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Japan's Reliance on "Private-Sector Vitality:" Helping or Hindering Economic Growth? [redacted] 25X1

Summary

At the US-Japan Dialogue on Economic Adjustment next week, Japanese officials are almost certain to argue that Tokyo's program to "promote private-sector vitality" will soon expand domestic demand, boost imports, and ease the bilateral trade imbalance. Prime Minister Nakasone has put his support behind the idea of relying on business efforts to energize the economy and apparently views the ruling party's recent landslide election victory as evidence of public backing for the conservative philosophy underlying the concept. [redacted] 25X1

The phrase "private-sector vitality" has a variety of often contradictory meanings even in Japan, and we are not optimistic that the program it represents will be positive for the United States. To the extent that the concept represents a rationale for continued fiscal austerity, a common interpretation, it provides philosophical support for policies that restrain Japanese growth and imports. The more specific initiatives covered by the notion--for example, the reliance on the private sector to

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Information available as of 17 July 1986 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Japan Branch, Northeast Asia Division, OEA, [redacted]. 25X1

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fund and manage large infrastructure projects such as the long-planned Tokyo Bay Bridge--probably will not come to pass without a substantial infusion of government funds, thus having little impact on economic growth and imports. Moreover, the "privatization" of government programs under a "private-sector vitality" heading could enable Tokyo to argue--as it has in freezing out bidding by foreign construction firms on the new Kansai international airport project--that the GATT code on government procurement requiring open bidding does not apply to such private-sector deals. 25X1

Rooted in Administrative Reform

Tokyo's success at slowing the growth of Japan's public sector stems largely from the recommendations of the powerful Ad Hoc Council on Administrative Reform.[1] Established in 1981, this blue ribbon panel was composed of influential business leaders, academics, and ministry officials who proposed policies for Japan in the 1990s that would correct what they saw as severe Japanese economic problems. These include:

- The decline in the rate of investment and Japan's international competitiveness because of the 1970's oil price hikes and the ensuing wage and price inflation.

- The sharp increase in Tokyo's budget deficit and the national debt in the late 1970s, as a result of increased social spending and Tokyo's reluctant attempt to spur global economic growth. The council argued that continued growth of the national debt would eventually bring tax hikes, reduced business profits, slowed investment, and degradation in economic vitality.

- The rapidly aging population--Japan will have the highest proportion of over 60-year-olds among major industrial countries by 2000--that threatens to bust the budget by driving up Tokyo's pension and health care costs. 25X1

In addition to pruning the public sector, the principal remedy suggested by the Administrative Reform Council was to "enhance private-sector vitality." To this end, the Council recommended fostering private investment and research and development by:

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[1] The Council also suggested other wide-ranging changes in the size, organization, and management of the government. 25X1

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- Reducing or eliminating a variety of regulations that discouraged or prevented business investment. The privatization of Nippon Telephone and Telegraph and the Japan National Railways fall in this category.

- Eliminating the deficit in current government expenditures by 1991 to slow the growth of the national debt. Because of strong opposition to tax increases--especially among the business community--this recommendation translated into cuts in Tokyo's operating budget, beginning in 1982. The phrase "fiscal reconstruction without tax increases" has been reflected in the government's subsequent budget guidelines. 25X1

Although the Council's recommendations largely reflected the views of big business, they also appealed to Japanese politicians and officials who foresaw a growing government debt falling due at the same time as Japan's rapidly aging population demanded increased pension and health care expenditures. Nakasone also was an advocate of administrative reform even before becoming Prime Minister--he headed the predecessor of the Management and Coordination Agency, to which the Council reported--and some commission members came from his brain trust. 25X1

The fact that Tokyo has proceeded to implement most of the Council's reform proposals has surprised many in Japan. The now yearly ritual of cutting 10 percent from the ministries' previous annual budget (except for defense and foreign aid) has sliced the budget deficit from 4.5 percent of GNP in 1980 to about 1.5 percent last year (see figures). In our view, this progress has depended on the backing of "private-sector vitality" by powerful Japanese interest groups, such as Keidanren--the leading business federation--and important ministries. The Finance Ministry, for example, has used the concept effectively to counter proposed spending increases as well as to resist foreign pressure for Japan to ease its tight economic policies. For their part, business leaders have used the idea to argue against increased taxes (see table 1). 25X1

Boosting Public Works?

Probably the most concrete manifestation of the vitality notion, outside of its contention that a leaner.government is better, is Tokyo's plan for shifting the burden of developing Japan's infrastructure to the private sector. The proposed incentives for private-sector participation in public works projects--such as the long-planned Tokyo Bay and Akashi Straits Bridges--range from tax breaks and disguised subsidies to government loan guarantees. The Diet this spring approved exemptions from real estate and municipal taxes for firms participating in several small harbor projects, but has not yet addressed the financial requirements of the major public works. Although the details of "using private-sector vitality to promote public works" are still fluid--all projects apparently are decided on a case-by-case basis--Tokyo has included the concept in recent trade and economic policy packages. It was also cited in last April's Maekawa Commission report on restructuring as a principal means of boosting Japan's economic growth and thus imports. The idea of a larger private-sector role in public works has struck a responsive chord in Japan:

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- Both politicians and the influential construction industry appear to find the concept appealing because it promises large-scale public works in a time of fiscal austerity. Nakasone has occasionally emphasized the pork barrel nature of such projects.

- It allows Tokyo--at least on paper--to maintain a tight-fisted approach to the budget while describing to its trading partners the menu of infrastructure development planned for the remainder of the decade. 25X1

Recently Tokyo has included the joint public-private sector management of major infrastructure projects under the "private-sector vitality" heading as well. The new Kansai international airport project 25X1 is a case in point. The semiprivate company created to oversee the 25X1 construction has received capital contributions from the central and local governments as well as private businesses. The government also has granted tax concessions and promised subsidized loans. 25X1

Whatever the net economic effects of a mixed public-private sector approach to long-term capital development projects, Tokyo has taken advantage of the unique arrangement to protect Japanese business from outside competition. Japanese officials claim that, because the airport is not a government project, the GATT provisions on government procurement requiring open bidding for major contracts do not apply. The Transportation Ministry and the Japanese construction industry are pushing for similar arrangements for other large projects, such as the Tokyo Bay Bridge, the largest construction project now planned through the 1990s. 25X1

Other variations on the "private-sector vitality" theme--with minor implications for the long-run competitiveness of Japan's industry--appear to be in the offing. The newest interpretation, advanced by MITI, focuses on government efforts to foster basic research in emerging technologies such as informatics, and is part of MITI's goal of weaning the economy away from basic industries. Japanese firms have traditionally been more adept at commercial application of existing technologies than in attaining breakthroughs leading to new technologies or product categories. MITI hopes to close this gap in basic research by assembling researchers in key fields and tapping private-sector funds for research facilities. Government funds to construct facilities for cooperative research are also intended to enhance "private-sector vitality," but are unlikely to be forthcoming in quantities large enough to alter Japan's basic research capability. 25X1

"Private-Sector Vitality" and Restructuring the Economy

Nakasone's emphasis on his pledge to implement the recommendations of the Maekawa Commission, which produced its widely advertised report on steps to restructure Japan's economy away from export-led growth last April, appear to present the Prime Minister with several problems. Some of the suggestions of the Maekawa panel, such as reducing regulations that constrain housing construction, meet the

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criteria of enhancing economic vitality. Others, such as proposed reforms to discourage saving and reduce the workweek, obviously raise problems for many Japanese who regard them as reducing the ability of both the government and the private sector to respond to the challenges of the 1990s. In our view, Tokyo is certain to resolve this by choosing from the structural adjustment agenda items that coincide with plans to promote" private-sector vitality" (see table 2). Such measures will probably include a liberalization of coal imports, continued financial deregulation, and restructuring of increasingly uncompetitive industries such as textiles and steel. They are unlikely to include substantial cuts in income tax rates--unless accompanied by new revenue sources--or elimination any-time soon of tax-free savings accounts. [redacted] 25X1

Implications for Japanese Economic Growth

Tokyo's successful paring of the public sector--through both spending cuts and privatization--has, in our view, reinforced the private-sector's capacity to adjust quickly to economic change and helped prepare Japan to respond to the growth areas of the 1990s. The widely held desire to avoid "the advanced country disease" of escalating welfare spending and taxes will probably keep Japan on this path. Thus, barring an economic downturn far worse than we--or the Japanese--expect, we do not foresee Tokyo abandoning fiscal austerity in the next few years. The final report of the Administrative Reform Council, issued last month, calls for continued budget restraint, although it allows for fiscal "flexibility" in economic emergencies. The government, for example, is likely to favor a modest supplemental budget--on the order of $15 billion dollars--this fall. [redacted] 25X1

Nakasone, who quickly endorsed the final report, apparently also interprets the landslide election victory as widespread support for his economic policies. Since the election, he has called for another round of budget tightening in fiscal 1987, which begins on 1 April. Work by the OECD, as well as our own analysis, suggests that Japan's budget policy continues to hold growth below its potential and thus restrains imports. [redacted] 25X1

We also are pessimistic about the prospects for a substantial increase in infrastructure development resulting from reliance on "private-sector vitality." An assessment by the US Embassy in Tokyo suggests that the projects under consideration cannot be completed without substantial government contributions--either directly or as tax concessions. We agree with this view. Unless private firms can earn substantial profits--by setting high bridge tolls, for example--or have their costs reduced by government subsidies, they are unlikely to embark on such projects. The willingness of the government to commit substantial public resources to private projects, therefore, remains central to any upbeat expectations about their economic effect, as well as the main sticking point for Nakasone. [redacted] 25X1

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Table 1
"Private-Sector Vitality" and Economic Policy in Japan, 1983-86: A Sampler

Date	Policy/Event	Comment
1983	Nakasone speech on administrative reform.	The Prime Minister, who began talking about private-sector vitality from the time he took office in 1982, contended that if the government limited its role to supplementing the vitality of the private sector and to reducing the regulations that block the creative power of individuals and enterprises, the unlimited potential latent in the Japanese economy would automatically bloom.
Summer 1983	Formulation of Japan's 10th postwar "economic plan."	Drawn up by high level Economic Council to set economic objectives for 1983-90 but rejects detailed forecasts as inconsistent with market economy. Report advocated "harnessing the vitality of the private sector" but provided little in the way of specifics. 25X1
Fall 1984	Publication of Report of Nakasone's Special Advisory Commission on Economic Policy called "Economic Policy and Fostering Private-Sector Vitality."	Report, which set the economic agenda for Nakasone's second term, is responsible for popularizing the phrase "private-sector vitality." Its recommendations for using private funds to stimulate the economy and to pay for major infrastructure projects surfaced in almost all subsequent government economic packages as well as reports of other study groups on issues ranging from trade policy to the shape of the economy in the 21st century.

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April 1985	Market-opening package	Commission headed by former Foreign Minister Okita noted the advantages of reducing the burden on the public sector: "Japan is full of economic vitality, as it is less rigid in its price structure and flexible in its labor market in addition to having a high savings rate, high investment ratio, and advanced technology. Maximizing this vitality...will contribute to the development of the world economy." Report also called for using Japan's economic vitality to aid LDCs by economic and technological cooperation.
July 1985	Interim Report of Admininstrative Reform Council	Called for more deregulation by local and central government in the finance, transport, energy, and urban redevelopment sectors. Deregulation package based on these recommendations passed Diet in October 1985. Report called for "harnessing the vitality of the private sector" through deregulation.
Summer 1985	MITI proposes new center to support private-sector vitality.	Center apparently intended to foster cooperative R&D efforts by private firms in high-technology areas. A $27 million budget allocated for fiscal 1986.
October 1985	Pump-priming package	Included in list of measures to expand domestic demand: introducing private-sector vitality into public works. The intention was to create semiprivate entities that would function more or less the way independent public works authorities function in the United States. The prototype for this concept is the new Kansai airport.
February 1986	Government introduces Private-Sector Vitalization Bill in Diet	Core of policy adopted in spring of 1986 to expand domestic demand. The bill targets six types of facilities for private-sector participation: research and development of industrial technology, telecommunications, news media center, cooperative use of facilities for telecommunications research, facilities for international exchanges such as trade fairs, and facilities to improve harbor use, such as passenger terminals. Participation will be encouraged by tax credits and government guarantees for funds borrowed by private firms for projects.
April 1986	Maekawa Report	Recommendations to promote housing and urban development focused on "mobilization of private-sector vitality" and deregulation. Called for retaining basic goal of fiscal austerity to enhance "economic vitality."
May 1986	Bank of Japan Special Report on Impact of Deregulation	Report concluded that deregulation and encouragement of private-sector investment, including private capital for Kansai airport, will boost GNP by 1.1 percent over the next year or two. Supports well-known Bank of Japan stance that economic stimulus is not needed because the private sector will soon recover from deflationary impact of strong yen.
July 1986	Nakasone's Postelection Press Conference	Nakasone asked MITI Minister Watanabe to work out by fall "bold" measures to stimulate domestic demand by capitalizing on the resources of the private sector as well as "some" increase in government spending.

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Table 2

Private-Sector Vitality and Structural Adjustment:
Probable Japanese Positions on Key Issues*

ISSUE	Probable Japanese Response
Deregulation	Support in principle; will continue with JNR and NTT privatization but regulations governing the distribution system will be defended.
Coal imports	Pressure from users of high-priced domestic coal plus high cost of subsidies leading Tokyo to slowly phase out protection.
Financial liberalization	Will continue with items agreed to in yen/dollar talks to have an internationally competitive financial sector, but Tokyo does not intend to liberalize its financial activities as much as the United States has.
Direct investment	Promoting outward investment to ease trade friction and encourage industrial restructuring.
Industrial Restructuring	Long-term plan to reduce size of uncompetitive industries such as textiles, steel, shipbuilding, should eventually increase imports although not necessarily from the US. MITI using strong yen to help with politically difficult task of reducing the uncompetitive small-business sector to free resources for more productive uses.
Housing Construction	Favor incentives in principle and may offer improved mortgage terms; key is availability of land restricted by zoning provisions and tax policy.
*Infrastructure Development	Modest increase likely in public works budget next year, but large scale projects will be promoted through private-sector vitality--that is, few new ones likely.

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*Represents our best judgment of Japanese consensus after assessing positions of business community, key ministries, and political leaders. Starred items represent issues on which private sector vitality concerns run counter to Maekawa Commission proposals. [redacted] 25X1

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*Budget austerity

Modest supplemental budget likely this fall, but GNP growth rate for FY 1986 probably will fall short of Tokyo's 4% forecast. Finance Ministry planning more spending cuts in FY 1987.

*Labor market changes

Although publicly supporting idea of shorter workweek, Tokyo will resist measures--such as conversion of bonuses to salary payments--that reduce flexibility, which it believes aided in Japan's quick recovery from the last oil price hike.

*Tax-free savings

Nakasone promised during election campaign not to touch tax exemption despite Maekawa recommendation. [redacted]

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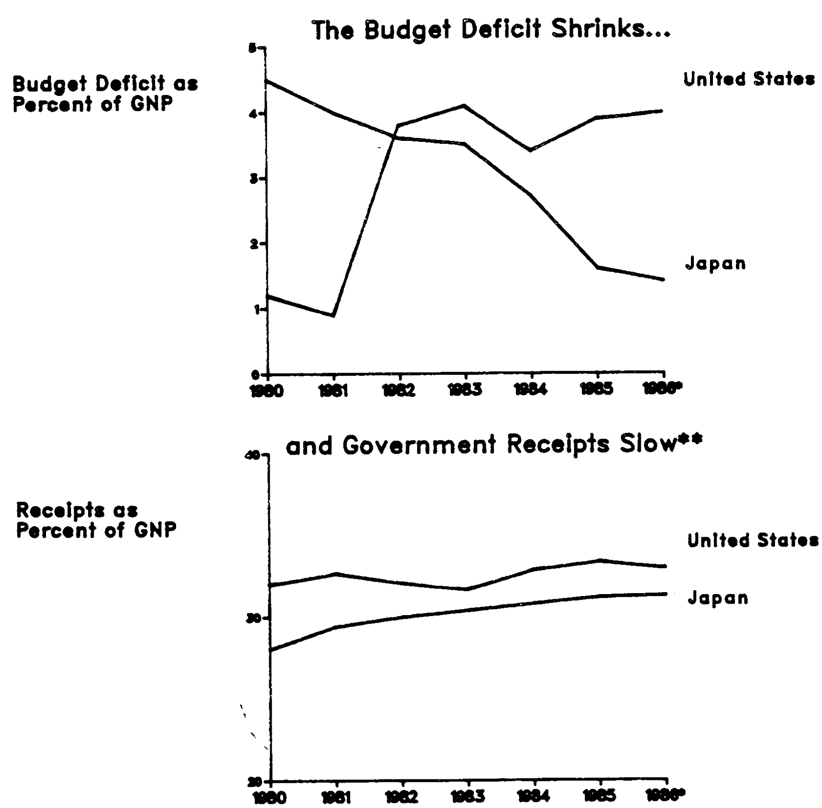
Japan: Public Sector Trends



*1986 data projected
**Receipts are principally taxes and social insurance contributions.

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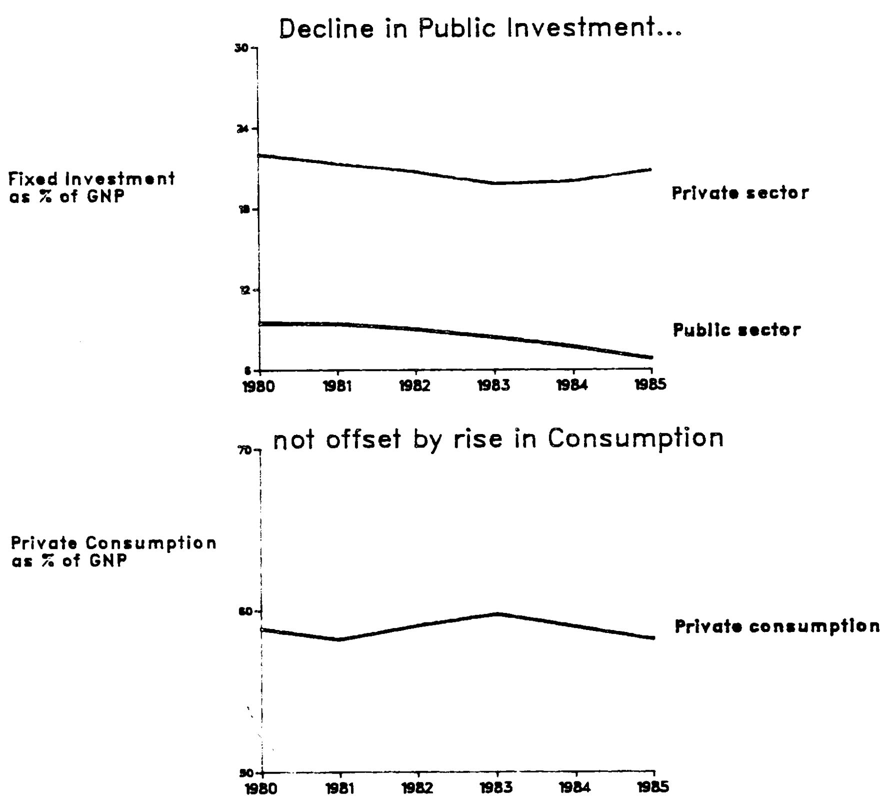
Japan: Private Sector Trends



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