Deregulating the Japanese Economy

On April 6 the Cato Institute and the Japanese business association Keidanren cosponsored a conference in Tokyo, "Deregulation in the Global Marketplace: Challenges for Japan and the United States in the 21st Century." Among the speakers were Cato Institute chairman William A. Niskanen; Jesper Koll, vice president of J. P. Morgan Securities Asia; Brink Lindsey, director of Cato's Center for Trade Policy Studies; and Alan Reynolds, director of economic research at the Hudson Institute. Following are excerpts from their remarks.

William Niskanen: The four major challenges that Japan and the United States will face in the next century are technology, trade, demographics, and politics. The one common theme is that individuals, firms, and national economies will prosper to the extent that they regard change as an opportunity, rather than as a threat.

New technology is reaching a broad market much more quickly. In the United States, the time from first demonstration of a new technology to its use by a quarter of the population was 55 years for the automobile, 26 years for television, 13 years for the cellular phone, and 7 years for the Internet.

We now appear to be at the dawn of a third industrial revolution, one based on the dramatic reduction in the cost of storing, retrieving, processing, and transmitting information that is made possible by digital technology.

In the workplace, organizations will become flatter. The Internet and organization-specific intranets will reduce the relative number of middle managers and middle staff positions. For a while, maybe for a generation, the relative earnings and influence of computer-literate employees, often younger employees, will increase. More employees will telecommute more of the time. Organizations will also subcontract tasks, often to other countries, the output of which can be transmitted on-line.

One old rule is even more important: Information is power, for individuals acting alone and for those within an organization. As more information is generated and made available to virtually anyone, inefficiencies and failures are more rapidly exposed,

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enhancing the role and influence of performance-based management systems. One of the young sages of this new technology has described this development as "the end of the official story."

The primary new effect on the marketplace will be to reduce the relative number of agents: travel agents, real estate agents, securities brokers, auto dealers, other retailers, and so forth. Sellers will find new ways of communicating with potential buyers without someone acting as liaison. Consumers will find new ways of shopping, such as scanning the options on-line and then asking for bids to sell a specific new model car. That will lead to lower and more uniform prices, by reducing both selling costs and inventories. The elimination of any significant distance effect on the costs of communication, of course, will accelerate the globalization of commerce.

The home, in contrast to the firm, will be *less* specialized, serving as the locus of many different activities formerly conducted in different locations. More adults will work at home; more students will study at home, with access to superior on-line instruction and libraries; a wider variety of entertainment will be available in the home. People will also have more choice of *when* they want to participate in such activities.

George Orwell's vision of the political effects of electronic technology, of course, was most ominous. Orwell feared that the ubiquitous telescreen would greatly increase the power of the state to monitor and control individual behavior. So far, fortunately, Orwell's fears have not been realized. The essential feature of government is its monopoly of the legal right of coercion in some defined space. Yet the obvious and dominant political effect of digital technology, because it reduces the economic role of space, is to reduce the monopoly power of government to tax and to regulate.

Politics will present a continuing major challenge for capitalism. The success of any economic system will depend on low marginal tax rates, limited and transparent regulation, a stable monetary framework, and a nondiscriminatory legal framework. Capitalism, however, is especially dependent on an effective agent to protect capital against both internal and external predators, and government is usually the most efficient such agent. The historical challenge has been to ensure that government does not use its power to become the dominant predator.

For most of human history, of course, the government *was* the dominant local predator, using tribute to build pyramids, palaces, and empires. Markets and private property were tolerated only to the extent that they increased the net returns to the government. Many governments in Africa are best described as "kleptocracies" even today.

Over the past several centuries, however, most governments have become increasingly responsive to the consent of the governed—a development, even if subject to occasional abuse or reversal, that we should welcome. A broader franchise has increased the number of people who share the net benefits of government but, by itself, has not much reduced the magnitude of coercive redistribution. The key difference between an exploitive majoritarianism and a just democracy is that in the latter the rules by which the government operates—the constitution—reflect a much broader and more stable consensus.

In the modern world, unfortunately, both capitalism and constitutional government are undermined by using the powers of government to serve special interests. Firms and industries that seek special favors are part of the problem—they encourage other firms to seek similar favors, corrupt the political process, and undermine political support for capitalism.

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In this sense, every firm that seeks a special favor creates a public bad. The larger problem, however, is the welfare state, a consequence less of the avarice of governmental officials than of being overly generous with other people’s money, time, patience, and goodwill. Any one firm is torn between playing the game to gain a special favor and supporting a principle to preserve the system. That is why it is especially important for broad-based business organizations like the Keidanren to maintain their support for the principles that preserve capitalism and constitutional government.

Jesper Koll: “For the first time, economics is coming to Japan.”

Jesper Koll: The Big Bang—the large-scale financial deregulation that is just getting under way—is part of a tremendous restructuring of Japan’s entire economic system. For the first time, economics is coming to Japan.

What is economics? Economics is the allocation of scarce resources. In Japan until 1990, there were never any real scarcities. Your labor force was growing, your land prices were going up, your economy was growing at 5 to 7 percent on a nominal basis. That has come to an end, and as a result Japan is forced to restructure its entire economic system. First, look at the rate of return on capital in the business sector, that is, the efficiency with which the economic system allocates capital for productive purposes. Japan has fallen behind even the European Community, and of course behind the United States. I think it is the realization that Japan *could* become a second- or third-rate power in the 21st century that is unleashing a demand for policy change in the business community.

Another element in the rethinking is the pension crisis. Japanese society is aging very fast. The pension crisis is not a problem of the future; it is a problem now. Since 1991 pension fund returns have fallen short of obligations. And as a result of that shortfall, Japanese pension managers have had to sell assets.

One other element is very important. The Japanese government is earning a higher return on financial assets than is the household sector. That is happening because the public sector’s role in the financial system has been getting bigger and bigger. One-third of financial intermediation is being done by the public sector. And as a result, the postal savings system actually generates higher returns than average investors can get. That situation is starting to generate tremendous political pressure.

Another real concern is the fact that Japan’s economy is going to slow down. At J. P. Morgan, we expect that the average growth rate over the next decade is going to be around 1.5 percent, at best. Why is it slowing down? The answer has to do with the factors of production—labor, capital, and land. In Japan the fundamental factor of production, labor, is actually starting to decline. The labor force grew annually by 1 percent on average in the 1980s, but from now on it will contract by half a percent. So there is a natural reduction in the rate of growth. Japan now is the only G-7 country that has net emigration. It’s a brain drain from Japan, and the impact on growth is, of course, negative.

Look at the second factor of production, capital—not money, but the capital stock. How much capital does Japan need to generate one unit of gross domestic product? At the time of the first oil shock, Japan needed one unit of capital to produce one unit of growth. Today Japan needs 1.8 units of capital for one unit of growth. Your country is very capital intensive already. So, as a result, the policymakers are trying to come up with a new paradigm of growth that would foster new investment opportunities through deregulation. Deregulation over the next decade will add between 5 and 7 percent to Japan’s potential GDP. However, at first the impact will be negative: the inefficient producers will have to go, and only then will we see a recovery.

Brink Lindsey: “When it comes to U.S. demands on Japan, three out of five right is good.”

And that is exactly what Big Bang is doing. Big Bang will bring about new producers and a new economic recovery in Japan. The old way of moving savings into investments was directly through straight deposits and loans or indirectly through mutual funds, insurance companies, pension funds. Big Bang opens up all the doors of competition. There is free entry for banking, insurance, and brokerage companies. The destruction of the old cartels in the financial service industry is what Big Bang is all about.

That will create a lot of failures. At J. P. Morgan, we think that about one-third of Japan’s financial companies will not exist in their current equity ownership form in three to five years. There will be mergers, foreign takeovers, and bankruptcies. At the same time, with deregulation a new mode of intermediation and disintermediation is being opened up. New companies that provide specialized financial services are going to spring up, and that will generate employment. Let me use an American example: between 1989 and 1993, one-third of American banks closed down. However, at the same time, the financial system as a whole generated 2 million new jobs. And that is the opportunity that Big Bang is going to provide the Japanese economy.

Brink Lindsey: In the 1970s and 1980s, a series of large and prominent U.S. industries found themselves under competitive assault by Japanese companies. Those industries

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included consumer electronics, automobiles, and semiconductors. At the same time, Japan as a whole was growing and advancing much faster than the United States, and extrapolation suggested that it would soon overtake the United States as the world's leading economic power. Finally, it was clear that Japan's economic system was significantly different from the American model. The differences included the close and informal ties between industry and government, stable cross-shareholding, and heavy reliance on relationship-based bank financing rather than impatient capital markets, *keiretsu* alliances with suppliers and distributors, and lifetime employment arrangements.

Many influential U.S. observers fundamentally misinterpreted the situation. They concluded that the Japanese system of political economy, widely known as "Japan, Inc.," was superior to the American system; that Japan, Inc. was fundamentally protectionist and predatory; and that a sharp deviation from the normal liberal trading rules was therefore necessary to avoid worldwide economic domination by Japan. In particular, they argued for high tariffs or restrictive quotas on Japanese imports, and for explicit market-share commitments for foreign products in the Japanese market—in other words, managed trade or results-based trade.

If the so-called revisionists were wrong, what then was really happening? First, Japanese companies had developed new and superior manufacturing techniques, including such innovations as continuous improvement and just-in-time inventory. Those innovations were sufficiently important that they distinguished a new system of so-called lean production from traditional mass production. Armed with superior techniques, Japanese companies did indeed pose a formidable competitive challenge in selected industries, although certainly not across the board.

Second, Japan as a whole was experiencing continuing high growth and rapid advancement because it was playing technological catch-up with the West. It is much easier to grow and improve productivity quickly when you are adopting and adapting technologies invented elsewhere than it is when you have to develop those new technologies yourself.

And market forces, not interventionist trade policies, were ultimately responsible for making the dire predictions of an unstoppable Japanese juggernaut look foolish in retrospect. First, with often-painful restructuring, U.S. companies adopted the new lean production manufacturing techniques and regained their competitiveness. At the same time, Japan's economic performance naturally slowed as the country reached the technological frontier. The limits of industrial policy were revealed, as such fiascos as the Fifth Generation Computer Project and the HDTV initiative showed.

Indeed, it turned out that the Japan, Inc. system of political economy was much better suited to playing catch-up than it was to fostering growth at the cutting edge. In particular, the clubby, relationship-based system of allocating capital now looks dreadfully wasteful and inefficient.

Alan Reynolds: "Japan is now more hostile to capital than is the United States."

The stereotype of Japan as a closed market remains, but the stakes have gotten dramatically lower. Gaining access to the Japanese markets continues to be important for particular companies, but there is no longer a widely held perception that we as a nation are threatened by Japan.

Today, criticism of Japan focuses on its failure to stimulate domestic economic growth that would absorb exports from the other ailing economies of the region. Beyond the complaint that "Japan is not bearing the burden of leadership"—as if pulling itself out of stagnation should be seen as a burden—there is the fear that the financial collapse of Japan could precipitate a global economic downturn.

Those new complaints about Japan, Inc. have implications very different from those of the complaints that dominated the 1980s. Most prominently, the United States is no longer pushing for deviations from free-trade principles: there are no serious calls for import restrictions, the demands for market-share targets have little steam, and there is no significant support for further currency manipulations.

Instead, the main U.S. proposals today are for Japan to cut taxes, boost spending, clean up the banking mess, deregulate the financial sector, and enforce the Antimonopoly Act more vigorously. Of those five reform proposals, only two are bad ideas. Keynesian public works spending has been tried on a massive scale over the past decade, and it has been a total failure. Most of the money has been utterly wasted, and all there is to show for the spending is a ballooning public debt. Increased antimonopoly enforcement is a blind alley. U.S. complaints are aimed at undermining *keiretsu* ties with suppliers and distributors, but government second-guessing of those arrangements is a quagmire where it is much easier to do harm than good.

Still, three of the items on the U.S. wish list—cutting taxes, resolving the bad debt crisis, and liberating the financial sector—are good ideas. When it comes to U.S. demands on Japan, three out of five right is an unusually good score.

Alan Reynolds: American economists have been giving policy advice to Japan since the Shoup Tax Reform Commission of 1949. Even then, the advice was not always helpful.

Rather than rely too heavily on economic theory, or on foreign advice, it is often useful for a country to reexamine its own history (and that of its neighbors) to see which policies were followed by prosperity and which were not.

In the late 1940s, the American occupation imposed brutal income tax rates on Japan, as high as 86 percent on income above 5 million yen. That was a central part of a severe austerity program, *not* a plan to

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“Marginal tax rates on capital and human capital are much too high in Japan, sapping entrepreneurial vitality.”

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promote economic growth. As Edwin Reischauer pointed out at the time, “Steeply graduated income taxes and inheritance taxes have been adopted to prevent in the future the accumulation of . . . concentrations of wealth.” But taxes designed to punish additions to *income* must also punish additions to *output*—economic growth. So Japan set out to free itself from the oppressive occupation tax regime.

From 1950 to 1974, Japan cut taxes *every year* (except 1960), often by greatly increasing the income thresholds at which the higher tax rates applied or by enlarging deductions and exemptions. The taxable income needed to fall into a 60 percent tax bracket was raised to 3 million yen by 1953, for example, compared with only 300,000 yen in 1949. The Shoup Commission’s net worth tax was also abolished in 1953. The sting of high tax rates was further neutralized by exemptions for interest income and capital gains, deductions from corporate and individual taxes on dividends, a deduction for earnings, and various other holes in the tax base, legitimate and otherwise.

Some deductions were far from neutral, and therefore less desirable than lower tax rates would have been. Yet the continual tax reductions from 1950 to 1974 accomplished two things. First, they greatly reduced effective marginal tax rates. Second, they moved the system a long way toward what is sometimes called a “consumed income tax” or “expenditure tax”—that is, a system that taxes income only once, regardless of whether the income is saved or devoted to immediate consumption.

Before 1975 tax policy greatly reduced marginal tax rates and eased the multiple taxation of saved income. Economic growth in Japan averaged 9.6 percent a year from 1952 to 1973.

From 1975 to 1987, “bracket creep” and higher social security taxes reversed much of the previous progress on marginal tax rates. Economic growth slowed to 4.3 percent from 1975 to 1991.

After 1989 tax policy also *reversed* much of the previous progress toward neutral treatment of savings. Tax rates on new capital investments increased (for individual investors). Economic growth slowed to 1.2 percent from 1992 to 1997. To continue blaming the change on the “oil shocks” of the 1970s, as many do, is no longer plausible. Oil has been very cheap for more than a dozen years.

Before 1985 Japan had much lower tax rates on capital than the did the United States. Since then, the situation has been reversed—*Japan is now more hostile to capital.* Little wonder that Japan’s domestic investment is weak and capital flows out.

It would be wonderful to see Japan embrace some sort of fundamental tax reform, perhaps borrowing ideas from Hong Kong or Singapore, but that might take more time than the present situation will allow.

The essential point is that marginal tax rates on capital and human capital are much too high in Japan, sapping the entrepreneurial vitality of the economy. The highest tax rates do the most damage to the economy in return for the least revenue.

Economic growth requires more and better capital, including human capital. All taxes, including taxes ostensibly levied on corporations, fall on individual suppliers of labor and capital or on consumption. Even consumption taxes are really production taxes. Taxes on a company’s stockholders, workers, and consumers hurt business; and taxes on business hurt stockholders, workers, and consumers. Excessive tax rates on capital hurt labor by reducing investment and therefore slowing the growth of real output and income per hour of work. Demoralizing tax rates on labor likewise hurt capital by raising reservation wages, shortening lifetime work hours, and reducing the intensity and quality of work.

If Japan continues to embrace the tax and spending policies of Europe and Scandinavia, nobody should be surprised if economic performance becomes as disappointing as it has been in those areas. Without more vigorous economic growth, Japan’s future budget problems could become far more difficult. Philosophers are free to debate “equity” all they like. But the serious question to ask about the structure of tax incentives is the question that was at the top of Japan’s list in the 1950s: *How will this tax proposal help economic growth?* An economy that is taxed into oblivion will not help anyone—not the poor, and not even the politicians. ■

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the Cold War, even that number is much too high.” To justify keeping more submarines than are really needed, “the Navy began assigning 2 vessels to protect each of the 12 aircraft carrier battle groups,” a mission that is “unnecessary and impractical.” Eland concludes that “a foreign policy that used military force sparingly and only as a last resort would allow the United States to reduce the number of submarines required for fighting wars. A smaller fleet of about 25 submarines . . . would be more than sufficient to fight one major theater war” and to serve as “a hedge against the improbable reconstitution of the Russian submarine fleet.” ■

Cato Calendar

Cato University Economics and History Seminar
Chicago • Intercontinental Hotel
September 4–6, 1998
Speakers include Steven Landsburg, Steven Davies, and Nathaniel Branden.

Cato University Law and Philosophy Seminar
San Francisco • Radisson Miyako Hotel
October 9–11, 1998
Speakers include Randy Barnett, David Kelley, and David Friedman.

Money in the New Millennium: The Global Financial Architecture 16th Annual Monetary Conference
Washington • Cato Institute
October 22, 1998
Speakers include Lawrence H. Summers, William Poole, Jeffrey Sachs, Robert Mundell, and Steve Hanke.

Washington, D.C., vs. Silicon Valley 2nd Annual Conference on Technology and Society
Cosponsored with *Forbes ASAP*
San Jose • Fairmont Hotel
November 19–21, 1998
Speakers include Milton Friedman, Scott Cook, Eric Schmidt, T. J. Rodgers, and William Melton.

Eleventh Annual Benefactor Summit
Cabo San Lucas, Mexico • Melia Los Cabos
February 17–19, 1999