



Economic Survey of Japan, 2008

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Summary

The Japanese economy is experiencing the longest expansion in its post-war history, and growth is projected to continue at a 1½ to 2% rate over the next two years. This expansion has been largely driven by buoyant business investment and strong export growth, especially to other Asian countries. Moving forward, Japan faces a number of challenges to sustained growth, most notably persistent deflation, a large and growing public debt and widening disparities between different segments of the economy. While large manufacturing firms have benefitted from buoyant export growth, the non-manufacturing sector – dominated by smaller firms – has been lagging in profitability, confidence, investment and wages. Dualism has also increased in the labour market, with a further rise in the share of non-regular workers, with lower wages and weaker social protection. Addressing these challenges requires a comprehensive package that includes sound macroeconomic policies and structural reforms to raise labour force participation and productivity while also tackling disparities in the economy.

Ensuring a definitive end to deflation. After raising the policy interest rate twice under the new monetary policy framework introduced in 2006, the Bank of Japan has appropriately left the rate unchanged since early 2007. Further hikes would not be warranted until inflation is firmly positive and the risk of renewed deflation is negligible, hence avoiding the risk of derailing the expansion. Given the need for an adequate buffer against deflation, the Bank's Policy Board should raise the lower bound of its understanding of price stability, which is now set at zero.

Achieving progress in fiscal consolidation. Japan has reduced its fiscal deficit from 8.2% of GDP in 2002 to around 4% in 2007 (excluding one-off factors). But government debt has continued to rise, reaching 180% of GDP in 2007. It is essential to achieve the target of a primary surplus for central and local governments combined by FY 2011 as a first step towards reducing the government debt ratio in the 2010s. While the first priority is to further cut spending, measures to raise revenue are also needed.

This Policy Brief presents the assessment and recommendations of the 2008 OECD Economic Survey of Japan. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

Implementing a comprehensive tax reform. Tax reform should aim at promoting growth, addressing the widening of income inequality and improving the local tax system, in addition to raising additional revenue. Meeting these goals will require wide-ranging reforms, including an increase in the consumption tax rate and the broadening of the direct tax bases. With only a third of firms paying taxes and more than half of wage income exempted from taxes, there is significant scope for base broadening. Base broadening would facilitate a cut in the corporate tax rate to promote economic growth. Aspects of the tax system that discourage labour force participation and distort the allocation of capital should be removed, thereby accelerating growth. An Earned Income Tax Credit could be introduced to improve income distribution. The complicated local tax system should be simplified.

Enhancing the productivity of the service sector. Labour productivity in Japan is 30% below the US level. Closing this gap largely depends on reversing the significant slowdown in productivity growth in the service sector in recent years. This requires a comprehensive strategy aimed at promoting competition by accelerating regulatory reform, strengthening competition policy and increasing international openness to trade and inflows of foreign direct investment. The special zone initiative should also be revitalised with more focus on nationwide regulatory reform. It is also essential to address regulatory problems in key service industries, such as the retail sector, energy, transport and business services.

Tackling growing dualism in the labour market while promoting higher labour force participation. The share of non-regular workers has reached about a third of employees, raising serious equity and efficiency concerns. Increasing dualism is creating a large segment of the population with lower wages, short-term job experience and limited opportunities to enhance their human capital. A broad strategy is required, including enhancing employment flexibility for regular workers and expanding social security coverage and training programmes for non-regular workers. Encouraging female labour participation is essential in the face of a rapidly ageing population. ■

What is the economic outlook for Japan?

The economic expansion, the longest in Japan's post-war history, continued through 2007, although at a slower pace of around 2%. This protracted upturn has reversed a decade of economic stagnation that reduced Japan's rank in per capita income from the fifth highest in the OECD area in 1992 to nineteenth in 2002. Business investment and exports have been the main drivers of growth, accounting for about three-quarters of increased output since 2002. Corporate restructuring to reduce excessive levels of debt, production capacity and employment laid the foundation for a rebound in business investment, while buoyant export growth boosted corporate profitability and demand for additional capacity. Closer trade links with Asia, which now accounts for one-half of Japanese exports, have sustained export growth during this expansion. In 2007, exports expanded at almost 9% despite weak demand from the United States. With exports growing strongly and corporate profits at record levels, the expansion is projected to continue through 2009, with growth rates of between 1½ and 2%.

Uncertainty about the world economy in the context of increased turbulence in international financial markets since mid-2007, coupled with the uneven pattern of growth in Japan, pose risks to continued growth. In contrast to buoyant exports and business investment, other components of domestic demand have decelerated since 2005. While strong export growth has favoured manufacturing, the non-manufacturing sector, which is more dependent on domestic demand, has been lagging in terms of profitability, confidence, investment and wage growth. With 90% of small and medium-sized enterprises in the non-manufacturing sector, the unbalanced recovery has also created a significant gap between large and small firms. In addition, regional inequality has increased, as areas specialising in manufacturing have benefited the most from this expansion. A more balanced economic expansion, with stronger growth in services, would ease these disparities.

Domestic demand has been further weakened by the disruption of construction activity after the revision of the Building Standards Law in June 2007, which resulted in a 40% drop in housing and corporate construction starts in the third quarter of the year. In addition, a 0.7% decline in wages during 2007, which reduced labour's share of national income to its lowest point since 1990, has limited private consumption. The persistent weakness of wages despite the marked fall in the unemployment rate is due in part to structural factors, notably the increasing portion of lower-paid non-regular workers in the labour force. Given weak domestic demand and falling wages, deflation continues with the core consumer price index (excluding food and energy) declining by about 0.2% in 2007, the ninth consecutive annual decline. The fall in the price deflators for GDP and private consumption was larger at around ½ per cent. ■

How can monetary policy help sustain the expansion?

Given slower output growth, increased uncertainty about the economic outlook and continued deflation, the Bank of Japan has appropriately kept its short-term policy interest rate unchanged at ½ per cent since February 2007. Under the new monetary policy framework introduced in 2006, the central bank sets the policy interest rate to achieve a path of sustainable growth under price stability. As part of the framework, the Bank of Japan's Policy Board announced that 0 to 2% is its understanding of price stability in the medium to long term, the first time that it has specified an inflation range.

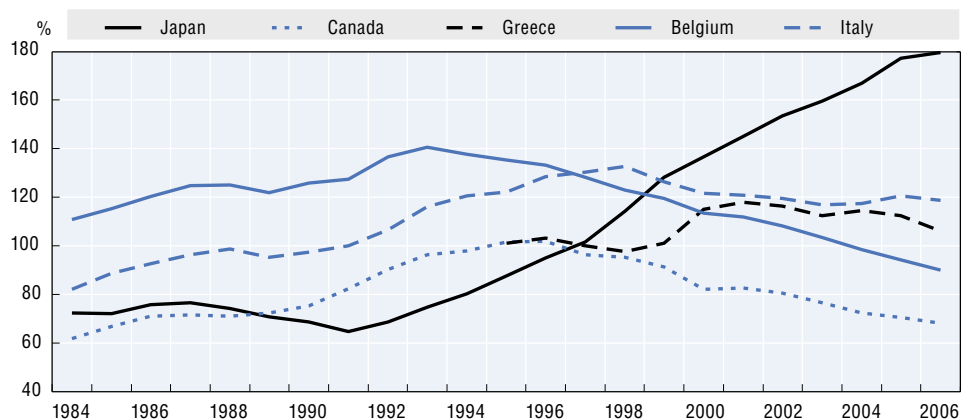
In addition, the central bank examines risk factors that may significantly impact economic activity and prices in the longer term.

The Bank of Japan should not raise the short-term policy rate further until inflation is firmly positive and the risk of renewed deflation becomes negligible. The central bank's outlook of a 0.4% rise in the consumer price index in FY 2008 is not sufficient to justify interest rate hikes for the time being, particularly as inflation has consistently undershot past projections. Waiting until inflation is significantly above zero would support the expansion and reduce the risk that a negative shock could push Japan back into deflation. The central bank's Policy Board should thus review the understanding of price stability and increase the lower end of the range to give an adequate buffer against deflation, as the zero floor is too close to deflation for comfort. While the announcement of the Board members' understanding of price stability enhances transparency, the fact that the inflation range will be reviewed each year makes it less useful as a guide for market expectations over the medium term. The course of monetary policy should take into account progress in fiscal consolidation, which will influence the pace of economic growth and the evolution of inflation. ■

What should Japan do to resolve its fiscal problem?

Japan has reduced its fiscal deficit from 8.2% of GDP in 2002 to around 4% in 2007 (on a general government basis excluding one-off factors), with the improvement divided almost equally between spending cuts and revenue increases. Government expenditure has fallen in nominal terms, primarily as a result of continued declines in public investment and the public-sector wage bill, although this has been partially offset by increased social security spending in the context of population ageing. On the revenue side, the government phased out the temporary income tax reduction and raised social security contributions, but a significant share of the increase in revenue was due to the economic expansion. Overall, about one quarter of the decline in the budget deficit since 2002 is explained by cyclical factors. On a primary budget basis, the deficit fell at an annual pace of around ½ per cent of GDP, adjusted for cyclical factors, between 2002 and 2007.

Figure 1.
OECD COUNTRIES WITH A LARGE PUBLIC DEBT RATIO
Gross government debt as a share of GDP¹



1. The five countries in this figure had the highest gross debt ratios in the OECD area in 2000.

Source: OECD, *OECD Economic Outlook*, No 82, December 2007.

Despite the reduction in the budget deficit, government debt has continued to rise, reaching around 180% of GDP in 2007, the highest level ever recorded in the OECD area. Further progress in fiscal consolidation is urgent, as Japan is increasingly vulnerable to a rise in the long-term interest rate from its current low level of around 1½ per cent. The government's medium-term plan targets a small surplus in the primary budget of central and local governments combined by FY 2011 as a first step to reduce the government debt ratio in the 2010s. With the primary budget deficit on a general government basis estimated at 3% of GDP in 2007 (excluding one-off factors), achieving a surplus in 2011 would require an acceleration in the pace of consolidation to about ¾ per cent of GDP per year. Moreover, stabilising the government debt ratio may require a significant primary surplus of 1% to 2% of GDP (on a general government basis), while an even larger surplus is necessary to achieve the objective of reducing the debt ratio.

Is there scope for additional spending cuts to reduce the budget deficit?

Further cuts in government outlays should be the priority to achieve the fiscal targets. In 2006, the government announced reductions by spending category through FY 2011. This important step should help maintain public confidence in the government's fiscal consolidation plan. However, the spending cuts are calculated relative to a baseline of 3% nominal output growth – higher than the 1.7% projected by the OECD for 2007-09 – which implicitly allows government expenditures to increase at an annual rate of between 1.2% and 1.7% over the period 2007-11. Thus, the medium-term spending plan is not sufficiently ambitious and may allow government outlays to rise as a share of GDP. A stricter spending plan is needed to make sure that the fall in government expenditures over the period 2002-07 is not reversed. Maintaining the sustainability of the social security system, which is excluded from the government's medium-term fiscal target, is important to ensure that a primary budget surplus for central and local governments combined is not achieved through a deterioration in the fiscal balance of the social security system.

Much of the spending restraint to date has been achieved by cutting public investment from 6% of GDP in 2002 to 4% in 2007, but even this lower level is still above the OECD average of 3%. This suggests that there may still be scope for further reductions, which should be accompanied by a better allocation of investment to enhance its productivity. Indeed, public investment has not been an efficient instrument to reduce regional disparities, which should be addressed by other policies. The government expects the cost of maintaining existing infrastructure to exceed new investment by 2011 and completely crowd out new investment by 2022. It is important to develop a plan to close underutilised infrastructure, based on strict cost-benefit analysis in the context of a declining population, to retain some room for productivity-enhancing public investment. Spending has also been reduced by a cut in the total compensation of central government workers (including employees of central government corporations) from 2% of GDP in FY 2001 to 1.7% in FY 2005. The government aims to reduce it further so as to halve its share of GDP by FY 2015. Spending reductions should be extended to local governments, all public enterprises and government-affiliated organisations, which account for more than 90% of public-sector employment. In any case, the scope for expenditure cuts in this area is limited by the fact that public-sector employment per population in Japan is already well below the

level in other major OECD economies. In addition to public investment and government wages, it is thus important to identify other areas for spending reductions.

How can Japan limit the impact of ageing on public spending?

Controlling social security spending in the context of rapid population ageing is essential to limit the growth of government expenditures. Despite the reform of the public pension system in 2004 and some changes planned in healthcare, the government projects that gross public social spending – pensions, healthcare, long-term nursing care and welfare – will rise at a 3% annual rate over the next decade, boosting it by almost 1% of GDP to 18.4% by FY 2015. Pension reform was intended to limit pension spending to around 9¼ per cent of GDP over the next decade and ensure the sustainability of the system for 100 years, but the recent confusion about the accuracy of pension records creates doubts about pension administration. Moreover, the 2004 projections were based on strong assumptions. Despite the fact that some of these assumptions were revised downward in 2007, they are based on past trends and could prove to be fairly optimistic. Any slippage from the spending target should be resolved by a hike in the pension eligibility age, rather than by a further rise in the contribution rate, which is already set to increase from 13.6% in FY 2004 to 18.3% by FY 2017, and by measures to boost the return on the pension fund's assets. As for public healthcare spending, the government aims to limit the rise from 5.4% of GDP in FY 2006 to 5.8% in FY 2015, a figure still below the current OECD average of 6%, despite population ageing. The increase in public healthcare spending is expected to be reduced by a number of reforms, including a reduction in medical fees and a new healthcare system in FY 2008 for those over age 75. However, the hike in the share of medical expenses to be paid by patients between 70 and 74 has been postponed for a year. In addition, healthcare spending is to be limited by preventing lifestyle-related diseases and reducing the length of hospital stays, although the impact of these reforms on healthcare spending remains uncertain. The key to achieving higher quality and greater efficiency in healthcare is accelerating needed regulatory reforms, in part to allow a greater role for the private sector. ■

How should the tax system be reformed?

Given the substantial primary budget surplus needed to stabilise the government debt ratio and the difficulty of significantly reducing spending, achieving the fiscal targets will require as much as 6% of GDP in additional revenue in coming years, according to a government estimate. Moreover, reducing the debt ratio would require even more revenue. The government should implement a comprehensive reform of the tax system to raise the necessary revenue. However, it is important to boost revenues in a way that limits any negative impact on Japan's growth potential in the medium term. Moreover, changes in the tax system should be phased in so as to help sustain the current economic expansion. At the same time, an overhaul of the tax system should address the upward trend in income inequality and improve the local tax system. Tax reform should thus aim at balancing the objectives of efficiency, equity and simplicity.

The negative impact of taxes on growth can be minimised by shifting the composition of taxes from direct to indirect taxes. Given the need for additional revenue in Japan, the amount of direct tax revenue should be

maintained while increasing indirect tax revenue. This requires a hike in the consumption tax rate from its current level of 5%, the lowest in the OECD area. A one percentage-point hike in the consumption tax rate would boost government revenue by about ½ per cent of GDP. In seeking additional revenues in this area, Japan should maintain a single consumption tax rate applied to a broad tax base and retain flexibility in allocating the additional revenues.

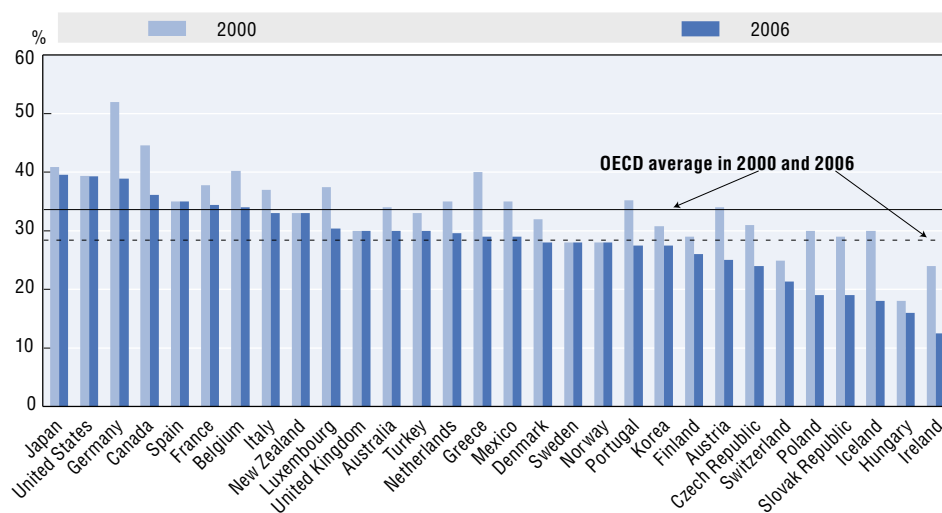
Is there scope to cut the tax rate on corporations?

This should be accompanied by broadening the corporate tax base by cutting tax expenditures and reducing generous deductions, thereby lowering the proportion of firms that do not pay tax. Indeed, only one-third of firms – and one-half of large firms – pay corporate taxes. Broadening the tax base would enhance potential growth by improving the allocation of resources and investment. The additional revenue generated by base-broadening would allow some reduction in the corporate tax rate, currently the highest among OECD countries at 40%, to a level closer to the OECD average of 29%, which would also promote growth. The negative effect on tax revenue from such a rate cut would be limited by positive supply effects, notably increased investment and a larger corporate sector.

How can the personal income tax base be broadened?

There is also considerable scope for boosting revenue by broadening the personal income tax base, given that less than half of wage income is taxed. This partly reflects the large deduction for wage earnings, which exempts more than a quarter of employees’ earnings from the tax base, in part to improve horizontal equity between employees and the self-employed. A reduction in the exemption for wage income must be accompanied by measures to increase the proportion of self-employed income that is taxed.

Figure 2.
STATUTORY CORPORATE
INCOME TAX RATES
 Combined rate in per cent
 in 2000 and 2006¹



1. Basic combined central and sub-central (statutory) corporate income tax rate. Averages are un-weighted.

Source: OECD (2007), Tax Database, (www.oecd.org/ctp/taxdatabase).

Higher personal income tax revenue resulting from base broadening would help to offset any decline in corporate taxes, thus maintaining the overall level of direct taxes. A greater role for the personal income tax, which has a positive impact on income distribution, may also be beneficial from an equity perspective. The additional revenue from base broadening could be used to finance an Earned Income Tax Credit, as well as perhaps reducing personal income tax rates so as to increase work incentives. An Earned Income Tax Credit provides support to low-income households while strengthening work incentives, although there could be difficulties in administration and possible fraud. Such an approach is likely to be effective in Japan, given its relatively wide earnings distribution, low taxes on labour and low benefits for the non-employed. In addition, equity concerns should be met by strengthening the inheritance tax, which is applied to only 4% of persons at the time of death. Finally, elements of the personal income tax system that discourage work – such as the exemptions and deductions for secondary earners – should be reformed, while improving the taxation of financial income to reduce distortions in the allocation of capital, thereby promoting growth.

How can the local tax system be improved?

Tax reform should also focus on improving the local tax system, which is exceptionally complicated, with 23 taxes, while allowing only limited autonomy to local governments. Barriers to the effective use of existing powers to set local tax rates should be removed. The priority should be to phase out the local tax on corporations, while increasing revenue through the existing local taxes on personal income, consumption and property. Such taxes are more stable and have less adverse effects on the potential growth rate than taxes on corporations. Raising the overall consumption tax rate would boost the local consumption tax rate if it remains at a quarter of the national rate, thus providing additional revenue to local authorities. In addition, the effective rate of tax on property should be increased by bringing property evaluations closer into line with market prices. Greater revenue from these taxes would more than offset the abolition of local taxes on corporations, which are excessively volatile and discourage employment and investment. Moreover, eliminating the local corporate tax would bring the overall statutory rate more into line with the OECD average and thus have a positive impact on growth. ■

How can Japan's growth potential be increased?

While a well-designed tax reform could have a positive effect on Japan's growth potential, the key priority for long-term growth is to improve the labour productivity performance. The potential growth rate in Japan is estimated at 1.4% over the period 2004 to 2013, the lowest rate in the OECD area, reflecting a large negative contribution from a declining working-age population. As the drag on economic growth from population ageing increases in the years to come, sustaining an improvement in living standards will depend on accelerating labour productivity growth. Given that labour productivity per hour worked in Japan is 30% below the US level, there appears to be a large potential for faster productivity growth. To accomplish this, it is essential to reverse the decline in productivity growth in the service sector, from 3.5% a year in the period 1976 to 1989 to only 0.9% between 1999 and 2004, in contrast to the high and sustained growth of productivity in the manufacturing sector.

How can Japan strengthen competition in its service sector?

The slowdown in productivity growth in services, in contrast to manufacturing, highlights the importance of strengthening competition. Indeed, the OECD indicator of the stringency of product market regulations in the non-manufacturing sector ranks Japan in the middle of OECD countries and well below the top performers. It is important, therefore, to strengthen competition by accelerating regulatory reform, as well as by upgrading competition policy and increasing international openness. The 2007 Regulatory Reform Programme, which includes a number of services, such as education, distribution and energy, should focus on lifting key regulations on entry and operations. It should also accomplish its goal of improving administrative tools, such as the “No-Action Letter” scheme, which allows a firm to seek advance clarification about the application of regulations to its business plan. Finally, it is important to strengthen the links between regulatory reform and the Special Zones for Structural Reform initiative introduced in 2003, which appears to be losing momentum. The initiative should be made more effective by removing barriers to the implementation of reform measures in the zones and ensuring that the initiative focuses on its key objective of nationwide regulatory reform rather than on regional development.

Enforcement of competition law by the Japan Fair Trade Commission has been strengthened by the 2005 revision of the Anti-Monopoly Act (AMA). Nonetheless, the legal framework and enforcement should be further reinforced. *First*, administrative penalties and fines, which are relatively low compared with other countries and compared with the potential gains from violating the AMA, should be increased to strengthen the deterrent effect. *Second*, explicit exemptions from the AMA in a wide range of areas, such as insurance, the liquor business, hair cutting, agricultural co-operatives and air and maritime transport, should be reduced. Exemption is appropriate only when necessary to correct clear market failures. *Third*, the special treatment of small and medium-sized enterprises, which play a dominant role in the service sector, should be scaled back. *Fourth*, the Japan Fair Trade Commission should ensure that the large number of trade associations do not limit competition. Foreign competition is also important to boost productivity, in part as foreign affiliates have higher productivity than domestic firms. However, the share of foreign affiliates in total service turnover in Japan, as well as the proportion of services in the total turnover of foreign affiliates in Japan, are the lowest in the OECD area. It is thus important to remove barriers to inward foreign direct investment, as well as product market regulations that discourage foreign investors, in order to strengthen competition. In addition, Japan is relatively closed to international trade in services. Indeed, the import penetration rate for services in Japan is the lowest among OECD countries, indicating the need to reduce trade barriers.

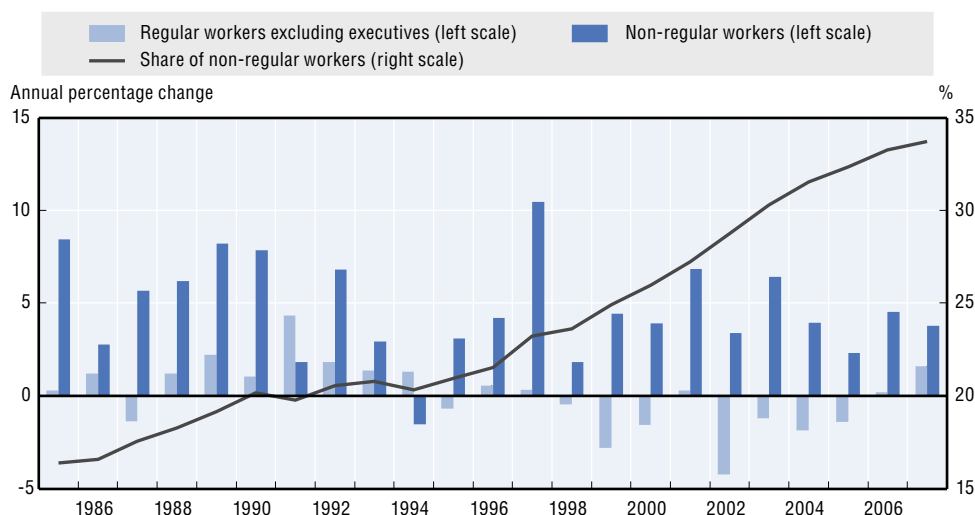
The privatisation of Japan Post, which began in October 2007 with its division into four companies, should be fully carried out in line with the announced schedule. This important initiative is likely to shift the flow of funds away from the public sector and towards the private sector, thus promoting the dynamism of the Japanese economy. Moreover, in December 2007, Japan announced a plan to strengthen the competitiveness of its financial and capital markets, including measures to enhance the transparency of regulations.

What reforms are needed in key service industries?

Competition in key service industries should be strengthened through wide-ranging reforms, while strictly enforcing competition law:

- **Retail sector:** The transparency and predictability of the Large-scale Retail Store Location Law, which aims at “maintaining the living environment”, and the City Planning Law, which is intended to revitalise urban areas, should be improved to ensure that they do not act as entry barriers to large stores.
- **Energy sector:** A single independent sectoral regulator should be established for both the electricity and gas sectors to ensure competition and the share of consumers allowed to choose their suppliers should be expanded. In electricity, although Japan has introduced accounting separation of vertically integrated incumbents, competition should be further strengthened through formal separation, reducing barriers to new entrants and expanding the interconnection capacity.
- **Transport industry:** Competitive pressures should be enhanced in ports by relaxing entry barriers and reforming the “Prior Consultation Process”. In the air transport industry, the current slot allocation scheme based on IATA guidelines should be improved by introducing market mechanisms. Moreover, airlines should be able to sell tickets directly to consumers at competitive prices. Airports should be privatised and their capacity expanded in order to increase efficiency and reduce high charges.
- **Business services:** Pervasive regulation, including by professional associations, should be relaxed, while encouraging international competition through increased recognition of foreign certificates.
- **Public services:** Reforms in areas such as education and healthcare should be advanced, in part through the special zone initiative and expanded use of market testing to outsource government activities to the private sector. ■

Figure 3.
**THE SHARE OF
NON-REGULAR WORKERS
IS RISING**



Source: Ministry of Internal Affairs and Communications.

How can the labour market be improved?

Product market reforms should be accompanied by reforms in the labour market to increase efficiency and equity. Japan has experienced a sharp rise in labour market dualism, with the share of non-regular workers rising from 20% in 1994 to 34% in 2007. Firms are achieving employment flexibility through increased hiring of non-regular workers, who have temporary contracts, boosting their share of employment. In addition, non-regular workers are relatively inexpensive; the average hourly wage of part-time employees, who account for three-quarters of non-regular workers, is only 40% of that of regular workers, and they are exempt from some social insurance systems. The increasing dualism is creating a large segment of the population, concentrated among young people, with only short-term employment experience and limited opportunities to enhance their human capital, given that they do not benefit fully from firm-based training, which plays an important role in Japan. There are also serious equity problems, given that the difference in productivity between regular and non-regular workers is much smaller than the wage gap. The equity concern is magnified by the lack of movement between the two segments of the workforce, trapping a significant portion of the labour force in a low-wage category from which it is difficult to escape. Reversing the trend towards increased dualism requires a comprehensive approach. This should include enhancing the flexibility of regular employment, increasing the coverage of temporary workers by social security insurance schemes and upgrading training programmes to enhance the employment prospects of non-regular workers.

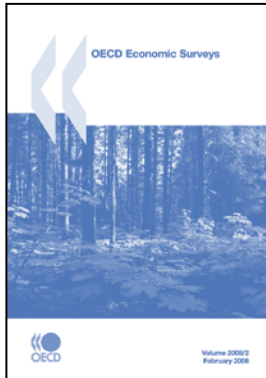
With women accounting for more than two-thirds of non-regular workers, reversing the trend toward labour market dualism as suggested above may help to boost female participation rates by providing more attractive job opportunities and encouraging flexibility in working arrangements. A higher participation rate of women would help buffer the impact of the decline in the working-age population, which is projected to fall by 9% in the decade beginning in 2007. The priority is to remove aspects of the tax and social security systems that discourage employment of secondary earners. In addition, private-sector practices, such as company allowances for spouses, the importance of tenure in setting wages and the use of age limits on potential new workers, may also discourage female participation in the labour force. The government should also reduce or eliminate aspects of the tax and social security system that discourage women from working full-time. Indeed, the proportion of women employed part-time, at 41%, is one of the highest in the OECD area. Improved access to childcare would be effective in boosting both female labour force participation and the fertility rate. Finally, efforts to promote better work-life balance, in part through stricter enforcement of the Labour Standard Law, may encourage greater female labour force participation. ■

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