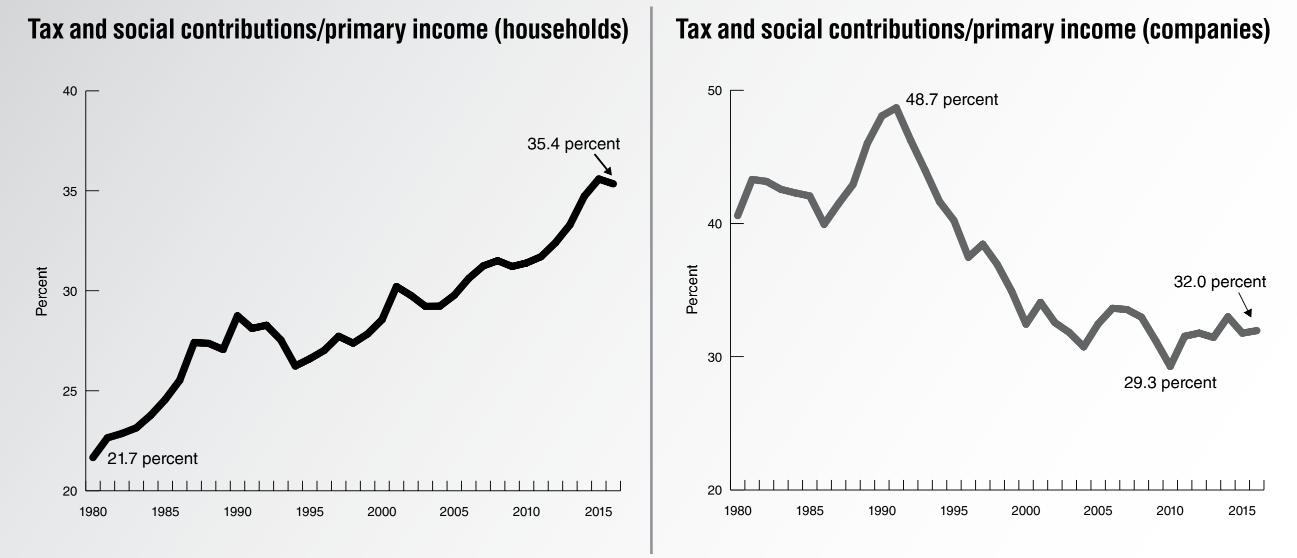
Japan could make this budget-neutral by raising corporate taxes. After all, companies are hoarding money, increasing neither capital spending nor wages. Moreover, this would eventually help companies by raising consumers' purchasing power and thus their sales. It would also enable companies to raise wages in the medium run, creating a virtuous cycle.

TRICKLE-DOWN REVERSED

"Trickle-down"—the idea that the economy benefits from giving breaks to companies as these profits will eventually trickle down to households—has proven to be a failure. It is time to turn this concept on its head. Governments need to aggressively pursue policies that help households and let those benefits flow to companies.

The government needs to shift its focus to helping households increase their purchasing power. Japan's current administration is unlikely to do so. Still, this story is likely to resonate in the United States and elsewhere. Who will have the courage to tackle this problem first? ◆

Figure 3 Japan: Tax and Social Contributions by Households and Companies



Source: Cabinet Office. Recent data is for 2016.