OECD Economic Surveys
JAPAN

April 2011

OVERVIEW

Summary

The 11 March 2011 Great East Japan Earthquake was the strongest ever recorded in Japan and triggered the country's worst disaster of the post-war era. We express our deep sorrow at the enormous loss of life and offer our condolences to those affected by this tragedy. The OECD will be working closely with the Japanese authorities in the coming months and is ready to assist them in any way we can at this difficult time.

While it is still too early to assess the full extent of the damage, the immediate impact will be to reduce output, although this will later be reversed by reconstruction efforts. Deflationary pressures are likely to remain a headwind to growth. The Bank of Japan should thus maintain an accommodative stance until deflation is overcome, paying attention to downside risks. The monetary policy framework could be improved, in part by raising the "understanding" of price stability to ensure more of a buffer against deflation.

The priority for Japan is to address the humanitarian and reconstruction needs, along with the nuclear situation. This inevitably creates the need for short-term increases in public spending. Nonetheless, in light of the debt situation, this may need to be funded by shifting expenditures and by short-term increases in revenues, appealing to the Japanese people's sense of solidarity.

The fiscal situation has reached a critical point. Chronic budget deficits were projected to push up gross public debt to an unprecedented 200% of GDP, and net debt to 115% in 2011. A credible and detailed medium-term consolidation plan that includes spending cuts and tax increases will thus be a top priority, while taking into account the need for reconstruction spending. The Fiscal Management Strategy should aim at a primary budget surplus large enough to stabilise the debt ratio by FY 2020, which may require as much as a 10% of GDP improvement in the primary budget balance. A detailed fiscal plan should be accompanied by social security reform to limit spending pressures due to rapid population ageing. Much of the deficit reduction will have to be on the revenue side, mainly through hikes in the consumption tax. Achieving the fiscal target may require that its rate be increased to as high as 20%, even if spending (excluding social security and interest payments) is held constant in real terms. In view of the severity of Japan's fiscal predicament, a reform of the fiscal framework may help achieve the fiscal targets and bolster credibility, helping to mitigate the risk of a run-up in long-term interest rates.

Sustaining economic growth through the New Growth Strategy. Stronger growth is also important to stabilise the debt ratio. The Strategy's objective of increasing demand in four areas – green innovation, health care, economic integration with Asia and regional development – should rely primarily on regulatory reform rather than on costly fiscal measures. In addition, the Strategy should emphasise economy-wide reform rather than focus on specific sectors. There is ample scope to boost demand through green innovation, but this will require market-based instruments placing a price on carbon – preferably through an emissions trading system – to promote private investment. Economic integration, by removing barriers to inflows of goods, foreign investment and foreign workers, should be promoted, in part, by comprehensive trade agreements. The high level of agricultural support should not be allowed to stymie Japan's participation in such agreements.

Reforming the education sector. Educational outcomes, which play a key role in productivity growth, could be improved by greater investment in early childhood education and care. The New Growth Strategy's plan to integrate childcare and kindergarten would help improve educational quality while allowing cost savings. The tertiary sector should be improved by strengthening competition through increased transparency about quality and by enhancing internationalisation, enabling universities to make a greater contribution to innovation. Given high tuition fees, ensuring access to student loans and making repayment income-contingent would improve equity. So would reducing dependence on private, after-school educational institutions, which place a heavy burden on families. Another priority is to improve vocational education to reflect changing labour market needs in the context of increasing dualism.

Addressing labour market dualism. Although the rising share of non-regular workers has helped firms to increase employment flexibility and cut wage costs, such workers face low pay, less training, precarious jobs and poor social insurance coverage. Reducing labour market dualism requires a comprehensive approach that includes greater social insurance coverage of non-regular workers, better training programmes, preventing discrimination against non-regular workers and lowering effective employment protection for regular workers. With the working-age population set to fall by almost 40% by 2050, it is essential to fully utilise Japan's human resources, including women and older persons. Female participation could be boosted by increasing the availability of childcare, promoting better work-life balance and reforming the tax system. The mandatory retirement age, set at 60 by most firms, should be abolished to encourage better use of older workers.

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The economic outlook following the Great East Japan Earthquake

Japan has been hit by its worst disaster of the post-war era…

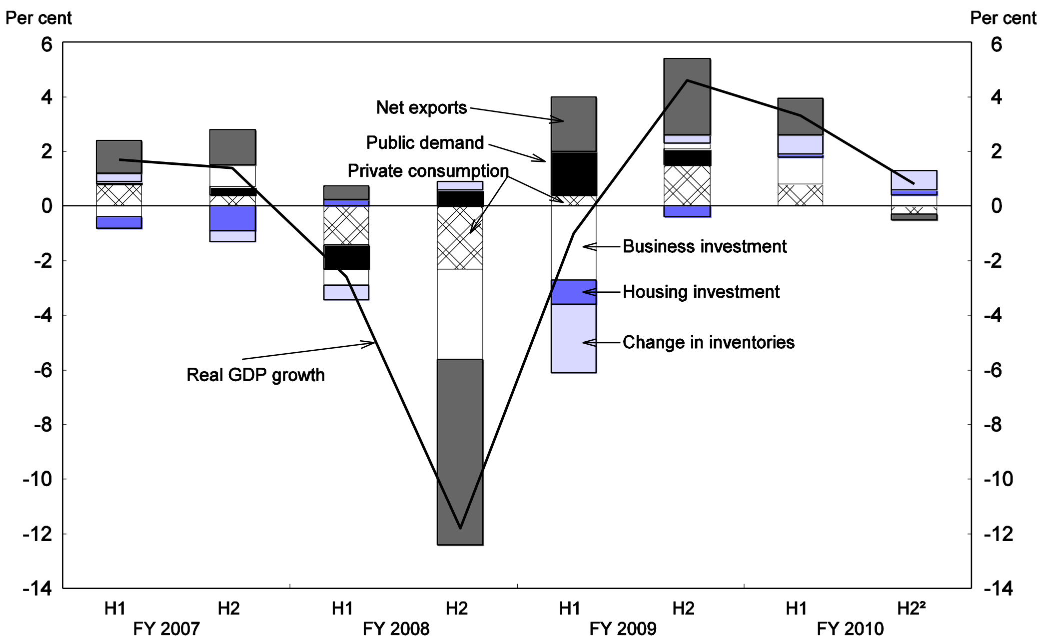
The Great East Japan Earthquake on 11 March 2011, the strongest ever recorded in Japan, led to a tsunami and an enormous loss of human life, as well as massive economic damage. The impact has been exacerbated by the damage to thermal and nuclear power plants, which has significantly reduced electricity generation. While it is still too early to assess the overall impact, it is likely to exceed the damage to the physical capital stock caused by the 1995 Hanshin-Awaji (Kobe) earthquake, which is estimated at 2% of annual GDP. A key priority has been to address the serious humanitarian needs resulting from the disaster.

…which will shape the path of the economy in 2011-12

It is also premature to assess the impact on economic growth, which had been projected at around 1¼ per cent during 2011-12. In early 2011, Japan had shown signs of emerging from the economic slowdown that occurred in the latter part of 2010. The immediate impact of the disaster will be to reduce economic activity, with the extent and length of the decline depending, in part, on how quickly the supply of

Japan's economic recovery

Contribution to growth in percentage point[1]



1. Given that Japan's fiscal year begins in April, the first half of each fiscal year includes the second and third quarters of the calendar year, while the second half includes the fourth quarter and first quarter of the following year.
2. The second half of FY 2010 combines the fourth quarter results with the Secretariat projections for the first quarter of 2011 published in *Economic Outlook*, No. 88.

Source: Cabinet Office, *National Accounts*, and OECD (2010),*OECD Economic Outlook,* No. 88 (November 2010).

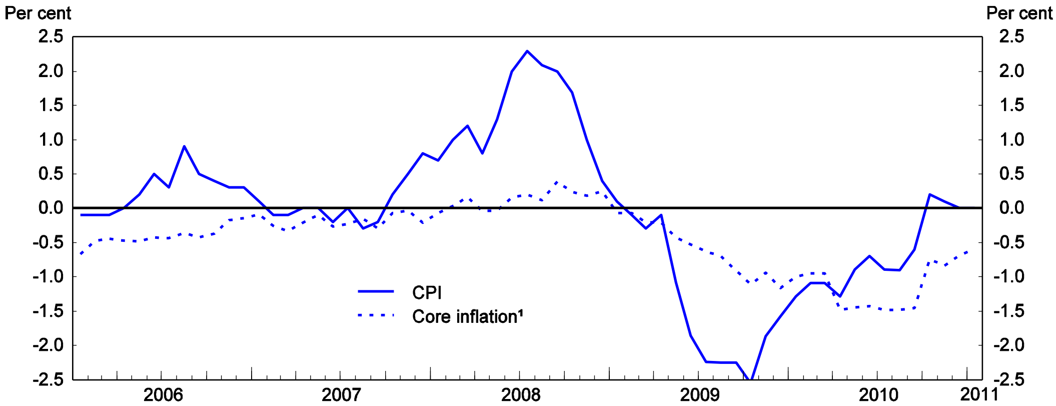
electricity is restored. Moreover, the adverse effects in areas hit by the disaster may spread to other parts of the country and overseas, in part by disrupting global supply chains. As in past disasters, the downward impact on activity is likely to be reversed as reconstruction efforts boost private and public investment, making an extended downturn unlikely. In addition to the uncertainty resulting from the earthquake, there are significant downward risks related to developments in the world economy, exchange rates and commodity prices. Most importantly, however, the unprecedented level of public debt makes Japan vulnerable to a rise in long-term interest rates.

Continued deflationary pressure is likely

The pace of growth may not be sufficiently rapid to close the output gap before the end of 2012, notwithstanding the uncertainties arising from the negative supply effect of the earthquake and subsequent reconstruction spending. As a result, deflationary pressure is likely to persist. Inflation, as measured by the headline consumer price index (CPI), turned positive in the final quarter of 2010 but this reflects a large tax hike on cigarettes and a surge in food prices. The core CPI, meanwhile, fell 0.8% on a year-on-year basis, albeit at a slower pace than previously. Chronic deflation has reduced the GDP deflator by 14% since 1998, despite the longest expansion in Japan's post-war history between 2002 and 2007. Deflation hampers growth by keeping real interest rates too high and squeezing corporate profits, resulting in downward pressure on wages and employment.

Consumer price developments

Year-on-year percentage change



1. OECD definition of core inflation, which excludes food and energy prices.

Source: *OECD Economic Outlook Database.*

Monetary policy

The Bank of Japan should keep an accommodative stance to ensure deflation is overcome…

The Bank of Japan reacted promptly following the disaster by providing liquidity on a large scale to stabilise financial markets. There was also intervention in foreign exchange markets as part of a multilateral commitment by G7 finance ministers and central bank governors to reduce exchange rate volatility. In addition, the Bank announced that it would double the size of the asset purchase programme to 10 trillion yen (2% of GDP) to prevent a deterioration in business sentiment and an increase in risk aversion. The programme was originally part of the "comprehensive monetary easing" launched in October 2010 to fight deflation by:

i. Establishing an additional asset purchase programme of initially 5 trillion yen that includes 3.5 trillion yen of government securities and 1.5 trillion yen of corporate bonds, commercial paper and real estate investment trusts, in an effort to reduce long-term interest rates and risk premiums;

ii. Reducing the policy interest rate from 0.1% to between 0 and 0.1%; and

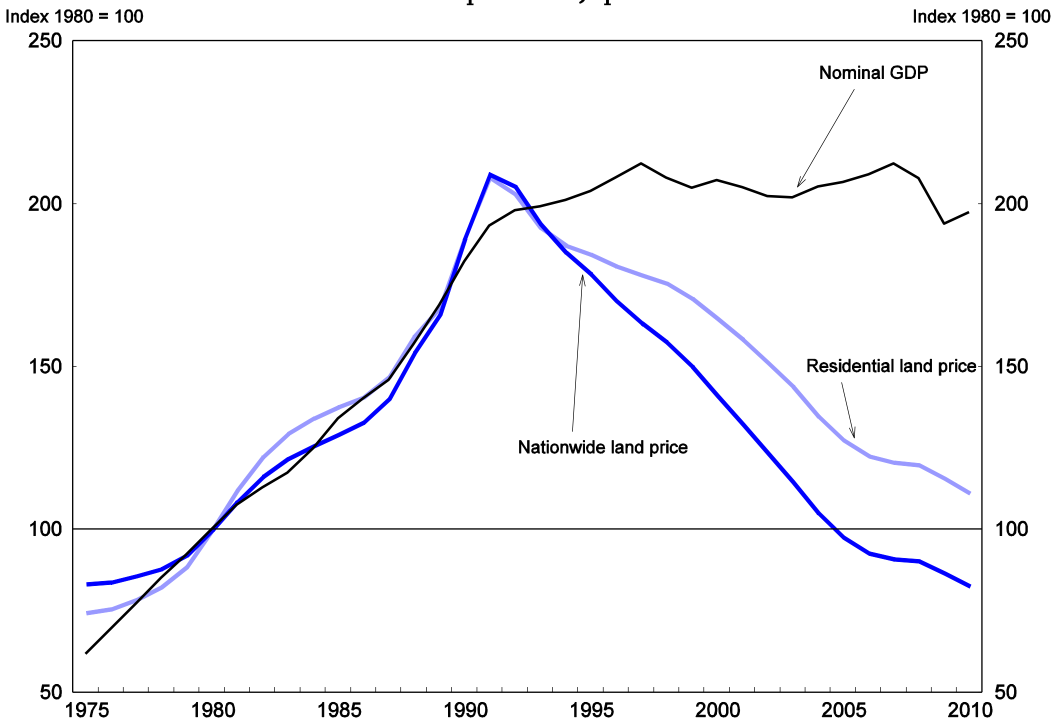
iii. Pledging to maintain a virtually zero policy interest rate until it judges that "price stability is in sight".

The Bank of Japan should maintain the current accommodative stance, paying attention to downside risks, including the impact of the earthquake, and should be ready to undertake further measures in the event of a deterioration of the outlook. In such a case, the focus should be on reducing long-term interest rates through expanded purchases of government bonds, while being cautious in buying high-risk private assets. Such an approach may also boost inflation expectations. Ending deflation may also have a positive impact on asset prices, particularly land prices, which have fallen to their 1975 level after 19 consecutive years of decline.

…while improving the monetary policy framework

There is also scope for improvements in the monetary policy framework. In December 2009, the Monetary Policy Board revised its 0 to 2% "understanding" of price stability by dropping the zero lower bound. This step still leaves the understanding very low, as it is met in principle when inflation in this range is "in sight". A higher inflation objective would provide more of a buffer against deflation. In addition, the Bank's policy intentions would be clearer, and thus much more credible, if expressed in terms of a range around a point. A typical target is 2%, plus or minus one percentage point. The case for revisiting the mechanism for setting the understanding of price stability can also be made. In some OECD countries, the inflation range is set by the government or by consultation between the government and the central bank, rather than independently by the central bank. Such an approach might promote government support for the inflation target and allow the central bank more independence in achieving it. Changes to the framework would further increase credibility and help ensure strong action to achieve price stability, thereby providing support to the economy during the long period of fiscal consolidation ahead.

Land prices in Japan[1]



1. Land prices on 1 January of each year for all uses (residential, commercial and industrial).
Source: Ministry of Land, Infrastructure, Transport and Tourism.

Inflation objectives in selected OECD countries and areas

	Introduction date	Current inflation target
Inflation-targeting countries		
New Zealand	1990	1 – 3
Canada	1991	2 +/- 1
United Kingdom	1992	2 +/- 1
Sweden	1993	2 +/- 1
Australia	1993	2 – 3
Czech Republic	2010	2 +/- 1
Israel	1997	2 +/- 1
Poland	1998	2.5 +/- 1
Chile	1999	3 +/- 1
Korea	2001	3 +/- 1
Mexico	2001	3 +/- 1
Iceland	2001	2.5 +/- 1.5
Norway	2001	2.5 +/- 1
Hungary	2001	3 +/- 1
Other central banks with a numerical inflation objective		
European Central Bank	2003	Below but close to 2%
Switzerland	2000	Not more than 2%

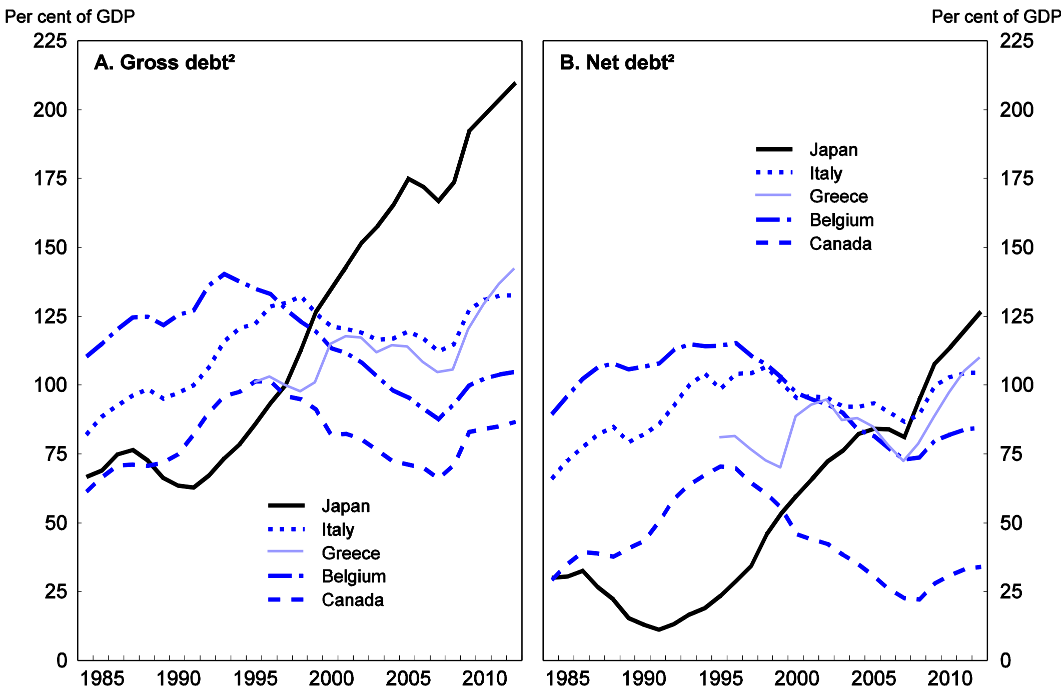
Source: Roger (2010) and OECD Secretariat.

Fiscal policy

The fiscal situation has reached a critical point...

Numerous fiscal stimulus packages and spending pressure related in part to population ageing have driven up government expenditure, while a prolonged period of weak economic growth and tax cuts have constrained revenue, resulting in 18 consecutive years of budget deficits since 1993. Consequently, gross public debt has risen rapidly to uncharted territory at around 200% of GDP, while net public debt, at around 115%, is also the highest in the OECD area. The impact of the extraordinary level of debt has been mitigated by very low long-term interest rates, currently about 1¼ per cent. However, Japan will need to step up fiscal consolidation efforts to reduce the risk of a run-up in long-term interest rates, as well as to mitigate the long-run cost of returning to a sustainable fiscal path. The Fiscal Management Strategy in June 2010 re-started the fiscal consolidation process by setting a target of halving the primary budget deficit of central and local governments, from 6.4% of GDP in FY 2010 to 3.2% by FY 2015. To this end, central government spending in the general account budgets (excluding debt repayment and interest) for FY 2011-13 is not to exceed the level in the initial budget for FY 2010, an objective that has been incorporated in the FY 2011 draft budget. However, reconstruction spending in areas devastated by the earthquake and tsunami will be significant given the scale of destruction. Such outlays by the central government amounted to more than 1% of annual GDP (over a six-year period) following the 1995 Kobe earthquake. It is important to finance reconstruction spending by shifting expenditures and by short-term increases in revenues, appealing to the Japanese people's solidarity. Over the medium term, fiscal consolidation remains a priority.

Public debt in selected OECD countries[1]



1. The five countries with the highest gross debt ratios in the OECD area in 2000.
2. OECD estimates for 2009-10 for Japan and 2010 for the other countries. OECD projections for 2011-12.

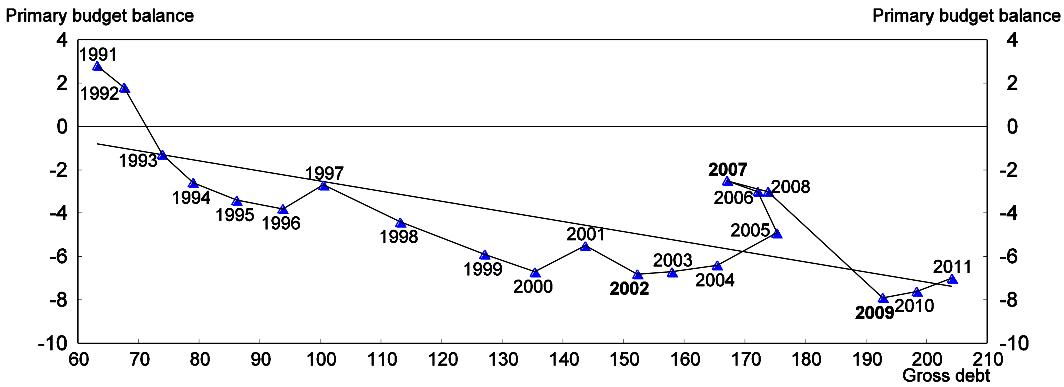
Source: OECD (2010), *OECD Economic Outlook*, No. 88 (November 2010).

…making a detailed and credible medium-term fiscal consolidation plan essential…

The Strategy's long-term target of a primary budget surplus for central and local governments by FY 2020 would not be enough to stabilise the debt ratio, which would require a surplus of around 3% of GDP, assuming that the nominal interest rate is no more than 1½ percentage points above nominal growth. Stabilising the public debt ratio may require an improvement of about 10% of GDP in the primary budget balance, with a larger budget surplus necessary to put the ratio on a downward trend. The revision of the medium-term fiscal framework, planned for mid-2011, needs to provide a detailed multi-year plan of spending cuts and revenue increases to achieve these targets. Government expenditures (excluding interest payments) have risen from 33.4% of GDP in 2007 to an estimated 38% in 2010 due to fiscal stimulus and initiatives of the new government, such as the child allowance. The marked increase in outlays suggests scope for reductions, in part by withdrawing emergency spending. In particular, public investment, although it has fallen from more than 8% of GDP in the mid-1990s to 4¼ per cent in 2009, is one percentage point above the OECD average. While it is likely to increase as a result of reconstruction following the earthquake, it could be scaled back over the medium term, while trying to improve its allocation to enhance its efficiency. In addition, wage growth in the public sector has significantly outstripped that in the private sector, pointing to scope for savings, particularly in local governments.

Japan's fiscal path after the collapse of the bubble economy

Primary budget balance[1] and gross government debt as a per cent of GDP[2]



1. Excluding one-off factors, which were about -5% of GDP in 1998 and ranged from -1% to +2% of GDP between 2002-11.

2. OECD estimates for 2009-10 and projections for 2011.

Source: OECD (2010), *OECD Economic Outlook*, No. 88 (November 2010).

…including reform of social security spending…

The revision of the medium-term fiscal framework is to be accompanied by a reform of social security, the main source of spending pressure. Given population ageing, social security outlays by the central government, which provides a subsidy to the social security fund, are projected to rise by almost 2% of GDP over the next decade, and perhaps by more given the consensus on the need to improve the quality of health and long-term care. In addition, the social security fund's balance has deteriorated over the past decade, reaching a deficit of 1½ per cent of GDP in FY 2009. Although the social security fund is not included in the Strategy's fiscal targets, it is part of general government and contributes to the evolution of public debt. Thus, it is important to achieve the Fiscal Management Strategy's objective of securing stable financing for social security. Moreover, measures to limit the rise in social security spending are a priority, in part through reforms of health and long-term care:

- Promoting the shift of long-term care away from hospitals toward more appropriate institutions using the fee schedule and closer monitoring of the classification of patients in hospitals.

- Improving the payment system by reforming the diagnosis procedure combination, which sets an overall fee based on the illness, so as to strengthen incentives for hospitals to increase efficiency.

- Expanding the use of generic medicine by making them the standard for reimbursement.

- Introducing gatekeepers to reduce the number of unnecessary consultations with specialists.

The general government balance also depends on the pension system, which is being reformed by raising the contribution rate to 18.3% by FY 2017, allowing the replacement rate of pension benefits for a single-earner couple to fall from around 60% to 50% and increasing the pension eligibility age gradually from 60 to 65 by 2025 for men and 2030 for women. As the long-run projection is sensitive to economic and demographic assumptions, additional reforms may become necessary in the future. In that case, further increasing the eligibility age would be the best option.

…and comprehensive tax reform to boost revenues

Given the upward pressure on spending and limited scope for further reductions, achieving the fiscal targets will require tax increases. Indeed, the government's long-term projection made in January 2011 shows a primary budget deficit in 2020 of between 2.5% and 4.2% of GDP (depending on the economic scenario) if spending (excluding social security and interest payments) is kept constant in real terms. Revenue should be increased by a comprehensive tax reform that broadens direct tax bases and encourages labour force participation, in part by relying primarily on the consumption tax for additional revenue. To balance the primary budget, the consumption tax rate would have to be raised by five to nine percentage points from its current 5%. Achieving the 3% of GDP primary surplus likely to be necessary to stabilise the debt ratio would require another 6 percentage-point hike in the consumption tax rate, bringing it towards the 20% average in Europe. Moreover, reducing the debt ratio from the 2020s would require even more revenue. Thus, a doubling in the consumption tax rate to 10% would be just a first step to achieving a sustainable fiscal situation. Given the size of the adjustment and the projection for continued output growth, tax reform should be spelled out and announced in FY 2011 and tax increases should begin as soon as possible, taking into account the need to reconstruct areas devastated by the Great East Japan Earthquake. The consumption tax should be the major source of additional revenue, given that its impact on economic growth is less negative than direct taxes on household and corporate income. The regressive impact of higher indirect taxes could be best offset by policies to assist low-income families, such as an earned income tax credit, although such measures themselves push up the deficit and thus require cuts in spending elsewhere or further tax increases. Environment-related taxes to meet the target to cut greenhouse gases might also be part of a package of measures to raise revenue.

Reform of the fiscal policy framework may help to bolster confidence in the long-run fiscal plan

Given the large deterioration in Japan's fiscal situation since the collapse of the asset bubble in 1990 and the unprecedented size of its fiscal problem, a strong fiscal policy framework is important to reinforce the credibility of a medium-term fiscal plan. *First*, budget procedures can be improved through a multi-year budgeting plan for spending and taxes, even if such plans have to be reconsidered in the event of unforeseeable exceptional circumstances. *Second*, the medium-term fiscal targets are a Cabinet decision that can be revised with a change in government. Establishing a stronger legal foundation for the fiscal targets would strengthen their credibility. *Third*, an objective body, at arm's-length from the policymaking process, to evaluate the government's progress in meeting its fiscal targets may enhance the transparency and credibility of a fiscal consolidation plan, especially one that will need to continue for at least a decade. Added credibility is key to mitigate the risk of a run-up in long-term interest rates.

Summary of recommendations to achieve fiscal sustainability

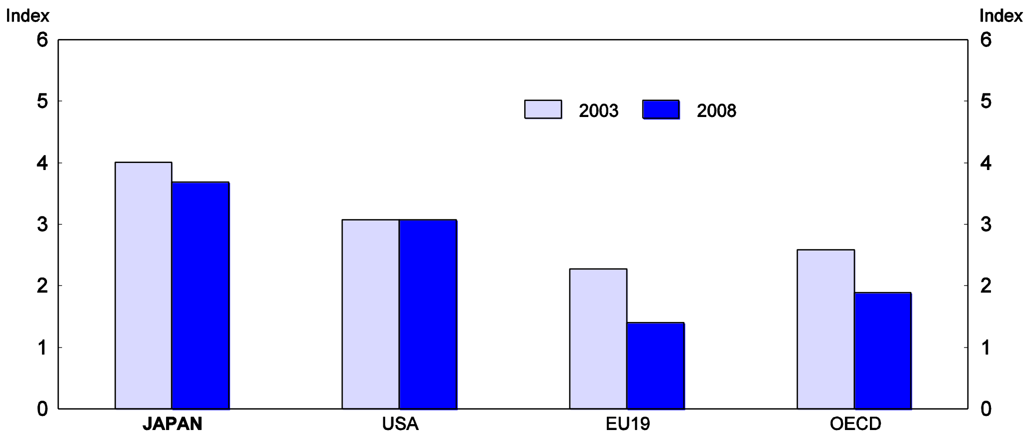
- Limit the deficit and the rise in debt by financing earthquake-related reconstruction spending by shifting expenditures and by short-term increases in revenues, appealing to the Japanese people's solidarity.
- Cut spending in such areas as the government's personnel costs and public investment in the medium term to offset rising social security outlays.
- Continue the screening process to find ways to reduce low-priority and ineffective spending programmes.
- Reform social security to limit spending increases and provide a sound funding source for pensions.
- Promptly implement tax reform, taking into account the need to reconstruct areas devastated by the earthquake.
- Rely primarily on the consumption tax and other indirect taxes, such as environment-related levies, to raise revenue while introducing measures, such as an earned income tax credit, to offset its regressiveness.
- Set the FY 2020 primary budget surplus at a level high enough, such as around 3%, to ensure that it is sufficient to stabilise the ratio of gross government debt to GDP.
- Include detailed and credible spending targets by category and a timetable for tax rate increases in the revised medium-term fiscal framework in the Fiscal Management Strategy to help maintain confidence and prevent a run-up in interest rates.
- Reform the fiscal policy framework through a multi-year budgeting plan, a stronger legal basis for the fiscal targets and an objective fiscal body at arm's-length from the policy-making process to monitor and evaluate progress in implementing the plan.

The New Growth Strategy

Economic growth is an essential part of addressing the fiscal problem, making the New Growth Strategy important…

Sustained fiscal consolidation will tend to depress economic growth from the already low potential rate of ½ per cent estimated by the government, making policies to support growth essential. The government's New Growth Strategy aims at accelerating real output growth to a 2% rate in the 2010s by creating new demand through green innovation, expanded health care, economic integration with Asia and regional development. Demand is to be stimulated by fiscal measures, including spending, tax measures and public lending, and the revision of the regulatory and institutional frameworks. However, in view of the severe budgetary situation, it is important to stress regulatory reforms, rather than fiscal measures, and ensure that any spending increases are consistent with fiscal consolidation needs. In addition, reforms should not be limited to specific sectors, but extended economy-wide to raise productivity. Given that the working-age population is projected to shrink by 10% by 2020, achieving the 2% real growth target implies that productivity growth will have to accelerate significantly from the 1% average annual rate of the past decade. Priorities include promoting entrepreneurship and business start-ups by reducing the cost of creating new firms and strengthening competition policy and innovation. Jump-starting the venture business sector and following through on the planned privatisation of Japan Post could also help foster private-sector dynamism.

Regulatory barriers to entry in network sectors[1]



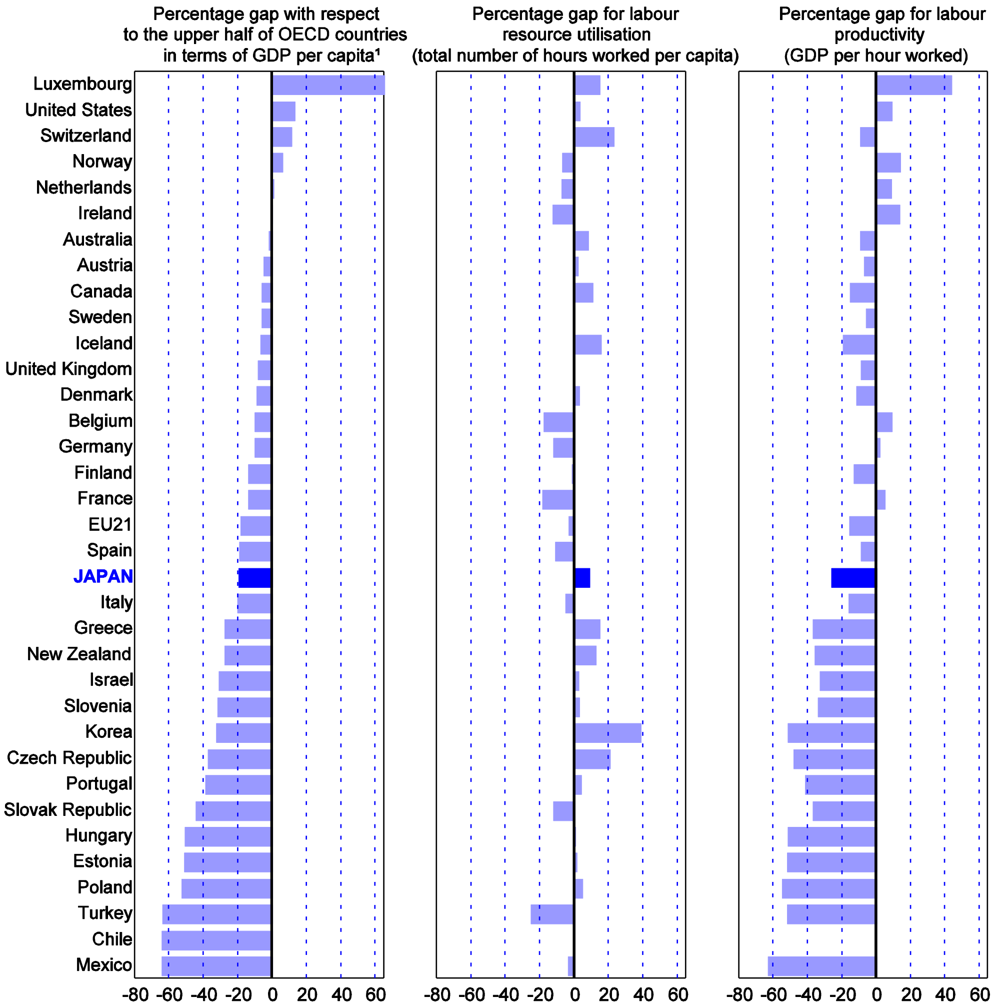
1. Includes electricity, gas, airline, rail, and telecommunications and post. The index scale is from 0 to 6, with 0 the least restrictive.

Source: OECD (2010b), *Going for Growth, 2010*, OECD, Paris.

…especially in the areas of green growth and health care…

Japan's target of reducing its greenhouse gas emissions by 25% by 2020 relative to 1990, premised on the establishment of a fair and effective international framework that includes ambitious targets for all major economies, calls for green innovation as an important source of growth. A top priority is to establish a price on carbon, preferably through a mandatory and comprehensive cap-and-trade emissions trading system (ETS), with the permits auctioned. A carbon tax should be introduced in areas not covered by the ETS and would also generate revenue for fiscal consolidation. Health care is also a potential source of growth, given Japan's large and increasing number of elderly and relatively low health outlays. However, given that the public sector covers 86% of health spending, boosting spending under the current framework would exacerbate the fiscal situation. The aim of public health insurance to cover all necessary treatment may have to be made less ambitious while expanding the scope of mixed billing to make treatments not covered by public insurance more affordable.

Explaining differences in income in 2009



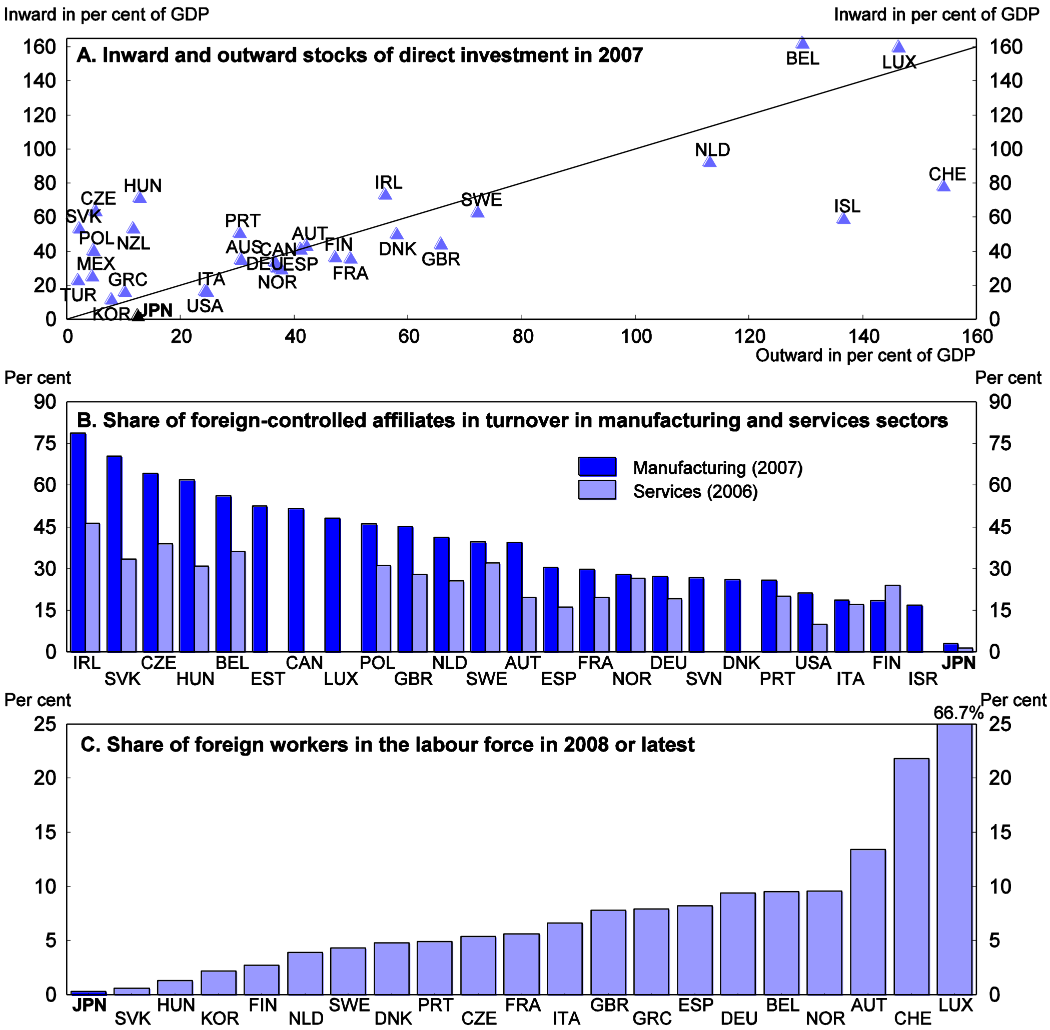
1. Using PPP 2009 exchange rates.

Source: OECD (2011), *Going for Growth, 2011*.

…and economic integration through free trade agreements

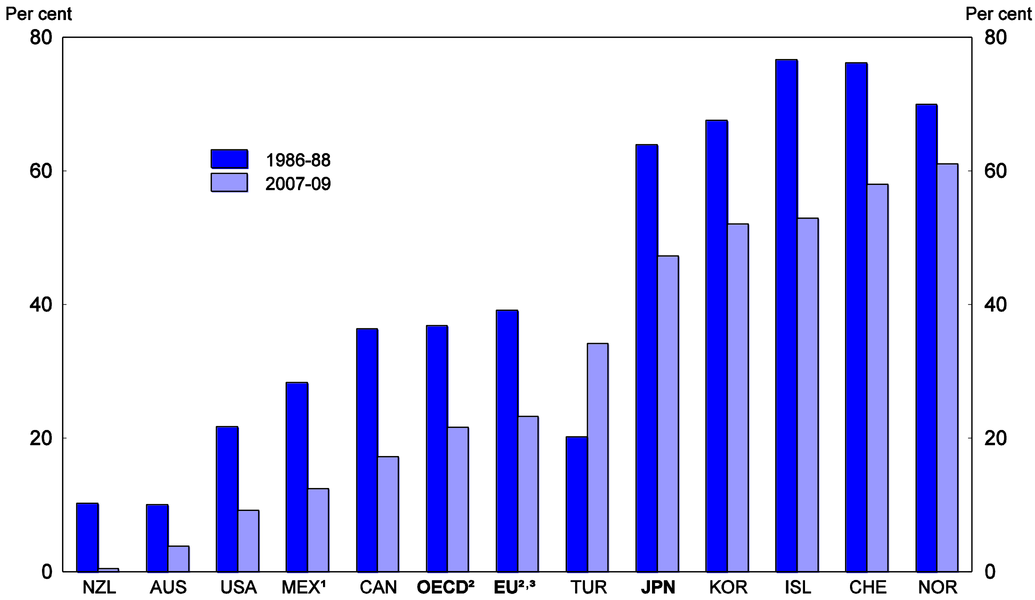
A core objective of the New Growth Strategy is to increase Japan's integration in the world economy. At present, Japan is an outlier in the OECD area, with the lowest level of imports and inflows of foreign direct investment as a share of GDP and the lowest share of foreigners in the labour force. The Strategy sets an objective of doubling the inflow of people, goods and capital by 2020 by reducing barriers to trade and restrictions on foreign investment and the movement of people into Japan. Increased openness is to be accomplished in part by negotiating Economic Partnership Agreements with major trading partners and starting discussions in 2011 with countries in the Trans-Pacific Partnership. Such agreements should be comprehensive and encompass agriculture, which has long been the major obstacle to Japan's inclusion in regional trade agreements. Greater openness to food imports would help push the restructuring of its agricultural sector. However, the Strategy also targets an increase in Japan's food self-sufficiency ratio, which may tend to fall as a result of regional integration that increases openness to low-cost food imports.

Economic globalisation indicators



Source: OECD (2010g), *OECD Economic Globalisation Indicators*.

International comparison of Producer Support Estimate for agriculture
Per cent of gross farm receipts



1. For Mexico, 1986-88 is replaced by 1991-93.

2. Austria, Czech Republic, Finland, Hungary, Poland, the Slovak Republic and Sweden are included in the OECD total for both time periods and in the EU from 2007-09. The OECD total does not include the non-OECD EU member states.

3. EU12 for 1986-88 and EU27 for 2007-09.

Source: OECD (2010a), *Agricultural Policies in OECD Countries: At A Glance*.

Summary of recommendations for Japan's New Growth Strategy

Improving the overall framework of the Strategy

- Carefully monitor the fiscal implications of the Strategy to ensure its coherence and consistency with the Fiscal Management Strategy and the needs of prolonged fiscal consolidation.
- Focus on accelerating regulatory reform, particularly in services, to encourage private investment.
- Promote entrepreneurship and a more business-friendly environment, particularly by reducing the administrative burden on start-ups.
- Strengthen competition policy by increasing fines on violators of the Anti-Monopoly Act (AMA) and reduce exemptions from the AMA, including the special treatment of SMEs.

Creating new demand

Green growth

- Set a price on carbon emissions by introducing market-based instruments, preferably a mandatory and comprehensive cap-and-trade ETS, thereby providing a clear price signal to encourage green-growth investment.

- Make greater use of environmentally-related taxes, particularly by introducing a carbon tax in areas not covered by the ETS, while ensuring the predictability and credibility of the tax framework.
- Encourage the development of renewable energy resources by removing non-economic barriers and creating a predictable and transparent support framework. The best option would be an electricity certificate system, with incentives that decrease over time.
- Phase out inefficient fossil fuel subsidies in line with the G20 initiative in order to ensure an appropriate price for carbon.

Health-care reform

- Shorten the drug and medical device lag by reducing the cost of clinical trials in Japan, accepting more overseas results and ensuring that reimbursement levels are appropriate.
- Expand mixed billing to make treatments not yet covered by public health insurance more affordable.
- Promote the shift of long-term care away from hospitals toward more appropriate institutions and home-based care using the fee schedule and closer monitoring of the classification of patients in hospitals.

Asian economic integration

- Accelerate the negotiation of comprehensive Economic Partnership Agreements with major trading partners and participate in the Trans-Pacific Partnership.
- Scale back the high level of agricultural protection and shift its composition away from price support towards direct support to farmers to facilitate regional economic integration.
- Improve the climate for FDI inflows by further liberalising trade, lowering barriers to investment and ownership, accelerating reforms of administrative procedures and relaxing labour regulations.
- Liberalise controls on immigration to allow more foreign students and highly-skilled workers in Japan.

Regional development

- Encourage use of the Special Zones for Structural Reform, focusing on nationwide regulatory reform, and ensure that any new special zones result in significant net benefit for the whole country.
- Allow local governments more autonomy and provide them with greater financial resources to promote regional development, including the creation of innovation clusters.

Reform in the financial sector

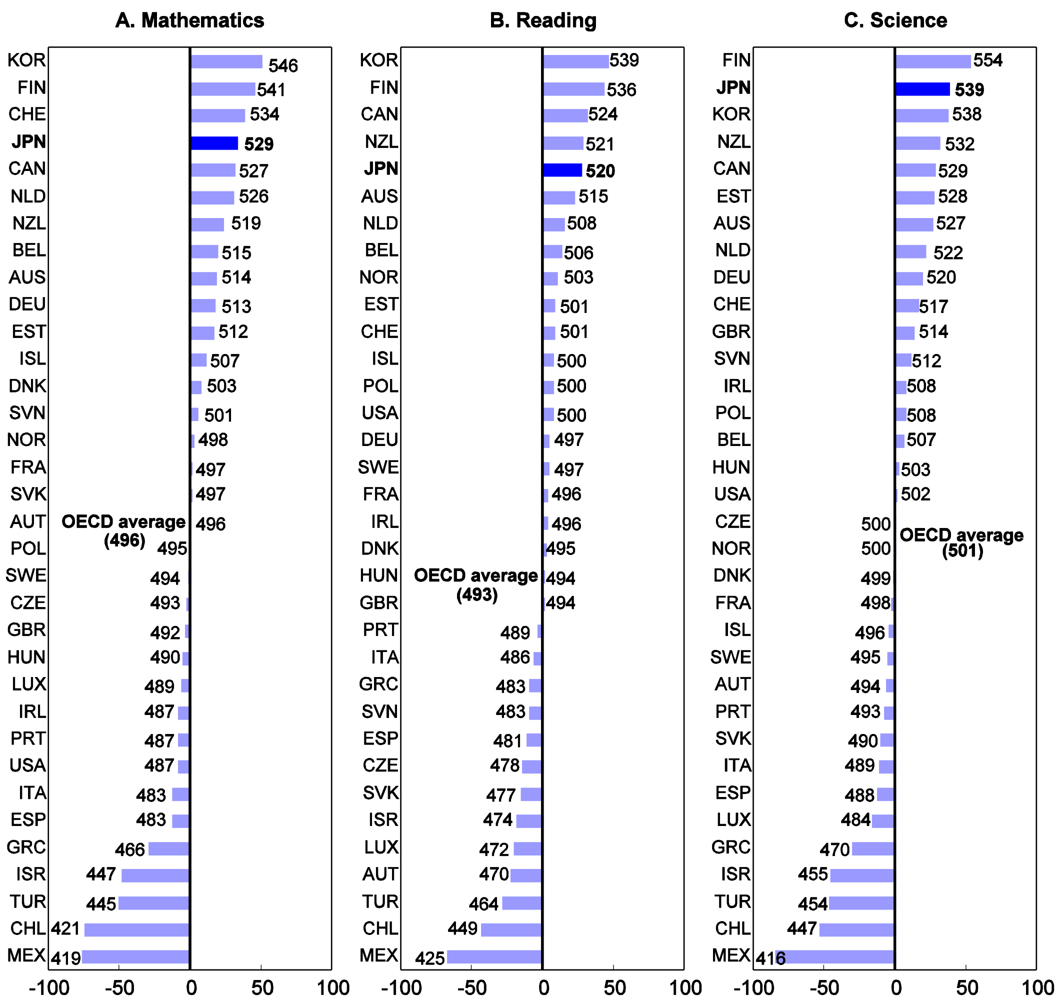
- Promote the supply of risk money, such as venture capital, for R&D and innovative business start-ups through policy measures to stimulate this market, which is relatively inactive in Japan.
- Scale back the size of public financial institutions, thereby reducing the flow of savings to the public sector and enhancing the availability of funds for venture business and new start-ups.
- Follow through on the privatisation of Japan Post.
- Reduce credit guarantees and relax the government's policy of encouraging financial institutions to increase lending to SMEs, with the economic recovery.

The education system

Economic growth also depends on the quality of education…

The New Growth Strategy also aims to increase the role of higher education in innovation. Education in Japan is outstanding both in terms of quantity and quality. Indeed, the share of the adult population that has completed tertiary education is the second highest in the OECD area at 43% and the quality, as reflected in the OECD's PISA exams, is one of the highest. These excellent outcomes have been achieved with public spending per student in primary and secondary schools that is slightly below the OECD average. It is supplemented, however, by high private spending, including outlays for tutoring at private, after-school institutions, known as *juku*. Given the importance of education for economic growth, it is important to invest wisely and well in education.

International comparison of student performance on the PISA test
Student performance at age 15 in 2009

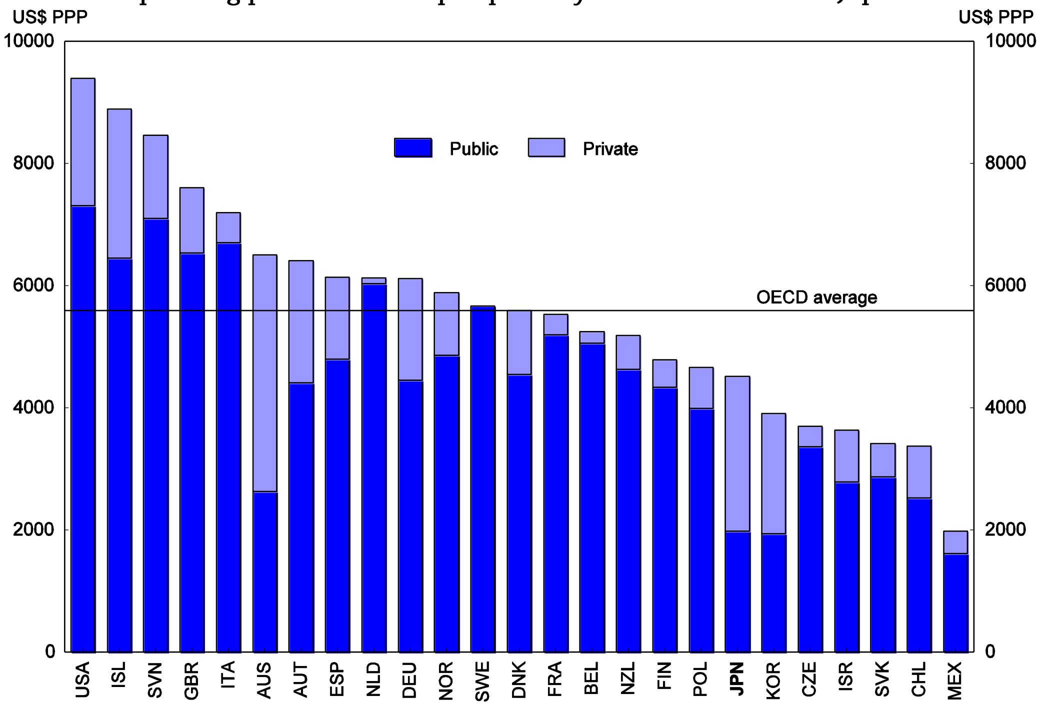


Source: OECD (2010d), PISA *2009 Results: What Students Know and Can Do, Volume I.*

…which could be improved through greater investment in early childhood education and care…

Public spending on early childhood education and care is low in Japan. Greater investment in this area is warranted, given that the returns appear to be large and as it would reduce the disadvantages of children from low-income families. At present, about one-third of children under the age of six are in licensed childcare centres under the direction of the Ministry of Health, Labour and Welfare, while another third are in kindergartens under the direction of the Ministry of Education, Culture, Sports, Science and Technology. The New Growth Strategy's objective of integrating kindergartens and childcare would improve the quality of education for children in childcare, while allowing cost savings by merging the two parallel systems. Another advantage of integration is that it would reduce the shortage of childcare by utilising excess capacity in kindergartens. There are waiting lists for licensed childcare centres, which are heavily subsidised, with the government paying 60%. The lack of affordable and high-quality childcare is cited as a major obstacle to raising Japan's relatively low female labour force participation rate. The government plans to increase capacity by 260 thousand places over the next five years, but this would have only a limited impact on female participation. Allowing a greater role for private suppliers, who are currently subject to controls, including price ceilings, would help address the childcare shortage. In the longer term, Japan could consider moving toward a system of vouchers that encourages suppliers to compete in providing the services demanded by parents.

Spending per student on pre-primary education is low in Japan[1]



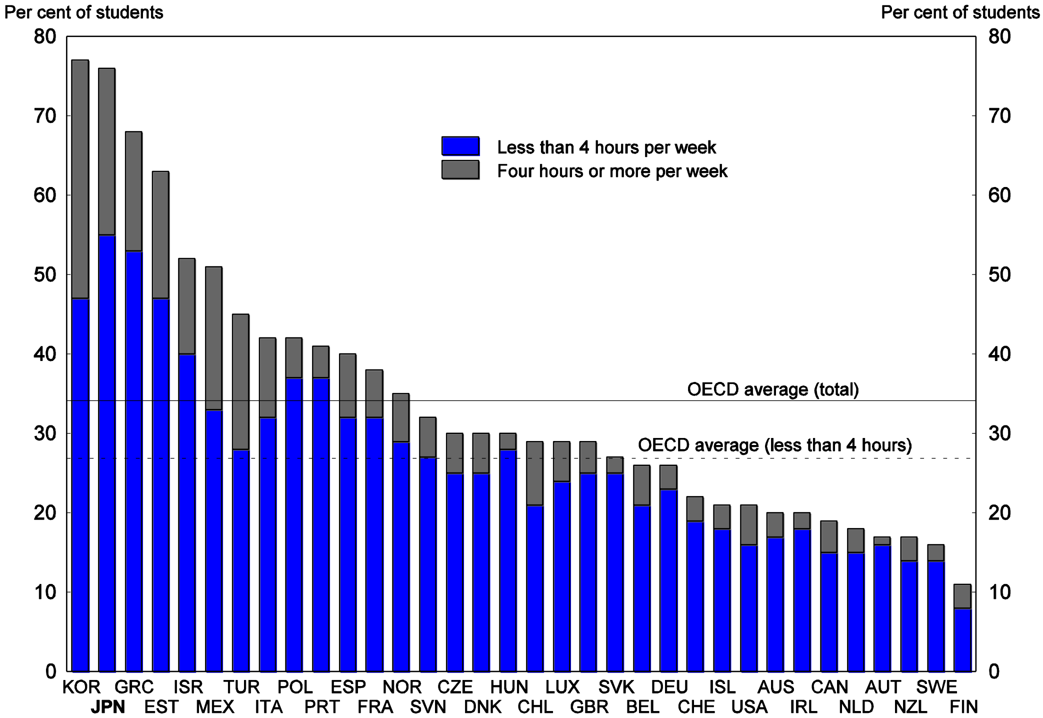
1. Annual spending based on full-time equivalent students in 2007.
Source: OECD (2010a), *OECD Education at a Glance 2010.*

…and reforms to improve primary and secondary education…

Japan is launching reforms to improve primary and secondary schools by lengthening textbooks by a quarter and increasing class time by one to two hours per week. While Japan is near the top in PISA scores, such a reform may have a positive effect, not least by weakening dependence on *juku*. Other reforms that would raise the quality of education include granting more autonomy for schools and expanding the scope for school choice by students and parents to encourage schools to excel. At present, only 14% of municipal school districts allow school choice.

The percentage of students attending after-school lessons in math

By hours per week



Source: OECD (2010d), *PISA 2009 Results: What Students Know and Can Do,* Volume I.

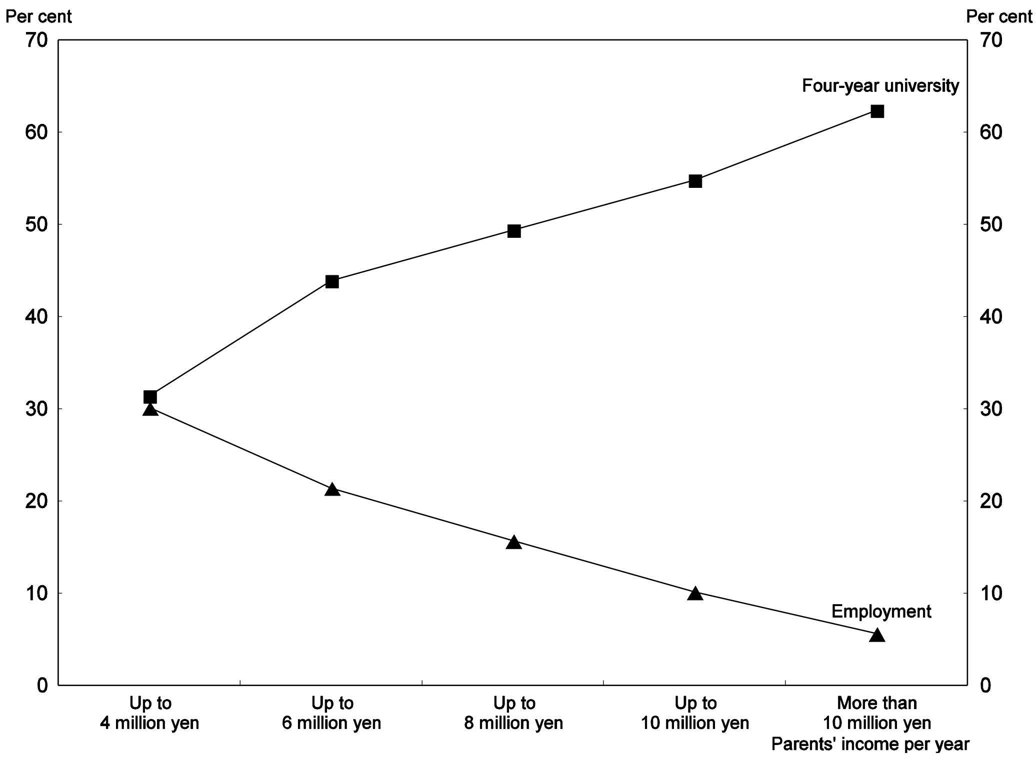
…as well as tertiary education, thereby enhancing innovation

In contrast to primary and secondary schools, universities in Japan do not stand out in international comparisons, suggesting more scope to improve quality. The expanding supply of tertiary education in Japan and the shrinking number of high school graduates have converged. As demographic trends further reduce the number of high school graduates, some tertiary institutions, including the national and public universities, would face pressure to consolidate if they fail to reform. Consolidation, with due regard to universities' autonomy, may make them more effective in R&D, but should take into account the impact on regional economies. It is important to increase transparency about the quality of tertiary institutions, including the labour market outcomes of their graduates, to strengthen competition and upgrade performance. Stepping up the internationalisation of universities, which have a relatively small share of foreign students, could also help boost performance, as would attracting leading foreign tertiary institutions to Japan. Higher-quality universities could make a larger contribution to innovation. While universities employ a majority of Japan's PhDs in natural sciences, they performed only 13% of R&D in 2007, of which 3% was funded by firms. The role of universities could be strengthened by enhancing labour mobility of researchers between universities, firms and government research institutes and raising the share of government R&D funding for universities that is competitively financed.

Expanding access to student loans and reducing dependence on juku would enhance equity, while easing burdens on families

It is important to expand access to public loans for tertiary education, which are currently available to only one-third of students despite high tuition payments in Japan. Making loan repayment contingent on income after graduation would also encourage students from low-income households to invest in education. Another equity concern is the prominence of *juku*, which provide additional instruction to about half of middle school and a quarter of primary students, resulting in long hours in classrooms that can have a negative impact on children's development. Reducing reliance on *juku* would also lower inequality in educational results as attendance at *juku*, which significantly raises educational scores, rises with family income. This inequality can be persistent, as higher test scores in turn allow students to attend more prestigious universities, which lead to regular employment and significantly higher lifetime earnings. Dependence on *juku* could be reduced by improving the quality of public schools and reducing the importance of multiple-choice tests – an area where *juku* are most effective – in entrance exams. In any case, *juku* are likely to continue to play a major role, making it important to increase the accessibility to low-income households. Reducing dependence on *juku*, along with greater investment in early childhood education and care, would also reduce the heavy burden of educational spending on households, which is reported to be a major cause of Japan's low birth rate – the second lowest in the OECD area at less than 1.4.

Path following high school graduation



Source: Ministry of Education, Culture, Sports, Science and Technology (2009c), *White Paper on Education, Culture, Sports, Science and Technology*, 2009.

Improving vocational education and training is becoming increasingly important

The traditional pattern, in which firms hire graduates for long-term employment and train them within the firm, is shifting in favour of employing workers with specific skills. The new approach increases the importance of effective vocational education. Meanwhile, the rising share of students attending university is forcing the closure of junior colleges and specialised training colleges that have traditionally played a major role in vocational education. To cope with changing labour market trends, it is essential to upgrade the quality of vocational education, including in universities, by developing effective curricula through close contacts with firms and unions, and by creating qualifications that are recognised by firms, another objective of the New Growth Strategy. It is also important to expand vocational training, which so far has played a relatively small role in Japan, given the emphasis on firm-based training. Expanding the programmes included in the Job Card initiative should be conditional on their success in improving the employment outcomes of participants. The need for greater vocational education and training is particularly important, given the rising share of non-regular workers – part-time, temporary and dispatched employees – who receive little firm-based training.

Summary of recommendations to improve the education system

Improve educational outcomes

Early childhood care and education

- Invest more in ECEC to expand quality and quantity.
- Integrate childcare and kindergarten, as outlined in the New Growth Strategy, to enhance the quality of ECEC.
- Expand the role of private providers of ECEC, in part by providing payments directly to families.

Primary and secondary schools

- Effectively implement the planned increase in curriculum and school hours, while retaining the advantages of the *yutori* reform.
- Increase the autonomy of schools.
- Expand school choice to encourage schools to excel, while increasing information about performance.

Tertiary education

- Increase transparency about performance, including labour market outcomes of graduates, to strengthen competition.
- Promote internationalisation by increasing the number of foreign students.
- Encourage the establishment of more foreign tertiary institutions in Japan.

Increase value for money

Early childhood care and education

- Reduce costs by integrating childcare and kindergarten.

Primary and secondary schools

- Support an efficient framework to cope with school consolidation.
- Use teachers' time more effectively.

Tertiary education

- Facilitate the consolidation of the tertiary sector.
- Liberalise restrictions, including those on tuition, student caps and programme changes, while assuring equity and quality.

Reduce burdens on household

Early childhood care and education

- Raise the public share of spending on ECEC.

Primary and secondary schools

- Reduce dependence on *juku.*
- Lower the burden of out-of-school education by developing low-cost alternatives.

Tertiary education

- Expand public loans for tertiary education to cover a higher share of students.

Reverse the rising trend in inequality

Early childhood care and education

- Invest more in ECEC to reduce the disadvantages of children from low-income families.

Primary and secondary schools

- Reduce dependence on *juku.*
- Make the benefits of *juku* more widely available and at lower cost, notably to students from low-income families.

Tertiary education

- Expand public loans for tertiary education to cover a higher share of students.
- Make repayment of loans income-contingent.

Enhance links between labour market and education

Primary and secondary schools

- Create vocational qualifications that are recognised by firms, as planned in the New Growth Strategy.

Tertiary education

- Expand the vocational training role of universities, which are educating an increasing share of young people.

Expand the contribution of tertiary sector to innovation

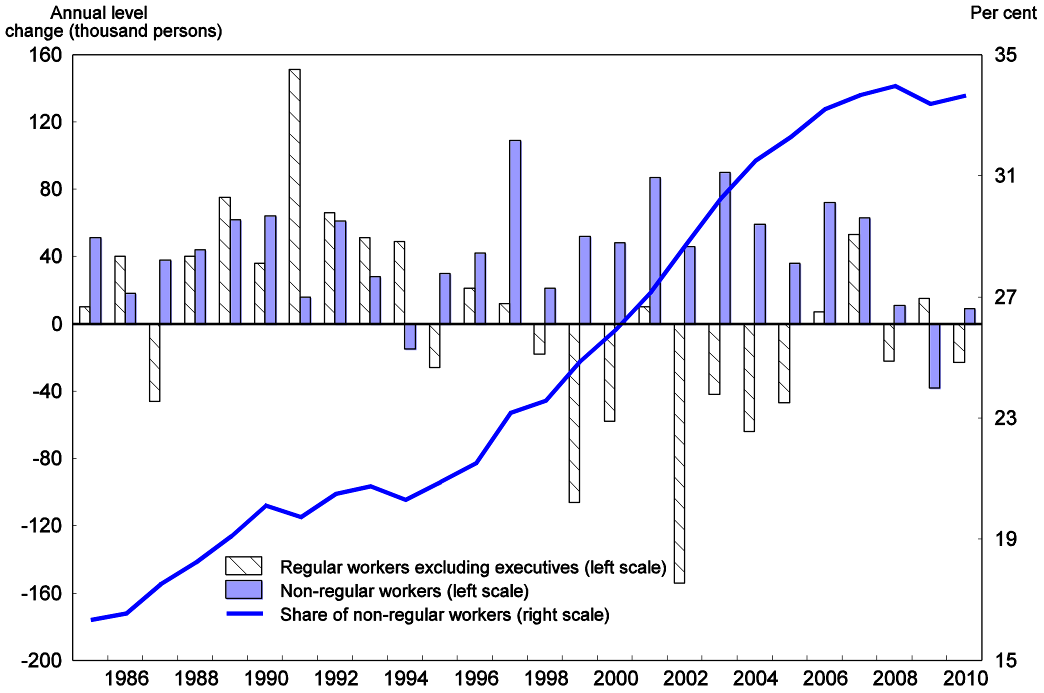
- Enhance co-operation between university research and industry.
- Increase public investment to create leading universities.
- Boost the share of public research funds for universities that is allocated competitively.

The labour market

Reducing labour market dualism is a top priority

Japan's labour market retains a number of positive features, including flexibility in wages and hours worked. However, as economic growth slowed dramatically since 1990, the traditional labour market practice of long-term employment, seniority-based wages and mandatory retirement at age 60 became increasingly ill-suited to economic conditions. As a result, firms have employed more non-regular workers in order to gain greater employment flexibility and to reduce labour costs. Indeed, non-regular workers now account for a third of employment, reflecting their advantages to firms. However, the rising share of non-regular workers creates concerns, as they are paid less, even after adjusting for the type of job and education, receive less training and are poorly covered by the social insurance system. In addition, they face considerable job precariousness. For example, non-regular workers accounted for two-thirds of the fall in dependent employment between 2008 and 2009. Moreover, the limited mobility in a segmented labour market means that non-regular employment is not a pathway to regular employment. The government has proposed legally restricting the use of short-term dispatched workers and policies to promote their continued employment. This may aggravate the costs of inflexibility and reduce overall employment. Instead, a comprehensive approach is necessary that includes increasing the social insurance coverage of non-regular workers and upgrading training programmes, preventing discrimination against non-regular workers and reducing effective employment protection for regular workers.

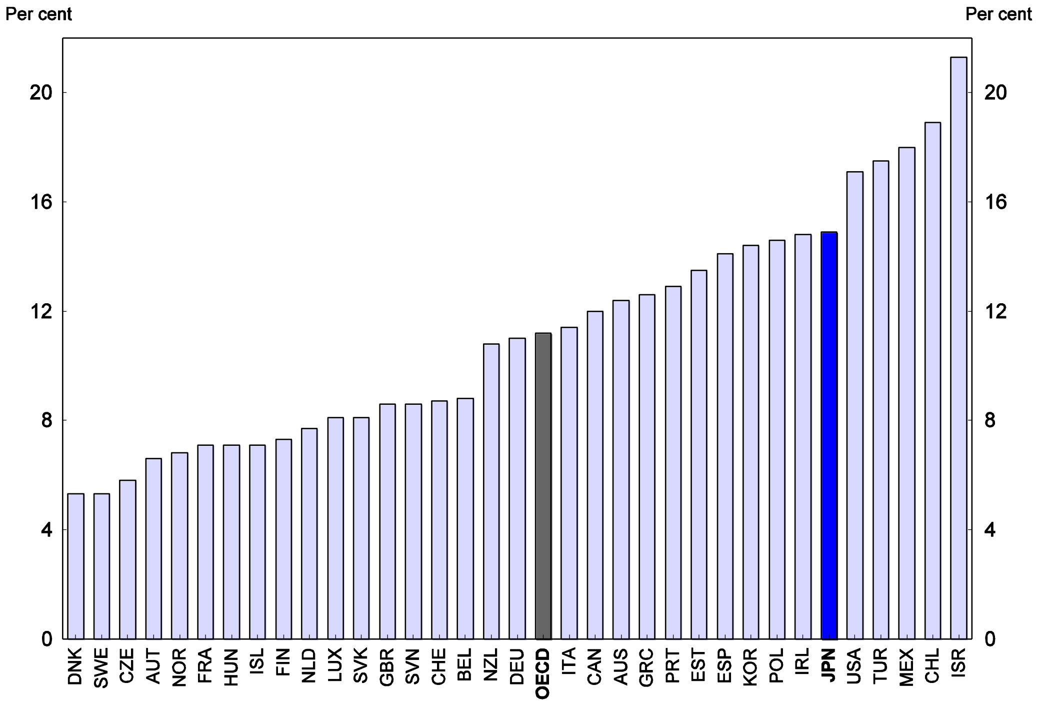
The share of non-regular workers is rising again[1]



1. Data is as of February until 2001 and as of the first quarter since 2002.

Source: Ministry of Internal Affairs and Communications, *Special Survey of the Labour Force*, from 1984 to 2001 and the *Labour Force Survey (Detailed Tabulation)* since 2002.

International comparison of relative poverty rates in the mid-2000s[1]



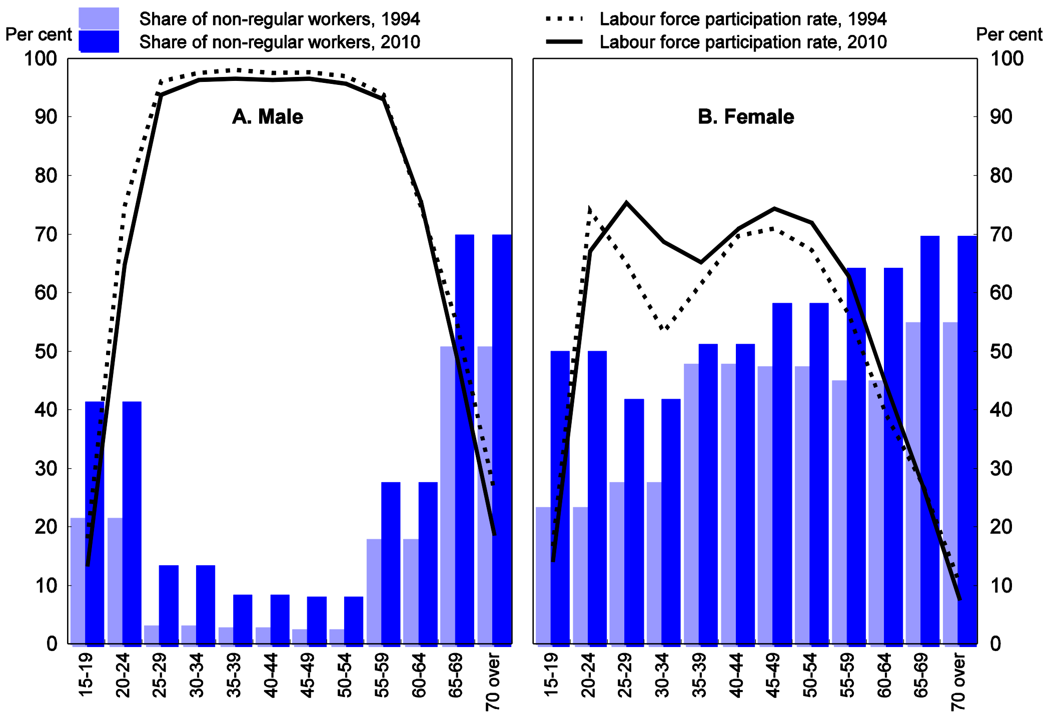
1. Poverty rates are defined as the share of individuals with equivalised disposable income less than 50% of the median for the entire population. Countries are ranked, from left to right, in increasing order of poverty rates. The income concept used is that of household disposable income adjusted for household size.

Source: OECD (2011), *Income distribution questionnaire.*

Raising female labour force participation and making better use of older workers is important to cope with population ageing

Reversing the upward trend in non-regular employment may also encourage the labour force participation rate of women, who account for 58% of non-regular workers. The difficulty of obtaining higher-paying regular positions may discourage women from working, particularly those who left the labour force to raise children. Raising the relatively low participation rate for prime-age women, while increasing the fertility rate, requires other reforms as well. *First*, it is important to expand the availability of childcare. *Second*, better work-life balance is needed so that women can combine employment with family responsibilities. *Third*, the tax and social security system should be reformed to remove aspects that discourage spouses from working. In addition to raising female participation, making more effective use of older workers is a priority in the face of a projected fall of nearly 40% in the working-age population by mid-century. At present, most firms impose mandatory retirement at age 60, although many workers are re-hired, usually on short-term contracts at significantly lower pay. The government should prohibit mandatory retirement and aim at a more flexible employment and wage system, based on ability rather than age. In sum, making better use of all of Japan's human resources – including women, older workers and youth – is essential to cope with the rapid population ageing. Such policies should be accompanied by increased inflows of highly-skilled foreign workers, as envisioned in the New Growth Strategy.

Changes in labour force participation and the share of non-regular workers by age and gender[1]



1. The share of non-regular workers is available for six age groups: 15-24, 25-34, 35-44, 45-54, 55-64 and over 65.

Source: Ministry of Internal Affairs and Communications, *Labour Force Survey*, and *Labour Force Survey (Detailed Tabulation)*.

Summary of recommendations to reform the labour market

Breaking down labour market dualism

- Expand the coverage of non-regular workers by workplace-based social insurance systems, notably by improving compliance, to reduce the cost advantages of non-regular workers and improve their security.
- Increase training and career consultation to enhance human capital and the employability of non-regular workers as well as to promote their transition to regular employment, thereby improving Japan's growth potential.
- Prevent discrimination against non-regular workers.
- Reduce the effective employment protection for regular workers so that firms can realise adequate employment flexibility without hiring increasing numbers of non-regular workers.
- Be cautious in legally restricting the use of short-term dispatched workers as it may aggravate the cost of inflexibility and reduce overall employment.

Encouraging labour market participation of women, elderly and youth

- Reform aspects of the tax and social security system that reduce work incentives for secondary earners.
- Encourage better work-life balance, in part by better enforcing the Childcare and Family Care Leave Law.
- Increase the availability of affordable, high-quality childcare, while avoiding generous child-related transfers that may weaken work incentives.
- Encourage greater use of flexible employment and wage systems to improve working conditions for older workers, in part by abolishing mandatory retirement at age 60.
- Emphasise practical training, combining on-the-job and classroom learning, in part through expanding the Job Card system, to equip youth with the skills needed in the labour market.
- Promote the development of a standard system of recognition of acquired skills to ensure effective training.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of Member countries.

The economic situation and policies of Japan were reviewed by the Committee on 7 March 2011. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 15 April 2011.

The report was thus prepared and reviewed before the tragic Great East Japan Earthquake on 11 March 2011. This published version has, however, been updated and approved by the Committee to adjust the short-term analysis and policy recommendations in light of the earthquake. We express our deep sorrow at the enormous loss of life and offer our condolences to those affected by this tragedy.

The Secretariat's draft report was prepared for the Committee by Randall S. Jones, Satoshi Urasawa and Byungseo Yoo under the supervision of Vincent Koen. Research assistance was provided by Lutécia Daniel.

The previous Survey of Japan was issued in September 2009.

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