A Blueprint for Reforming Japan

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Japan is poised to pick its third prime minister in three years. The hope that the "lost decade" of economic growth was over has been shattered as the economy has begun contracting again. Economic anxiety is the leading concern of the Japanese people. Politicians from both the ruling coalition and the opposition are going back to the old playbook and trying to address people's fears by limiting market competition and protecting inefficient sectors. To them economic anxiety is a result of the reform agenda of former Prime Minister Junichiro Koizumi’s government, which introduced more competition into the economy.

This diagnosis is superficial and misses the deeper point that growth has been anemic even during the expansion of the last several years. The fragile recovery meant that many people did not see their situations improve. Rolling back reforms in the name of protecting the weak will prolong the economic stagnation and worsen economic anxiety. What Japan needs now is more, not fewer, reforms. If the next prime minister does not understand this, Japan will see yet another new prime minister again next year.

The proposals that follow are our blueprint of reforms to reinvigorate the Japanese economy. They are based on the unifying principle that economic peace of mind depends on sustained growth. In particular, healthy growth in a mature and aging economy like Japan's requires a continuous improvement of the economy that is fueled by productivity advances. In what follows, we focus on five specific policy changes.

First, the government should stop subsidizing, directly or indirectly, the most inefficient parts of the economy. Protecting weak sectors retards the growth of innovative sectors. One prominent protected sector is small business. Last month, the government proposed the Emergency Policy Measures for Achieving Peace of Mind. A major component of the package related to helping small firms, including via subsidized lending. Small Japanese firms are, on average, far less efficient than larger firms. Keeping the weakest ones afloat puts a speed limit on growth. Admittedly some of the measures in the proposal, such as monitoring large firms' abusive practices against small firms, are reasonable, but the overall continuing protection of small firms just lowers the rate of economic growth.

Similarly, generous subsidies to agriculture protect inefficient part-time farmers and prevent the
all-too-rare full-time, productive farmers from expanding. The government's stimulus plan calls for strengthening the competitiveness of agriculture, but still includes many general subsidies. This hurts Japan in more ways than one. The export sector in general is Japan's crown jewel, and would flourish from a more liberal world trading system. Yet the latest world trade negotiations broke down over disagreements about farm subsidies. While Japan was not at the center of that dispute, Japan was not a leader in seeking the dismantling of subsidies, either. The protection of farming also holds back growth via this indirect channel.

The third reform we propose is the introduction of a more comprehensive taxpayers' identification system to make income taxation fairer and more efficient. One important way tiny firms and farmers get subsidized is through taxation. Because large corporations are required to withhold taxes before they pay their employees' salaries, the tax agency has fairly precise information about the salaried workers' taxable income. Farmers and self-employed workers are not required to have taxpayer IDs. This facilitates the underreporting of their income and complicates the ability to track retirement contributions.

A more comprehensive taxpayers' ID system will increase the tax base and help narrow the budget deficit as well. Restoring fiscal sustainability for the public sector is an important medium-term policy goal. This includes the sustainability of the social security system as well as the budgets of central and local governments. Indeed the uncertainty about how much taxes and contributions will be raised and how much public services will be reduced is an important source of economic anxiety today. Figuring out how much people are earning and paying in taxes and contributions is necessary to achieve fiscal sustainability and eliminate an important part of economic anxiety.

Fourth, Japan needs to reform immigration policy. The aging of the Japanese population guarantees a declining work force. Therefore, efficiency enhancements alone will not be sufficient for maintaining the quality of life. Encouraging higher labor participation by women and old people will help, but is probably not enough. Economic stagnation has hidden the impending aggregate labor shortage problem, and the sooner this issue is addressed, the better.

Japan has been gradually accepting foreign workers, targeting temporary workers for mostly low-skilled jobs. Current policy also is tilted to foreign workers with Japanese ancestors. Immigration should be expanded to draw in more foreign workers with various skills, especially high-ability professionals who would stay in Japan longer and contribute to growth. The reform must include not only opening the country for more foreigners but also measures to integrate them into society. These changes will not be easy to implement, and will require collaboration of many parts of the government, but they are imperative to undertake.

Finally, improving monetary policy making is also important. Until very recently Japan has been mired in the unusual experience of deflation for more than a decade. This made it difficult for the central bank to define its primary mandate -- price stability -- and to communicate to the market how the bank intends to achieve it. Today's inflationary environment actually provides a good opportunity for the central bank to make the shift to a much more standard Bank of England-style monetary policy framework with a targeted inflation range safely away from zero inflation. This shift will help the Japanese central bank bolster its independence by establishing an unambiguous benchmark for evaluating its performance and providing a strategy for organizing its communications. It will also enhance the transparency of monetary policy and reduce macroeconomic uncertainty.

Our proposals are bold and some who will face the restructuring will resist the changes. Reformers need to stress the fact that the status quo has been shown to be a failure. The same
doubts about the feasibility of fundamental change were raised in opposition to the Reagan and Thatcher proposals for deregulation in the United States and Britain. Those programs, however, set the stage for long periods of prosperity in those countries. The same is possible in Japan if a leader with the right vision takes charge.

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