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OVERVIEW

BETTER POLICIES FOR BETTER LIVES

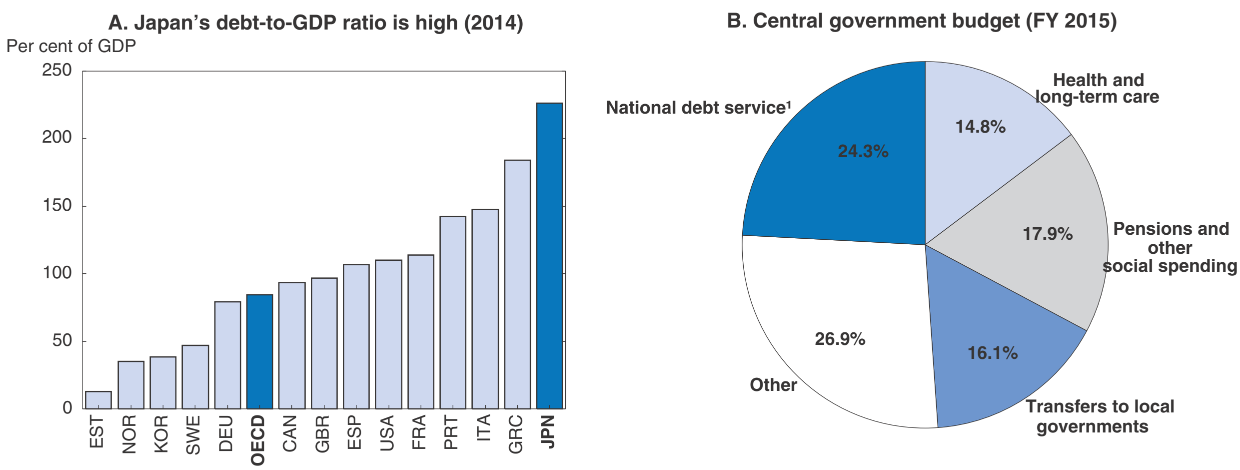
Executive summary

- *Main findings*
- *Key recommendations*

Main findings

Two decades of sluggish growth and persistent deflation have reduced Japanese living standards below the OECD average. Gross government debt has risen to 226% of GDP, the highest in the OECD, driven by rising social spending and inadequate revenues. Rapid population ageing is putting continued pressure on public spending, while pushing down Japan's potential growth rate to around ¾ per cent. Abenomics – bold monetary policy, flexible fiscal policy and a growth strategy to revitalise the economy and end deflation – had an immediate positive effect in 2013, thanks to the first two arrows. Growth was interrupted in the wake of the tax increase in April 2014, but resumed later in the year.

Japan's debt is the highest in the OECD, pushing up debt service costs



1. Debt service includes debt redemption, which is not included in general government spending.
Source: *OECD Economic Outlook Database*; Ministry of Finance.

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Boost economic growth through bold structural reforms. Fundamental structural reforms – the third arrow – urgently need to be stepped up to raise output growth, which is essential for fiscal consolidation and improved living standards. The role of women is limited by a range of factors, including their concentration in non-regular jobs and disincentives in the tax system. Japan remains internationally isolated with the lowest share of inward foreign direct investment (as a per cent of GDP) in the OECD area. Low rates of firm creation and exit reflect a lack of economic dynamism in the business sector. Venture capital investment is at an early stage of development and the small and medium-sized enterprise sector is lagging.

The top fiscal priority is reducing government debt. With a primary deficit of nearly 7% of GDP in 2014, public debt remains on an upward path. The impact of the high debt is mitigated by low long-term interest rates, but weakening confidence would cause interest rates to rise substantially. A run-up in interest rates would increase debt rapidly and destabilise the financial sector and the real economy. Large-scale revenue increases are indispensable, although this will tend to temporarily hold back GDP growth. Constraining spending is difficult but crucial, given upward pressure on social outlays, notably for health and long-term care, and the need to promote social cohesion. Social spending, which is concentrated on the elderly, has only a limited impact on income inequality among the working-age population, whose relative poverty rate increased through 2012. This partly reflects the rising share of non-regular workers, who are paid much less than regular workers.

End deflation. Persistent deflation has been a headwind to growth and has exacerbated the fiscal situation by steadily reducing nominal GDP. The Bank of Japan has set a 2% inflation target and launched "quantitative and qualitative monetary easing", boosting its balance sheet to 65% of GDP.

Key recommendations

Effective implementation of all three arrows of Abenomics is required for its success

Boost economic growth through bold structural reforms

The top priorities in this regard are to:

- Slow the trend decline in the labour force by:
  - Increasing female employment by expanding childcare, reforming aspects of the tax and social security systems that reduce work incentives for second earners and breaking down labour market dualism to reduce gender inequality.
  - Expanding the use of foreign workers.
- Participate in high-level trade agreements, notably the Trans-Pacific Partnership and a Japan-EU Economic Partnership Agreement.
- Improve the business climate to boost productivity growth by:
  - Upgrading corporate governance.
  - Promoting labour market flexibility and mobility.
  - Improving the entrepreneurial climate by ensuring second chances and developing entrepreneurial education.
  - Revitalising venture capital investment to promote firm creation and innovation.
  - Reducing government support for SMEs to promote the restructuring of viable firms and the exit of non-viable ones.
  - Moving to a more market-based agricultural system by measures such as reducing commodity-specific payments to farmers, accelerating the consolidation of farmland and reforming the role of agriculture co-operatives.

The top fiscal priority is reducing government debt while promoting social cohesion

- Set out a detailed and credible plan to constrain government spending and raise revenues so as to achieve the target of a primary surplus by FY 2020.
- Rely primarily on the consumption tax with a single rate and a broadening of the personal and corporate income tax base to boost government revenue, while raising environmental taxes.
- Reform pension and health and long-term care to limit spending growth in the face of population ageing.
- Improve the targeting of public social spending and introduce an earned income tax credit for low-income workers.
- Break down labour market dualism by increasing the coverage of social insurance and upgrading training programmes for non-regular workers, and reducing effective employment protection for regular workers, in particular by increasing transparency.

End deflation

- Continue monetary expansion to durably raise inflation to the 2% target, while monitoring risks.

Assessment and recommendations

- *Recent macroeconomic developments and short-term prospects*
- *Structural reforms to boost growth: The Japan Revitalisation Strategy (the third arrow)*
- *Reducing government debt: Flexible fiscal policy (the second arrow)*
- *Ending deflation: Bold monetary policy (the first arrow)*

During the past two decades, economic growth has been sluggish, reducing Japan's relative per capita income from a level matching the top half of OECD countries in the early 1990s to 14% below (Figure 1). The collapse of the asset price bubble in the early 1990s was followed by an extended period of corporate restructuring and a banking crisis. Weak growth has contributed to Japan's serious fiscal problem by limiting the growth of government revenue. Rising spending, driven by population ageing and frequent fiscal stimulus packages, has been financed largely by borrowing, boosting gross government debt to 226% of GDP in 2014 (Panel B), the highest ever recorded in the OECD. Net debt is also the highest at 129% of GDP. Upward pressure on the debt ratio continues, with a primary budget deficit of nearly 7% of GDP in 2014 (Panel C). Persistent deflation has contributed to the run-up in the debt ratio by reducing nominal GDP (Panel D), while acting as a headwind to output growth. The 2011 Great East Japan Earthquake – the worst disaster in Japan's post-war history – put further pressure on public finances.

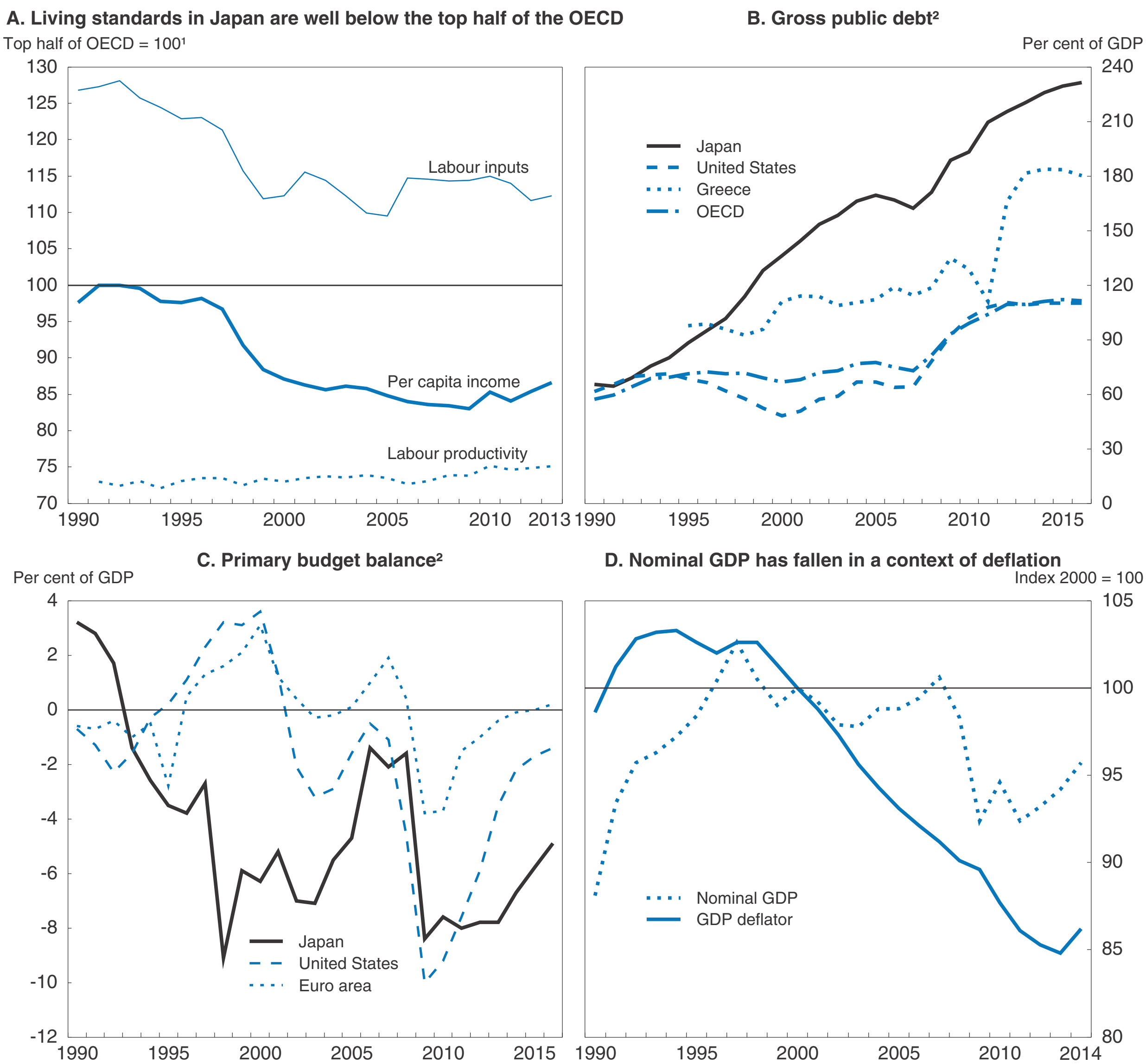
In early 2013, Japan launched a three-pillar approach, the so-called three arrows of "Abenomics", to exit deflation and revitalise the country: a bold monetary policy; flexible fiscal policy; and a growth strategy. The first arrow was launched in early 2013 with the introduction of "quantitative and qualitative easing" (QQE). It was accompanied by the second arrow, which included two large fiscal packages. The third arrow – the Japan Revitalisation Strategy – was announced in June 2013 and revised a year later. The combined effects of fiscal and monetary policy expansion and structural reform were intended to strengthen business investment and private consumption, with a view to boost real growth to a 2% annual pace through 2022 and to achieve a 2% inflation target. The initial results of the first two arrows were encouraging; nominal GDP increased at a faster pace, aided by a pick-up in inflation, reflecting a large depreciation of the yen. Output growth reached 1.6% in 2013, as business and consumer confidence soared and the stock market rose by 57%. Following a contraction in the wake of the consumption tax hike, growth resumed in late 2014.

The third arrow of Abenomics is its most crucial component, without which the unprecedented monetary expansion and the fiscal effort will not succeed in putting Japan on a path to faster growth and fiscal sustainability. The ten key reforms in the Strategy include important measures to promote growth, but they need to be more ambitious and implemented rapidly. The top priorities are: i) stabilising the size of the labour force by boosting the participation of women and older people and expanding inflows of foreign workers; ii) enhancing Japan's integration in the world economy through trade agreements, notably the Trans-Pacific Partnership (TPP) and the Japan-EU Economic Partnership Agreement; and iii) improving the business climate by upgrading corporate governance, enhancing labour flexibility and mobility, promoting venture capital investment and improving policies for small and medium-sized enterprises (SMEs).

The key messages in this *Survey* are:

- Bold structural reforms are crucial to boost Japan's growth potential.

Figure 1. **Japan has faced low growth, rising government debt, large deficits and deflation**



1. Per capita GDP is calculated using 2005 prices and PPP exchange rates. Labour productivity equals GDP per hour of labour input. Labour inputs equal total number of hours worked per capita.
2. General government basis as a percentage of GDP. OECD estimates for 2014 and projections for 2015-16.

Source: OECD, *Going for Growth Database*; *OECD Economic Outlook Database*.

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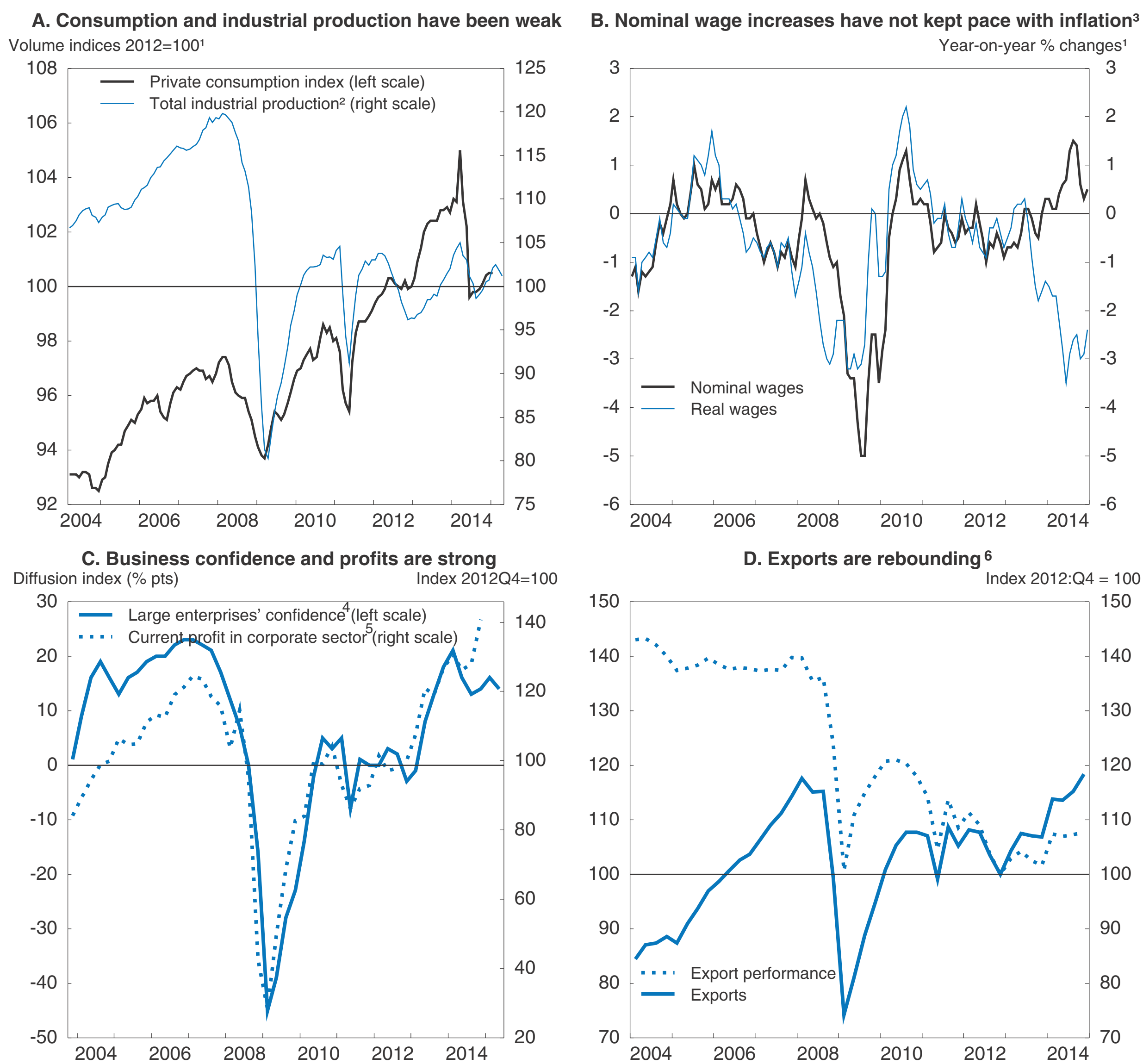
- Increasing government revenue and keeping spending in check are essential to put government debt on a downward trend, while promoting social cohesion.
- QQE should continue until the 2% inflation target is sustainably achieved.

Recent macroeconomic developments and short-term prospects

The April 2014 tax hike resulted in a volatile quarterly growth pattern. Strong growth in private consumption and business investment in the first quarter was followed by declines of around 19% (seasonally-adjusted annual rate) in both components in the second quarter, despite a fiscal package of 1.1% of GDP. Output fell further in the third quarter due to a large negative contribution from stockbuilding and weak domestic demand, plunging Japan into its fourth technical recession since 2008 and delaying the planned second hike in the consumption tax to 10% until 2017.

The 2014 downturn reflects, in part, the weak rebound in private consumption (Figure 2) as real wages fell (Panel B). While nominal wage growth turned positive in late

Figure 2. **Key macroeconomic indicators show a mixed picture**



1. Three-month moving average.
2. Producers' estimates for March and April 2015.
3. Total cash earnings (including bonuses).
4. Diffusion index of "favourable" minus "unfavourable" conditions. Numbers for 2015:Q2 are companies' projections made in March 2015.
5. Profits, which are for non-financial firms, are seasonally adjusted.
6. There is a statistical break in 2014:Q1, reflecting the shift from the *Balance of Payments Manual* 5 to *Balance of Payments Manual* 6. Export performance measures the extent to which Japan gains or loses market share in foreign markets.

Source: Ministry of Economy, Trade and Industry; Cabinet Office; Ministry of Health, Labour and Welfare; *OECD Economic Outlook Database*; Ministry of Finance; OECD calculations.

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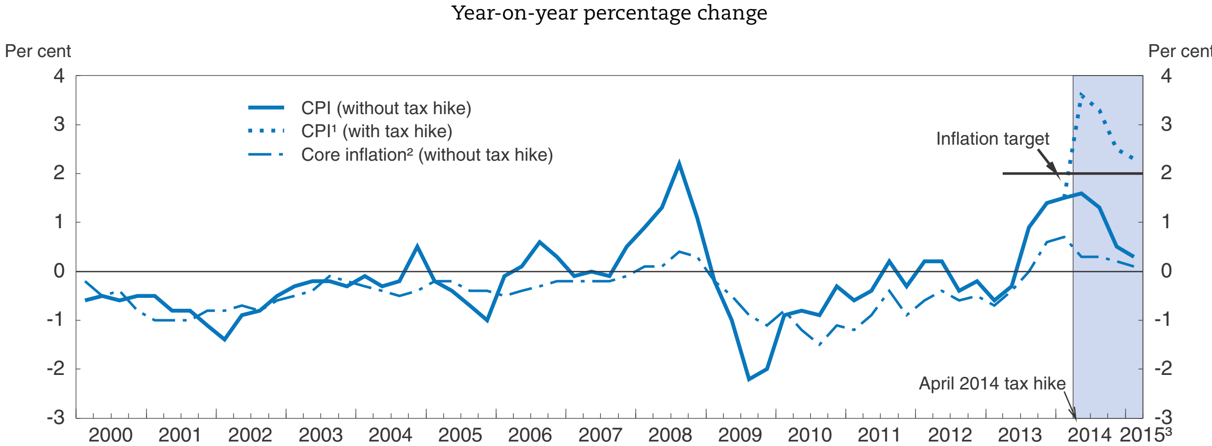
2013, it has lagged inflation (including the tax hike), reducing consumers' purchasing power and confidence. Faced with weak domestic demand, business investment declined for three consecutive quarters, despite still strong business confidence and high profitability (Panel C), reflecting the cut in the corporate income tax rate in 2014 and yen depreciation. The weaker yen helped increase export growth, reversing the longstanding downward trend in Japan's export market share (Panel D). However, the depreciation also squeezed households and small companies, partly offsetting gains in corporate profits and exports. Falling oil and commodity prices, combined with weaker output growth, have slowed inflation, which reached 1.5% (year-on-year, excluding the impact of the consumption tax hike) in early 2014, to ¼ per cent by the first quarter of 2015 (Figure 3).

Output growth is projected to pick up to 1% in 2015 (Table 1). The fall in oil and commodity prices has resulted in significant terms-of-trade gains that are promoting private consumption and investment. Indeed, the fall in oil prices from $85 per barrel in October 2014 to $60 in March 2015 is projected to boost output growth by about ¼ percentage points. Given that the energy component of the consumer price index fell only 4% during the second half of 2014, most of the gains for consumers and firms will be realised in 2015. In addition, the FY 2014 supplementary budget of 0.6% of GDP announced in January 2015, which includes support for households, small businesses and local governments as well as public investment, is expected to boost output growth by another 0.3 percentage points in 2015. Nevertheless, fiscal policy will be a headwind with a projected 2 percentage points of consolidation during 2015-16, even with the supplementary budget and the delay in the second hike in the consumption tax to 2017.

Wage growth is key to output growth. With the working-age population falling 1.5% a year and firms already reporting the highest level of labour shortages since the early 1990s, workers are likely to obtain significant pay increases in the spring 2015 wage negotiations, pushing real wage growth into positive territory and helping support private consumption. Indeed, the rise in bonus payments in mid-2014 was the largest in 30 years and the initial results from the 2015 wage negotiations are encouraging. Labour shortages and high

Figure 3. **Inflation fell during 2014**

Year-on-year percentage change



1. In April 2014, the consumption tax was raised from 5% to 8%.The tax hike added 2 percentage points to inflation according to estimates by the Bank of Japan and the Cabinet Office.
2. OECD measure, which excludes food and energy.
3. The average of January and February 2015.

Source: OECD Economic Outlook Database; Bank of Japan (2014); Cabinet Office (2014).

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Table 1. **Macroeconomic indicators and projections**[1]

	2011	2012	2013	2014	2015	2016
Demand and output (volumes)						
GDP	-0.5	1.8	1.6	0.0	1.0	1.4
Consumption						
Private	0.3	2.3	2.1	-1.2	0.7	1.6
Government	1.2	1.7	1.9	0.3	0.8	0.7
Gross fixed investment	1.4	3.4	3.2	2.6	-0.2	0.6
Public[2]	-8.2	2.7	8.0	3.7	-4.8	-19.1
Residential	5.1	3.2	8.7	-5.2	-2.6	6.8
Business	4.1	3.7	0.4	4.1	1.7	5.3
Final domestic demand	0.6	2.4	2.3	-0.1	0.5	1.2
Stockbuilding[3]	-0.2	0.2	-0.4	0.1	-0.1	0.0
Total domestic demand	0.4	2.6	1.9	0.0	0.4	1.2
Exports of goods and services	-0.4	-0.2	1.5	8.2	6.6	6.4
Imports of goods and services	5.9	5.3	3.1	7.2	3.0	4.7
Net exports[3]	-0.9	-0.9	-0.3	0.0	0.6	0.2
Inflation and capacity utilisation						
GDP deflator	-1.9	-0.9	-0.5	1.7	1.8	1.5
Nominal GDP	-2.3	0.8	1.1	1.6	2.8	2.9
CPI	-0.3	0.0	0.4	2.7	1.0	1.5
CPI[4]	-0.3	0.0	0.4	1.2	0.5	1.5
Core CPI[4]	-0.9	-0.5	-0.1	0.5	1.2	1.6
Unemployment rate	4.6	4.3	4.0	3.6	3.5	3.3
Output gap	-1.7	-0.7	0.4	-0.4	-0.3	0.2
Memorandum items						
World trade growth	6.7	3.0	3.3	3.0	4.5	5.5
Oil prices (spot Brent price in $)	111.2	111.6	108.7	101.4	60.0	60.0
Net government lending[5]	-8.8	-8.7	-8.5	-7.7	-6.8	-5.9
Net primary balance[5]	-8.0	-7.8	-7.8	-6.7	-5.8	-4.9
Gross government debt[5]	209.6	215.5	220.3	226.0	229.3	231.5
Net government debt[5, 6]	127.3	129.3	122.9	128.6	131.9	134.1
Household saving ratio (%)	2.7	1.2	-0.2	1.1	1.6	1.4
Current account (% of GDP)	2.1	1.1	0.7	0.6	2.2	2.4

1. The *OECD Economic Outlook* No. 96 projections have been updated by including the second estimates of GDP for 2014:Q3 and Q4 and the government and household sector accounts (through 2013) announced in December 2014. It also incorporates the FY 2014 supplementary budget, approved by the Diet in February 2015, and the fall in oil prices.
2. Including public corporations.
3. Contribution to GDP growth (percentage points).
4. Excluding the impact of the consumption tax hike in April 2014. See footnote 1 to Figure 3. The core CPI is the OECD definition, which excludes both food and energy.
5. General government basis as a percentage of GDP.
6. Net debt is gross debt less assets held by the government.

Source: OECD Economic Outlook Database.

profitability will also support investment, which will benefit from a further cut in the combined (central and local government) corporate tax rate to 31.3% in 2016. With a weaker yen, Japan is well-positioned for export growth as world trade picks up, which, along with the fall in oil and commodity prices, is projected to lift the current account surplus to around 2½ per cent of GDP in 2016. Inflation is projected to pick up to around 1½ per cent in 2016.

Many downside risks overshadow this projection. Sustained growth requires a virtuous circle of rising wages, prices and corporate earnings. Sluggish wage growth is the key risk in this regard. Given low labour mobility in the context of lifetime employment, wages react slowly to changing labour market conditions. The fragile global economic situation also poses risks, such as slower-than-expected growth in China, uncertainty in the euro area and the impact of the anticipated US monetary tightening. The major concern, though, relates to Japan's unprecedentedly high level of public debt. In the absence of a credible plan to achieve its fiscal targets, Japan could face a loss of confidence in its fiscal sustainability that would result in a run-up in long-term interest rates. This could make fiscal consolidation nearly impossible and could destabilise the financial sector and the real economy. Such a development would have large spillovers to the world economy, given the size of the Japanese economy and its large stock of foreign assets.

Growth remains well below the targets set in the 2012 consumption tax legislation: 3% for nominal GDP, 2% for real GDP and 1% for the GDP deflator on average over 2013-22 (Table 2). These targets, which were adopted by the government and the Bank of Japan in a January 2013 agreement, require reversing the downward trend in nominal GDP and the GDP deflator over 1997-2012.

Table 2. **Japan's macroeconomic targets**[1]

	Target (%)	Average over 1997:Q2 to 2012:Q2	Required increase[2]	Average over 2012:Q3 to 2014:Q3	Additional increase required[2]
Nominal GDP	3	-0.6	3.6	1.4	1.6
Real GDP	2	0.6	1.4	0.5	1.5
GDP deflator	1	-1.3	2.3	0.8	0.2

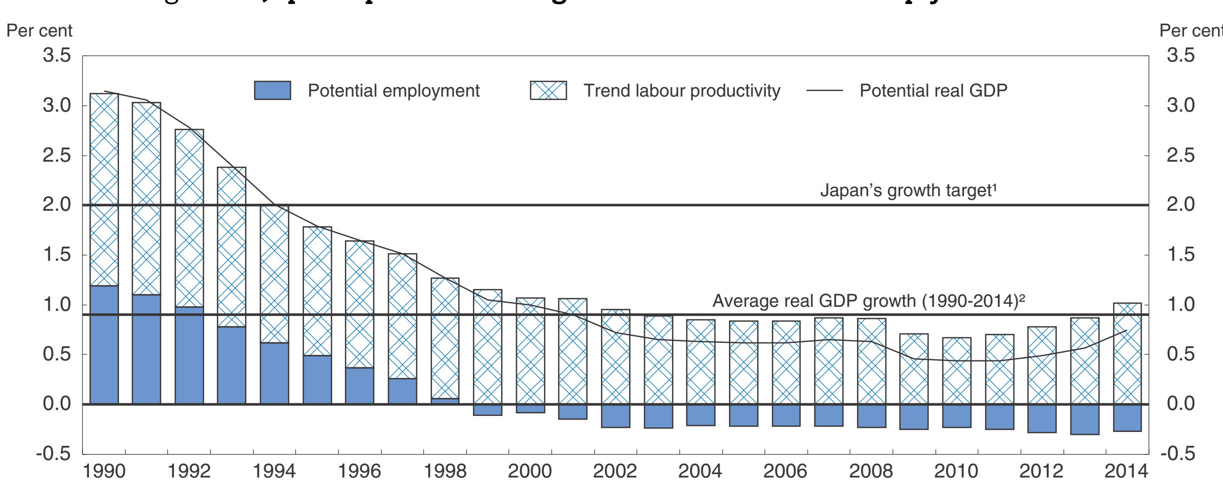
1. Included in the August 2012 consumption tax legislation and adopted by the Abe Administration.
2. Increase (in percentage points) in the annualised growth rate needed to meet the target.

Source: *OECD Economic Outlook Database.*

Structural reforms to boost growth: The Japan Revitalisation Strategy (the third arrow)

Reversing the fall in Japan's potential growth rate, which slowed from over 3% in the early 1990s to around ¾ per cent in 2014 (Figure 4) requires additional steps to: i) slow the

Figure 4. **Japan's potential GDP growth rate has fallen sharply since 1990**



1. The 2% target was set in 2009 and maintained by subsequent governments.
2. Average annual GDP growth in real terms in Japan between 1990 and 2014.

Source: *OECD Economic Outlook Database.*

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decline in the labour force or even reverse it; and ii) boost labour productivity growth, which will depend to a large extent on innovation. The government aims to boost real annual output growth to 2% through 2022 (2.4% in per capita terms), well above the 0.9% rate of the past two decades. In December 2014, the government stated that "Japan must aim to become the most innovative country in the world by carrying out social and economic structural changes". The ten key reforms in the Strategy that was revised in June 2014 (Table 3), which have been addressed in previous *OECD Economic Surveys of Japan*, contain many important measures. However, the implementation of the third arrow has lagged behind the first two arrows. It is essential that Japan implement the planned reforms. Moreover, further reforms are needed to achieve the 2% target. The issues discussed below include the priorities in the 2015 edition of the OECD's *Going for Growth*: i) relaxing barriers in the service sector, in part through foreign direct investment;

Table 3. **Ten key reforms in the Japan Revitalisation Strategy**

Reform	Objective	Actions taken
1. Enhance corporate governance: Aiming for sustainable growth in corporate value.	Sustained growth in corporate value through enhanced corporate governance as well as improved management and strengthened fundamentals supported by financial institutions.	The JPX-Nikkei Index 400 was launched in January 2014, followed by a Stewardship Code in February. A draft corporate governance code would require listed firms to have at least two outside directors on a "comply or explain basis".
2. Reforms for management of public and quasi-public funds.	Steadily implement reforms for management of public and quasi-public funds, based on the recommendations presented by the expert panel.	The Government Pension Investment Fund decided in 2014 to increase the share of equities in its portfolio and reinforce its governance structure.
3. Promotion of venture business: Creating an entrepreneur-friendly environment.	A 'Venture ecosystem' (virtuous cycle of venture funding and business creation), leading to globally competitive companies.	The tax system for business angels was made more user-friendly and measures to promote crowd-funding were promulgated in 2014.
4. Corporate tax reform: Bettering the business environment for all companies.	Strengthen Japan's competitiveness as a global business location by reforming the corporate tax rate to a globally competitive level.	The FY 2015 tax reform will reduce the combined corporate income tax rate from 34.6% to 31.3% in FY 2016.
5. Stimulate innovation through science and technology and a "Robot Revolution": Japan as a technology frontier.	Promote innovation of science and technology and develop infrastructure that links innovative technology with new business.	The budget for science and technology, which had been managed by a number of ministries, was centralised in the Council for Science, Technology and Innovation to promote effective R&D.
6. Enhancing women's participation and advancement.	Provide a working environment conducive to women with/caring for children and improve the business environment to enhance women's career advancement at workplaces.	An additional 0.4 million childcare places are being added to eliminate waiting lists, together with another 0.3 million places in after-school care for school-age children. These measures have contributed to a 3.9% rise in female employment since late 2012.
7. Enable flexible working practices: Improving the talent pool.	Develop more creative working practices where performance is evaluated over number of hours worked. Spread and promote model cases of "diversified regular employment" focusing on job duties, etc. Develop a transparent and globally recognised labour dispute resolution system.	Subsidies to maintain jobs are being shifted to promoting labour mobility. Measures against overwork will be reinforced and the government will review flex-time and discretionary working-hour systems. The government will propose a system to evaluate high-level professionals based on performance rather than working hours.
8. Attract talent from overseas: A society where foreign workers play an active role.	Create an environment where skilled professionals from overseas can play an active role. Conduct a drastic review of the Technical Intern Training System for foreign workers in Japan.	Foreign trainees, who are allowed to stay in Japan for three years, will be allowed an additional two years.
9. Aggressive agricultural policy.	Aim to double the income of farmers and farming communities by making agriculture a growth industry. Draw on corporate experience while accelerating private- sector participation in agriculture.	The production quotas for table rice are being phased out over a five-year period by FY 2018. Reforms to agricultural co-operatives are planned.
10. Healthcare industry and high quality services: A stronger healthcare industry and improved services.	Secure a sustainable social security system and revitalise the healthcare industry by establishing a structure to provide efficient and high quality services as well as streamlining insurance benefits coverage.	A new health insurance scheme will be introduced to give patients faster access to new treatments that are yet to be covered by public health insurance. A new institution to manage R&D in healthcare was created.

Source: Government of Japan.

ii) reducing producer support for agriculture; iii) improving the efficiency of the tax system by raising the consumption tax and cutting the corporate tax; iv) raising female labour participation; and v) reforming employment protection.

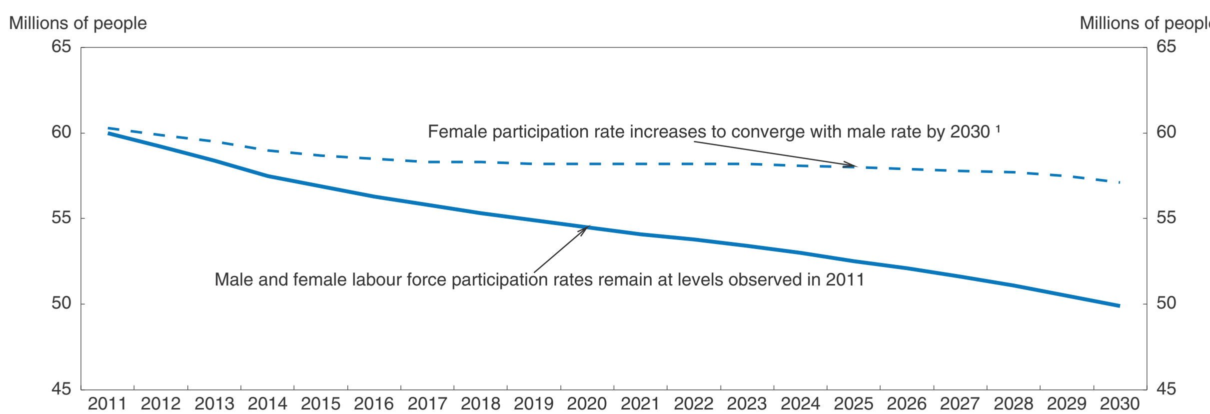
Sustaining the labour force in the face of a falling population

Two of the key reforms in the Strategy – increasing women's participation and advancement and talent from overseas – would limit the decline in the labour force. The working-age population (15-64) is already falling by more than one million per year and is projected to decline by 17% by 2030 and by nearly 40% by 2050. The ratio of working-age persons to the elderly will plummet from 2.5 in 2013 to 1.3 in 2050, remaining the lowest in the OECD. Japan already faces worker shortages. Greater gender equality is needed to mitigate declines in the labour force. The male labour participation rate, at 85%, is 20 percentage points above that of women. If the female participation rate were to converge to those of men by 2030, the labour supply would decline by only 5% (Figure 5), increasing GDP by almost 20% compared with unchanged participation rates. Gender imbalances represent a substantial opportunity cost, given that 63% of young women (25-34 years) in 2011 had a university degree compared with 55% of young men.

The gender gap in employment reflects the fact that only 38% of women remain in the labour force after having a baby. Japan spends about one-third as much as Sweden and the United Kingdom, as a share of GDP, on childcare and after-school care (although spending more would require more tax or social contribution revenue). To facilitate work by mothers, the Strategy plans to boost the number of childcare places by about 0.4 million by March 2018 and to create 0.3 million places in after-school care for older children by March 2020. Expanding childcare may also boost the fertility rate, which was only 1.4 in 2013 (D'Addio and Mira d'Ercole, 2005). Other reforms are needed: i) the tax and benefit systems should be reformed to make them neutral with regard to work decisions by secondary earners in households; and ii) work-life balance needs to be improved by changing the culture of long working hours. Indeed, Japan's well-being index shows that its work-life balance is one of the worst in the OECD, which contributes to its low birth rate (Figure 6).

Figure 5. **Increasing female employment can help avoid looming labour supply shortages**

Projected size of the labour force, working-age population (15-64)



1. Assuming that the labour force participation rate for men remains constant from 2011 to 2030.

Source: OECD (2014d).

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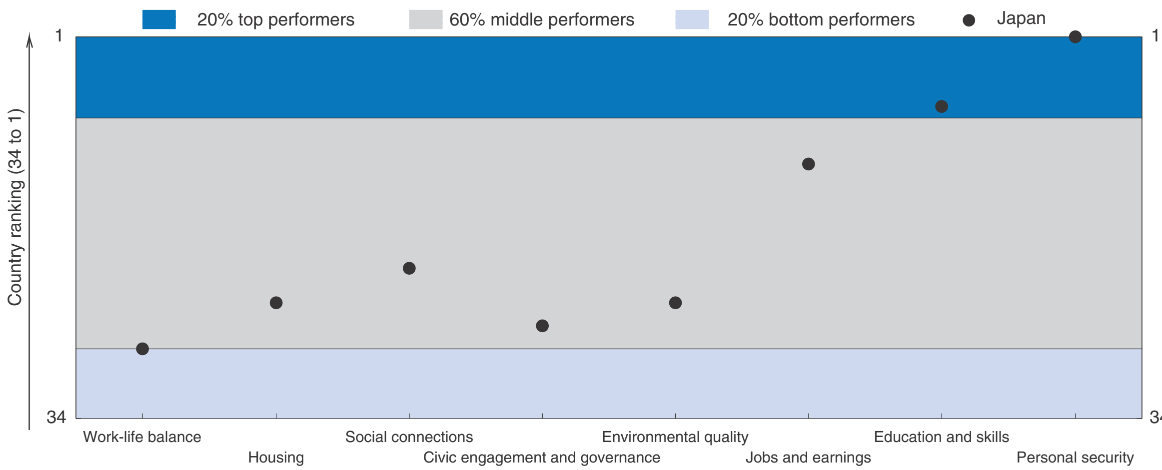
Figure 6. **Japan's well-being performance lags behind in a number of dimensions**



Source: OECD (2014c).

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In addition, the large gender wage gap, which is 27% at median earnings, the third highest in the OECD, discourages women from working. Women hold only 2.1% of seats on boards of directors in Japan, compared with 36% in Norway, around 30% in France and Finland and about 20% in Canada and the United States. Women filled only 3.3% of managerial positions in the central government in 2014, which is even lower than their 7% share in local governments. The government is still pursuing its 2003 target of having women occupy 30% of "leadership" positions by 2020, and now requires listed companies to disclose the number of women in executive positions. The gender wage gap is also closely linked to labour market dualism. Women make up 70% of the relatively low-paid non-regular workers, while men make up 70% of regular workers, limiting opportunities for highly educated women. Indeed, the employment rate for women with a university education was the third lowest among OECD countries in 2013, even though Japan's rate for all women in the 15-64 age group is above the OECD average (63% versus 58%).

Raising the employment rate for older people would also mitigate demographic pressures. Most firms still impose mandatory retirement at age 60, reflecting steep seniority-based wage profiles and the cost of dismissing regular workers. While many retirees are re-employed as non-regular workers, the employment rate of the 65-69 group was only 39% in 2013, versus 77% for the 55-59 group. Given Japan's long life expectancy, mandatory retirement at age 60 is not appropriate. Later retirement would also facilitate a rise in the pension eligibility age, thereby improving the sustainability of public pensions. The government should abolish the right of firms to set a mandatory retirement age and move to a flexible employment and wage system, based on ability rather than age.

The Strategy set a goal of making Japan "a society where foreign workers play an active role" but no quantitative measures were mentioned. Foreign workers account for less than 2% of Japan's labour force, well below the average of 10% in European countries and 16% in the United States. The net annual inflow of foreign workers slowed from 76 000 in 2009 to 35 000 in 2013 (0.03% of Japan's population). This includes high-skilled workers who enter Japan on a points-based system. However, only around 1 500 people have been admitted to Japan under this system. In principle, Japan does not accept low-skilled workers, although foreign trainees (around 140 000) can stay for three years. Expanding the use of foreign workers would help mitigate the trend decline in the labour force, although large-scale inflows could create challenges for social cohesion. Cohesion may also be put under strain by the uneven impact of demographic change. While a few major urban centres are expected to continue gaining population, many regions and cities are likely to experience even faster ageing and population decline than the country as a whole. The government has been taking action to revitalise rural areas.

Boosting labour productivity by deepening Japan's integration in the world economy

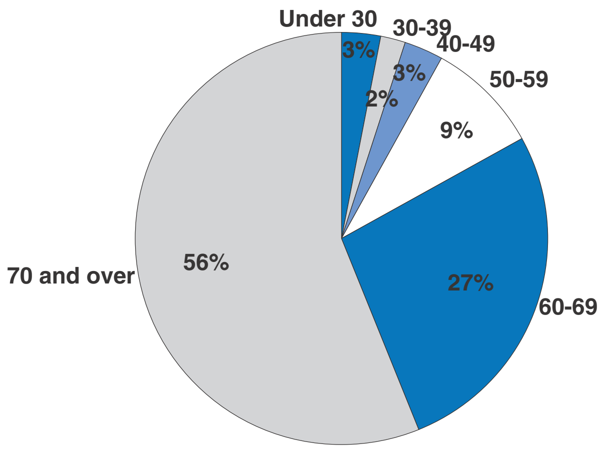
The liberalisation of barriers to international trade and investment strengthens competition, promotes restructuring and spurs innovation by broadening the scope for technological transfers across borders (Jaumotte and Pain, 2005). While Japan has signed 15 Economic Partnership Agreements (EPAs) since 2002, they cover less than a quarter of its trade. The Strategy seeks to raise the share of Japan's trade with countries with which it has an EPA or a FTA from 19% in 2012 to 70% by 2018. This requires agreements with key trading partners, such as the United States, China and the European Union, as well as the Trans-Pacific Partnership. One area where trade agreements would spur needed structural adjustment is agriculture, as they would necessitate cutting border measures on farm goods, such as the tariff on rice. Such measures contribute to the high level of agricultural assistance: the Producer Support Estimate was 54% in Japan in 2011-13, three times the OECD average. Consumer spending on agricultural products was 1.8 times what it would have been in the absence of government policies.

The Strategy calls for an "aggressive agricultural policy" that aims to double the income of farmers and farming communities within ten years and double exports by 2020 (Table 3). Japan decided to phase out production quotas for table rice by FY 2018 and to abolish direct payments for rice in 2018. However, subsidies for manufacturing and feed rice, and for other crops, such as barley and wheat, were increased to fully utilise paddy fields to increase food self-sufficiency. Such an approach will keep the rice price high by limiting its supply. Commodity-specific support accounts for around 90% of producer support in Japan, compared with 32% in the European Union (OECD, 2014a). It is essential to shift away from commodity-specific payments, which isolate farmers from market forces, and allow farmers to make their own production decisions in response to market demands (Jones and Kimura, 2013).

Fundamental agricultural reform requires shifting from self-sufficiency targets to a multi-faceted approach to food security that includes a more competitive domestic agricultural sector, diversified sources of imports, sufficient emergency food reserves and the conservation of an adequate agricultural resource base. This should be accompanied by farm consolidation to boost productivity. Farmland consolidation will be promoted by the regional government-supported institutions established in each prefecture in 2014. However, their impact will be limited by existing policies, such as price supports, which discourage farm exit. The advancing age of farmers provides an opportunity for bold reform: in 2010, the average age of rice farmers was 68.5 and 56% were 70 or over (Figure 7).

Trade liberalisation would also promote foreign direct investment (FDI) (Thangavelu and Findlay, 2011). Japan's stock of inward FDI has stayed below 4% of GDP since 2008, keeping it the lowest in the OECD. The Strategy aims to double the stock of inward FDI from 18 trillion yen in 2012 to 35 trillion yen in 2020, echoing the 2003 plan to double FDI over

Figure 7. **Japan's farm workforce is elderly: the age distribution of rice farmers in 2010**



Source: Ministry of Agriculture, Forestry and Fisheries, *2010 Census of Agriculture and Forestry.*

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five years. Foreign firms have identified the key factors that have hindered FDI inflows (Expert Group of the Cabinet Office, 2014 and EBC, 2014):

- The low level of corporate mergers and acquisitions, a key channel for FDI.
- The high corporate income tax rate.
- The lack of clarity and accountability in Japan's corporate governance framework.
- An unclear regulatory environment.
- Inflexible employment and termination rules for labour and the lack of mid-career mobility.
- Rules restricting the entry of foreign workers.

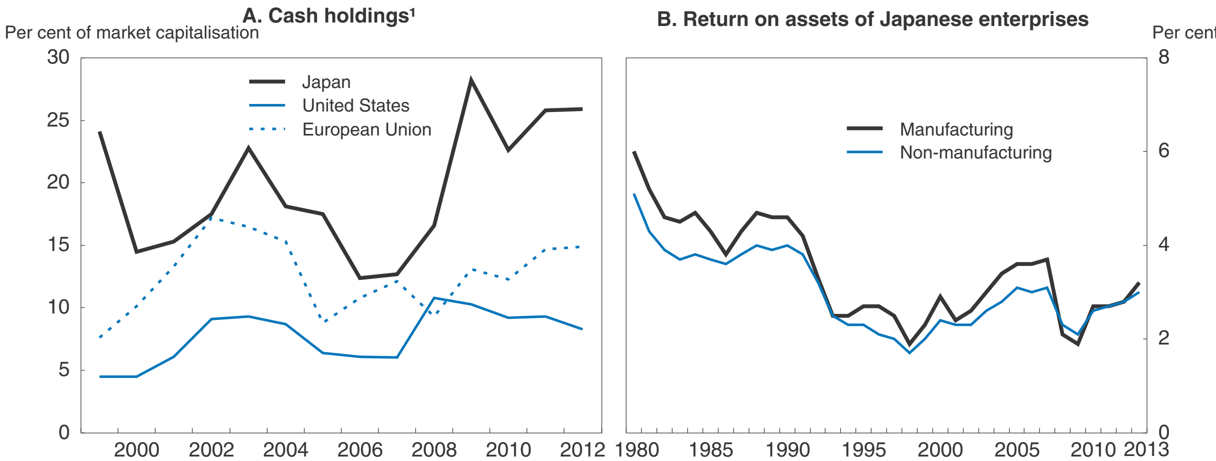
Boosting labour productivity by promoting innovation

While Japan spends heavily on education and R&D, reforms are essential to increase the return on such investments by: i) creating an appropriate framework that strengthens competition and improves resource allocation; ii) upgrading the science and technology system; iii) expanding the role of venture capital-backed firms, which play a key role in commercialising innovation; and iv) making SMEs a source of growth. Greening growth would also be beneficial for growth and productivity.

Framework conditions for innovation

Appropriate framework conditions are needed to encourage greater innovation by firms (OECD, 2010). Japan's corporate sector holds a large amount of cash compared to other advanced economies (Figure 8). Indeed, cash holdings reached 62% of GDP in FY 2012 and may play a role in Japan's low return on assets, which have been on a long downward trend (Panel B). High cash holdings have restrained aggregate demand and limited potential output growth (Shinada, 2012). Cash holdings can be reduced in one of three ways: greater investment, increased dividend payments and faster wage growth. Promoting investment and innovation requires a change in the business environment to modify firms' incentives.

Figure 8. **The corporate sector has high cash reserves and falling returns on assets**



1. Cash and marketable securities of listed companies as a percentage of market capitalisation in each country or region. For Japan – Topix 500 Index; US – S&P 500, euro area – Bloomberg Europe 500.

Source: Bloomberg; OECD calculations; Ministry of Finance.

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The first key reform in the Strategy, enhancing corporate governance, would help address these challenges. The gradual unwinding of cross-shareholdings provides an opportunity to improve governance and increase pressure on firms to innovate and invest their cash. Japan's governance framework lags behind global standards, according to foreign firms in Japan (EBC, 2014). Cross-country studies show that good governance tends to reduce corporate cash holdings (Aoyagi and Ganelli, 2014). Japan has taken steps to reform corporate governance, including the Stewardship Code introduced in 2014. The planned introduction of a corporate governance code offers an opportunity to introduce best practices, in line with the OECD Principles of Corporate Governance, which are currently being revised. In particular, Japan's draft code requires firms to have at least two outside directors. It is essential to ensure their independence.

Another priority is to reduce product market regulation (PMR). Studies show a significant relationship between PMR and productivity at the aggregate level (Bouis et al., 2011). Less restrictive PMR promotes: i) private investment in innovation; ii) the effective diffusion of knowledge from both domestic and overseas sources (Westmore, 2013); iii) improved managerial performance; and iv) entry by new firms. The 2013 Industrial Competitiveness Enhancement Act, which established the Strategy, cited over-regulation as a major distortion limiting competitiveness and pledged to "realise accelerated regulatory reforms". While Japan's score on the OECD's 2013 PMR index indicates that regulation is less stringent than the average, it lags behind the best performers (Koske et al., 2015). To promote reform in specific sectors and geographic areas, the government has launched "National Strategic Special Zones". Their effect would be enhanced by extending the reforms nationwide. Finally, competition policy should be upgraded by reducing exemptions to the Anti-Monopoly Act and increasing administrative fines.

Innovation also requires the continuous reallocation of labour within and across firms and sectors. Employment protection has a major impact on labour flows and reduces productivity by hindering the ability of innovative firms to attract resources (Martin and Scarpetta, 2012). Moreover, it reduces R&D expenditure (Andrews and Criscuolo, 2013).

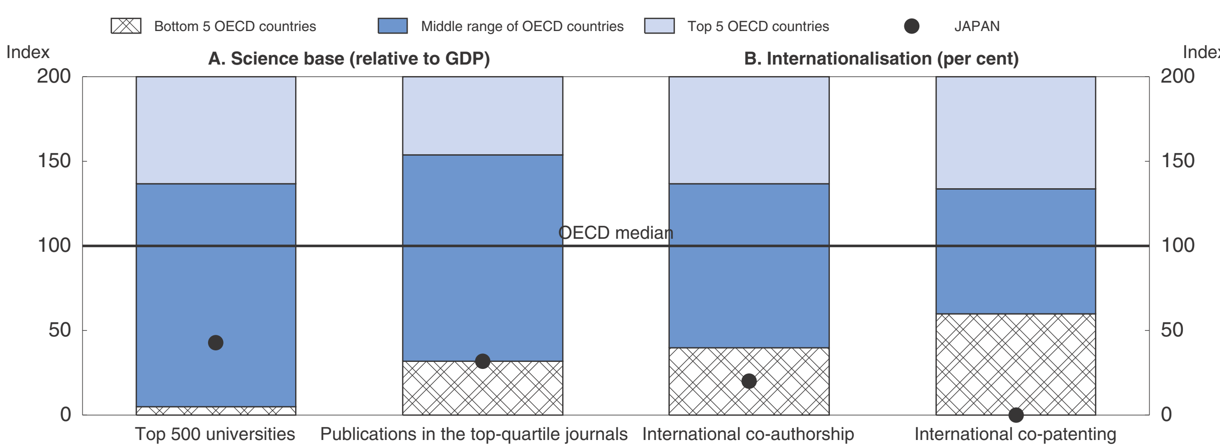
Japan's Strategy states that the country needs to shift "from an excessive employment stability policy to a policy of supporting labour movement to enable individuals to smoothly change jobs". Companies have increased employment of non-regular workers (including fixed-term and dispatched workers, i.e. sent from private employment agencies) from 16% of employees in 1985 to 37% in 2014 to enhance employment flexibility and avoid the cost of laying off regular workers, who receive higher employment protection. Indeed, firms that face greater uncertainty in their sales have a higher share of non-regular workers (Matsuura et al., 2011). However, the reliance on non-regular workers, who receive less firm-based training, has negative consequences for growth, as well as equity (see below).

Upgrading the science and technology system

Japan's gross domestic expenditure on R&D was the fifth highest in the OECD in 2012 at 3.4% of GDP. Moreover, business R&D, which has the greatest impact on total factor productivity (TFP) growth (Westmore, 2013), is particularly high. Nevertheless, Japan's TFP growth has been well below the OECD average in recent years, suggesting that Japan's return on its investment is low. One problem is a lack of skilled labour in science and engineering. By 2007, there were 4.5 job offers for each graduate in science and engineering, compared to a nationwide average of 1.5.

In addition, it is important to upgrade the quality of universities and strengthen their links with firms and expand international collaboration in innovation. The number of Japanese universities ranked in the top 500 worldwide (relative to GDP) was well below the OECD median in 2014 (Figure 9), suggesting scope to improve quality. The keys to improving quality include promoting internationalisation of universities and strengthening competition. The share of foreign students in Japanese universities was only 4%, in 2012, half of the OECD average of 8%, and the number of branch campuses of foreign universities in Japan fell from around 40 in the early 1990s to five at present. Strengthening competition depends in part on increasing transparency about the quality of tertiary institutions and raising the share of public funding that is linked to a university's

Figure 9. **Japan ranks low in some areas of its national science and innovation systems (2014)**



Note: Normalised index of performance relative to the median values in the OECD, which are set at 100. The top performer is set at 200 and the lowest at zero. The fifth-highest performer in the case of the "Top 500 universities" had a score of 137 relative to the OECD median, while the fifth lowest had a score of 5. Japan, with a score of 43, was in the middle range.
Source: OECD (2014e).

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performance, thereby ensuring that consolidation results in the restructuring and closure of the weakest institutions (Jones, 2011). Under Japan's 2014 university reform plan, universities are to be divided into three categories. The 22 universities in the top category are expected to compete with the top institutions of higher learning in the world.

Improving the quality of universities would enable them to make a larger contribution to innovation. Only 0.5% of business-financed R&D in 2013 was carried out at universities, indicating weak linkages between academia and business (Table 4). Moreover, only 2.6% of research performed at universities was funded by firms (Panel B). Spending on R&D performed in universities rose by only 12% (adjusted for inflation) in Japan over 2000-12, compared with 50% in Germany and 59% in the United States. Under the new Innovation National System (the Amari Plan), government research institutes (GRIs) are to play a bridging role to promote exchanges between business, academia and the government. Labour mobility will be facilitated by allowing researchers to have cross-appointments in universities, GRIs and enterprises.

Table 4. **Flows of R&D funds in 2013**

A. R&D funding

Source of funding	Share of total R&D spending	Allocation of R&D spending by sector performing it: Government	Universities	Business enterprises	Total
Government[1]	18.1	54.4	40.2	5.4	100.0
Universities	5.9	0.6	99.3	0.1	100.0
Business enterprises	75.5	0.6	0.5	98.9	100.0
Foreign sources	0.5	9.6	1.6	88.8	100.0

B. Sector performing R&D

Sector performing R&D	Share of total R&D performed	Funding source for R&D performed: Government	Universities	Business enterprises	Foreign sources	Total
Government[1]	10.4	94.5	0.3	4.7	0.5	100.0
Universities	13.5	54.1	43.2	2.6	0.1	100.0
Business enterprises	76.1	1.3	0.0	98.1	0.6	100.0

1. Includes private non-profit institutes.
Source: OECD R&D Statistics Database.

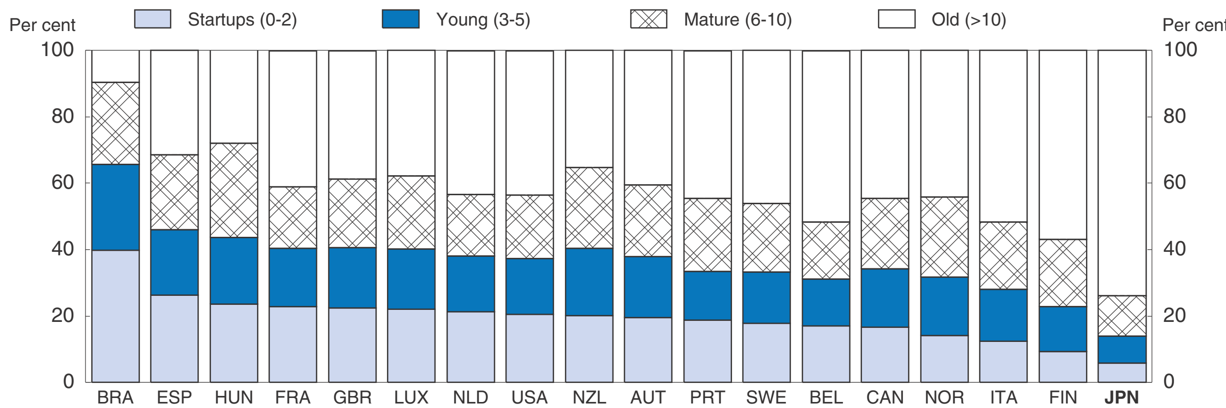
In addition, Japan needs to become more integrated in global innovation networks. Only 0.5% of the R&D carried out in Japan in 2013 was financed from abroad (Table 4), one of the lowest shares in the OECD, while the share of immigrant scientists in Japan is also among the lowest (Franzoni et al., 2012). Consequently, the levels of international co-authorship of academic papers and international co-patenting are among the lowest in the OECD area (Figure 9, Panel B).

Expanding the role of venture capital-backed businesses

Start-ups play a major role in economic growth and innovation. Firms less than five years old, regardless of size, accounted for less than a fifth of total non-financial business employment but generated half of all new jobs in the OECD over 2001-11 (OECD, 2013b).

Figure 10. **Small firms in Japan are relatively old**

Share of small firms (fewer than 50 employees) by age (in years) over 2001-11



Source: Criscuolo et al. (2014).

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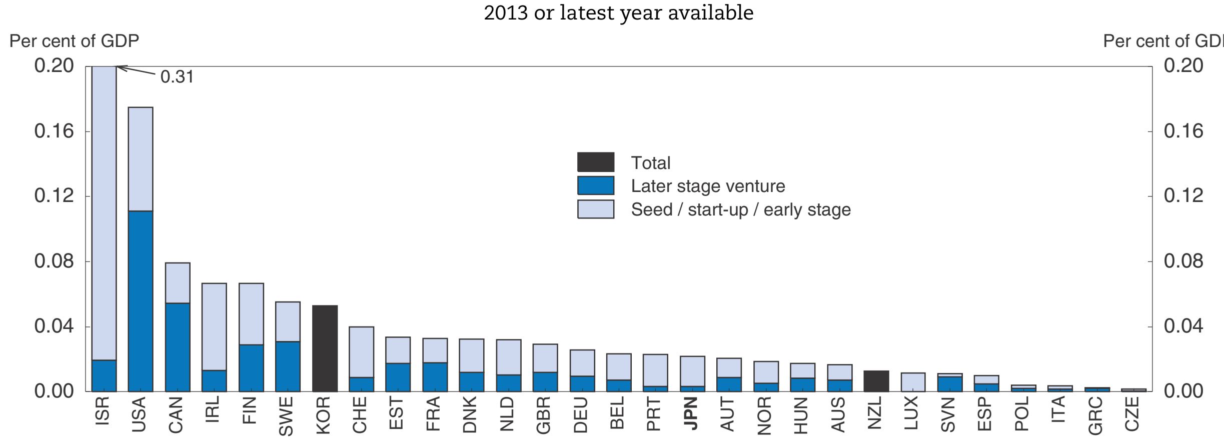
Japan's Strategy set a target of raising the business start-up and closure rates from the 4.5% average over 2004-09 to the 10% rate recorded in the United States. Given the low firm birth rate, Japan is dominated by older companies: three-quarters of small firms are more than ten years old compared with less than half in most OECD countries (Figure 10).

Venture capital-backed firms, which are important in promoting innovation, play a relatively minor role in Japan. Although the sharp decline in venture capital investment over 2006-09 has been reversed, it remains below earlier peaks. Moreover, the level (0.02% of GDP) is slightly below the OECD median and far behind leading countries such as Israel, the United States and Canada (Figure 11). To expand the role of venture capital, policies should: i) encourage entrepreneurship by implementing entrepreneurial education in schools; ii) reduce the stigma attached to failure to promote second chances; iii) enhance the role of venture capital firms and business angels, which together currently account for about one-third of venture capital investment in Japan; and iv) promote a more active M&A market to encourage venture capital investment by allowing investors to realise their gains.

Figure 11. **Venture capital investment as a share of GDP is relatively low in Japan**

2013 or latest year available



Source: OECD (2014b).

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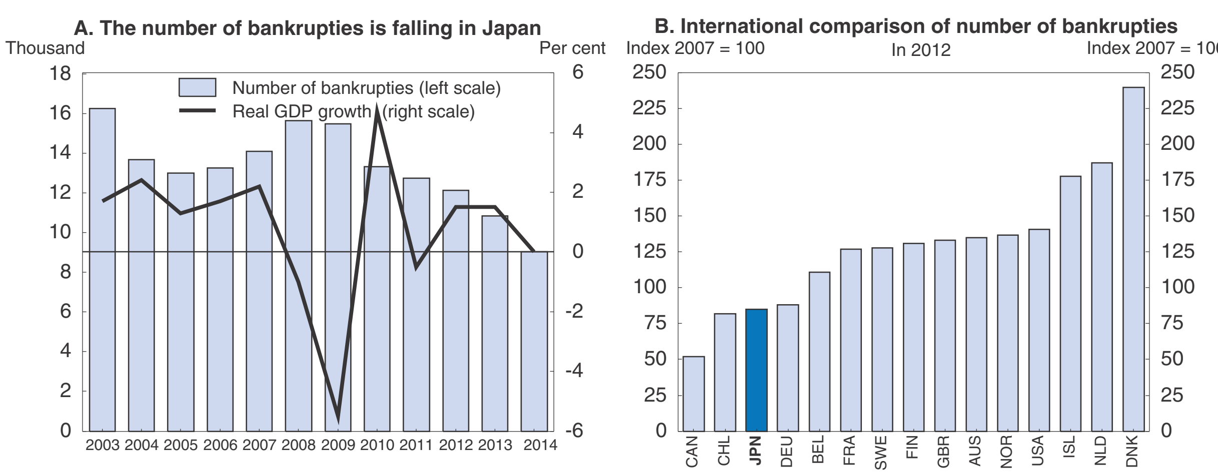
Making SMEs a source of growth

SMEs, which accounted for 99.7% of registered firms, 74% of employment and more than 50% of value added in 2012 (SMEA, 2014), also need to play a more prominent role in innovation. However, they have long suffered from low productivity, weak profitability and high leverage. Indeed, their net profit margin is only 1.5%, against 6.2% for large firms, and less than a third reported a profit in FY 2012 (Lam and Shin, 2012). The problems in the SME sector are linked to the weakness of services, given that more than three-quarters of SMEs are in that sector. Efficiency in services is crucial as they account for almost 40% of Japan's exports on a value-added basis (OECD, 2014f).

SMEs receive substantial government support. The government provides about 10% of financing for SMEs, and its share rises to 20% including guarantees, which are much higher than in other OECD countries. However, high public support for SMEs has negative side effects. *First*, it hinders the development of market-based financing. *Second*, generous government support delays restructuring by keeping non-viable enterprises (so-called "zombie" firms) afloat (Caballero et al., 2008). Even though the Japanese economy contracted sharply in 2008-09 and 2011, the number of bankruptcies has fallen since the crisis and by 2014 was a third below its 2007 level (Figure 12). Indeed, it dropped below 10 000 for the first time since 1990. In contrast, bankruptcies increased by an average of 66% in OECD countries over 2007-12 (Panel B). *Third*, there is little evidence that government financial support improves SME performance (Ono and Uesugi, 2014). *Fourth*, SMEs are discouraged from expanding and thereby losing government assistance. Indeed, only a fifth of Japan's largest companies (by market capitalisation) have been created since the 1960s, compared with three-quarters in the United States (Shirakawa, 2013).

Government support should be scaled back and guarantees focused on young firms for limited periods. Financial supervisors should tighten standards requiring financial institutions to conduct regular credit reviews of SMEs, publicly announce the results, and prepare restructuring plans for non-viable firms. Pressure on banks to ease lending terms for SMEs should be reduced. In addition, market-based financing for SMEs should be developed.

Figure 12. **The number of bankruptcies in Japan has fallen since 2008 despite two crises**



Source: OECD (2014b); *OECD Economic Outlook Database.*

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Promoting green growth and restructuring the electricity sector

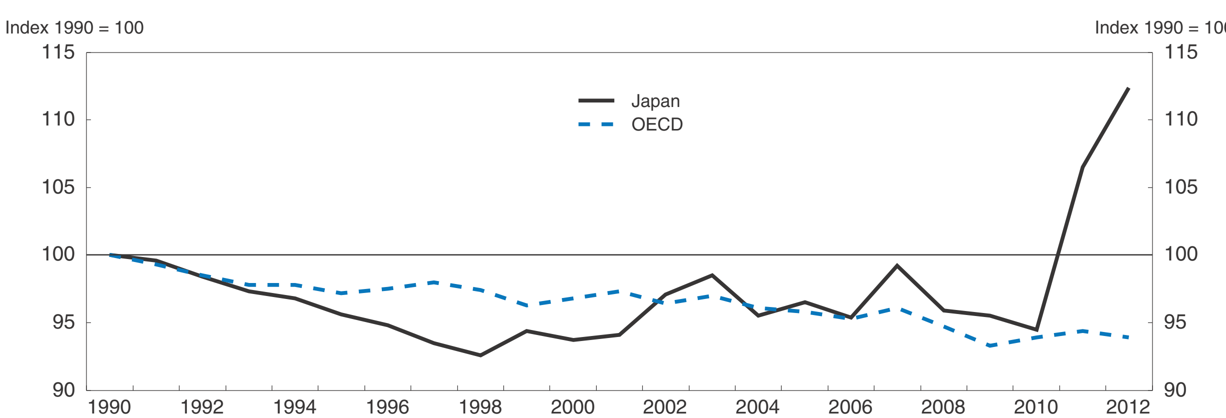
The 2011 nuclear accident led to the shutdown of Japan's 48 remaining nuclear power plants. Greater reliance on thermal energy resulted in a sharp spike in the carbon intensity of Japan's energy mix (Figure 13). The 2009 objective of reducing greenhouse gas emissions by 25% from their 1990 level was revised in 2013. The new target calls for cutting emissions by 3.8% from their 2005 level, implying a 3% rise from the 1990 level. Whatever the target, it is important to achieve it efficiently by placing a price on carbon through an emissions trading system or a carbon tax (2013 *OECD Economic Survey of Japan*).

Japan's 2014 Energy Plan views nuclear power as an important and low-carbon baseload source. However, dependence on nuclear power generation is to be reduced to the extent possible through energy saving and expanding renewables. Given that regulatory failure contributed to the nuclear accident, the government created a new supervisory body, the Nuclear Regulatory Authority, to carefully review compliance of nuclear power plants with the new regulatory standards (Jones and Kim, 2013). After the accident, it is more important than ever to promote renewable energy, which accounts for only 12% of electricity, as against the OECD average of 21%. Expanding the role of renewables, while enhancing their cost efficiency, would promote green growth. The Feed-in-Tariff system, introduced in 2012, has resulted in a 70% expansion in renewable energy capacity. At the same time, the fixed long-term contracts at high prices offered for renewables risk creating a serious financial burden on consumers and the government, as has occurred in some OECD countries.

The use of renewables is limited by the structure of the electricity sector, which is dominated by ten regional, vertically-integrated monopolies, resulting in inadequate interconnection facilities and weak market mechanisms. The government has launched reforms to expand competition in power generation and the retail market, including the introduction of "legal" or "management" unbundling of generation, transmission and retailing by 2020. However, it would be better to require ownership unbundling to eliminate all incentives for cross-subsidisation between generation and transmission. The government should also break down regional monopolies and create a competitive, nationwide electricity market.

Figure 13. **Carbon intensity of the energy mix**

Energy sector carbon intensity index, 1990 = 100[1]



1. The IEA Energy Sector Carbon Intensity Index tracks how many tonnes of carbon dioxide (CO2) are emitted for each unit of energy supplied (total primary energy supply).

Source: IEA (2014).

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Key recommendations to boost economic growth through bold structural reforms

- Slow the trend decline in the labour force by:
  - Increasing female employment by expanding childcare, reforming aspects of the tax and social security systems that reduce work incentives for second earners and breaking down labour market dualism to reduce gender inequality.
  - Expanding the use of foreign workers.
- Participate in high-level trade agreements, notably the Trans-Pacific Partnership and a Japan-EU Economic Partnership Agreement.
- Improve the business climate to boost productivity growth by:
  - Upgrading corporate governance.
  - Promoting labour market flexibility and mobility.
  - Improving the entrepreneurial climate by ensuring second chances and developing entrepreneurial education.
  - Revitalising venture capital investment to promote firm creation and innovation.
  - Reducing government support for SMEs to promote the restructuring of viable firms and the exit of non-viable ones.
  - Moving to a more market-based agricultural system by measures such as reducing commodity-specific payments to farmers, accelerating the consolidation of farmland and reforming the role of agriculture co-operatives.

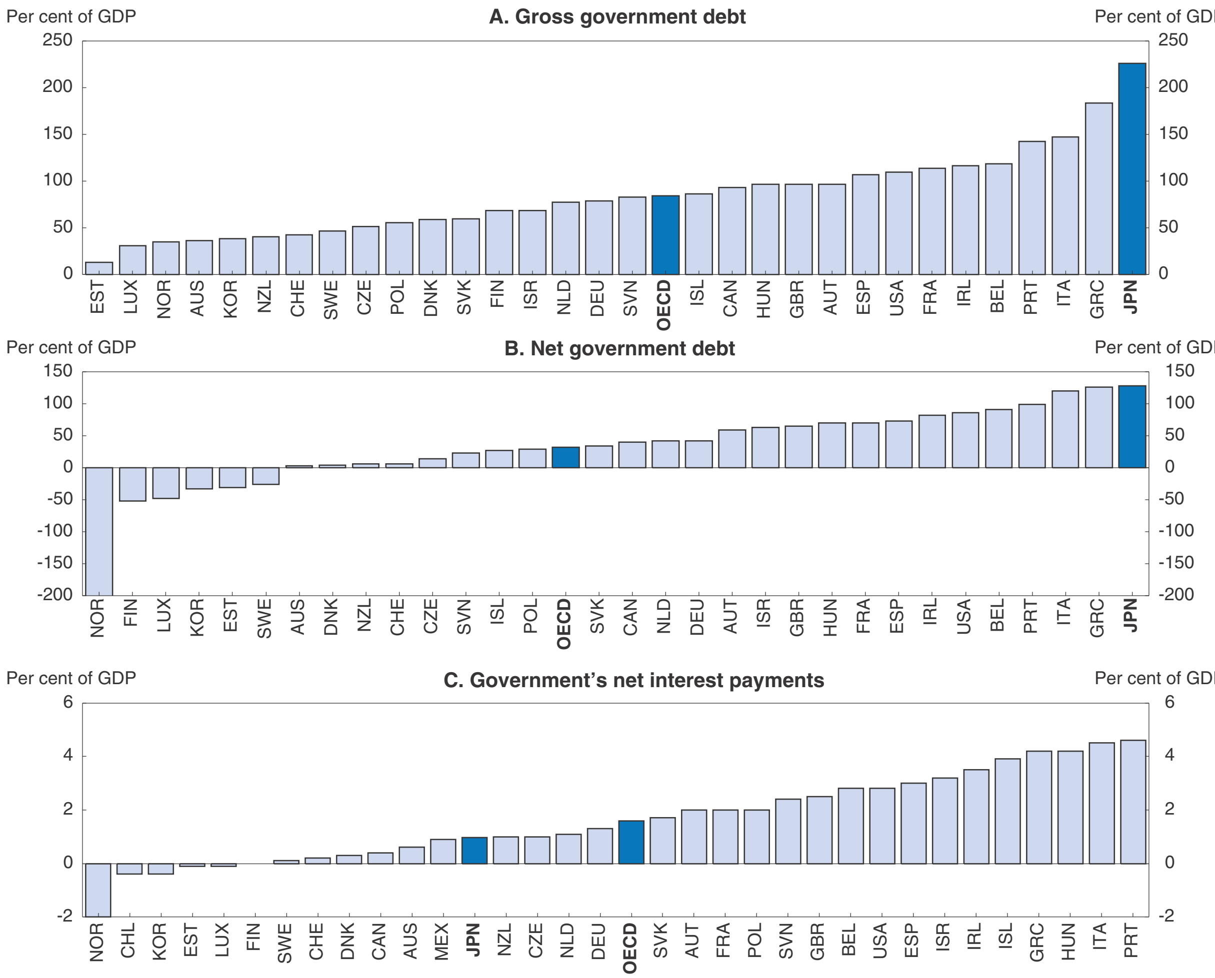
Reducing government debt: Flexible fiscal policy (the second arrow)

Twenty-two consecutive years of budget deficits have driven gross government debt to 226% of GDP in 2014, by far the highest in the OECD (Figure 14). Even after taking account of government assets, net debt is also the highest, at 129% (Panel B). The impact of such high debt on government interest payments has been mitigated thus far by exceptionally low interest rates. Indeed, the effective interest rate on government debt is the lowest in the OECD at 0.9%, limiting net interest payments to 1.0% of GDP, below the OECD average of 1.6% (Panel C). The low interest rate partly reflects government bond purchases by the BoJ, which now holds nearly a quarter of the stock. The Quantitative and Qualitative Easing introduced in 2013 (see below) has further lowered the yield on 10-year government bonds to around 40 basis points. In addition, persistent deflation and the risk aversion and "home bias" of investors have contributed to low interest rates. Moreover, Japan's large stock of net external assets helps maintain confidence in its ability to meet its debt obligations. Around 90% of government debt is domestically held and the government's external debt (including the BoJ) was less than $1 trillion in mid-2014, compared to $6.6 trillion for the United States and $4.2 trillion for the euro area.

Japan's persistent deficits are a structural problem stemming from rising public social spending together with chronically weak nominal output growth that has limited government revenues. Public social spending doubled from 12% of GDP in 1990 to 24% in 2013, and now accounts for about half of general government spending. However, total government revenue in Japan in 2012 was unchanged from its 1990 level of one-third of GDP. While central government tax revenue has been rising since 2009, it still finances only about half of spending (Figure 15).

Figure 14. **Japan's government debt is the highest but interest payments on the debt are low**

General government basis in per cent of GDP in 2014



Source: *OECD Economic Outlook Database.*

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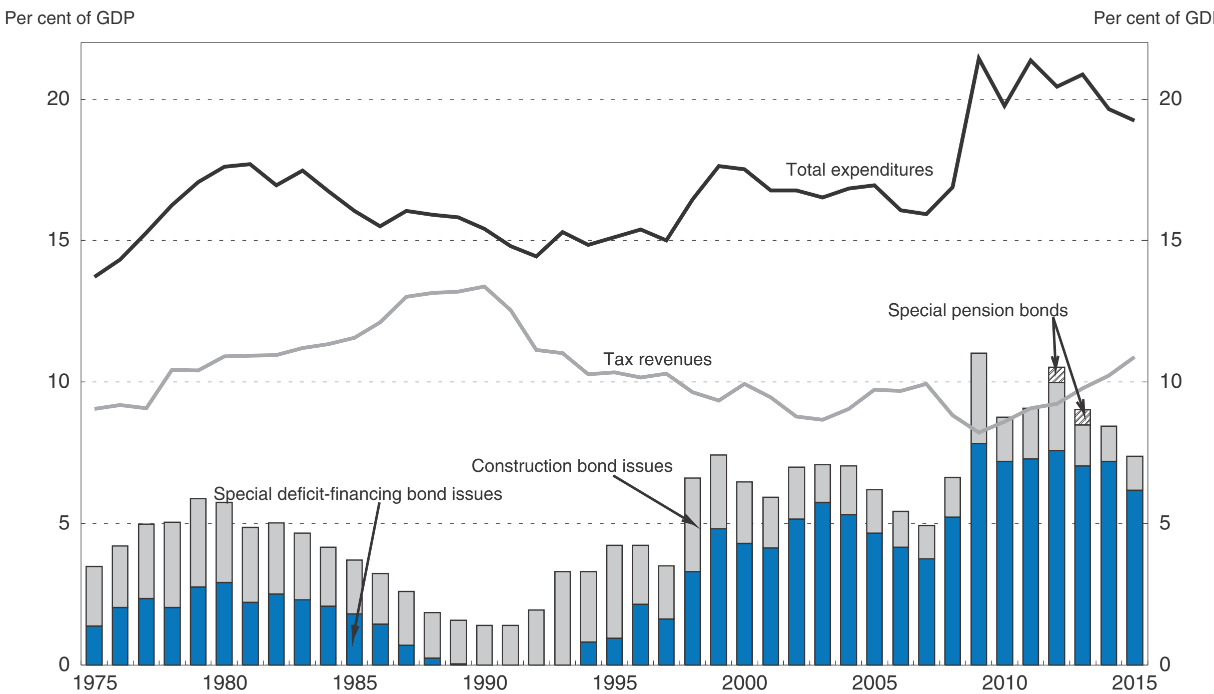
However, the financing of large government deficits at low rates by Japanese savers will not continue indefinitely, leaving Japan vulnerable to rising interest rates. A normalisation in the government's effective borrowing rate from the current 0.9% in 2014 to 3%, for example, would expand the deficit from 8.5% of GDP in 2013 to around 13%. In addition to the fiscal consequences, banks, which hold about a third of government bonds, would also be destabilised by falling bond prices (Jones and Urasawa, 2013).

In 2013, the government adopted a medium-term fiscal plan whose targets are broadly in line with the fiscal strategy laid out in 2010: i) halving the primary deficit of central and local governments from 6.6% of GDP in FY 2010 to 3.3% by FY 2015; ii) achieving a primary surplus by FY 2020; and iii) putting the debt ratio on a downward trend thereafter. However, there was little progress over 2010-14, as the primary deficit remained around 7% of GDP (on a general government basis), in contrast to large reductions in the United States (7 percentage points) and the euro area (3 points). After the Great East Japan Earthquake in 2011, reconstruction spending amounting to 5% of GDP slowed fiscal consolidation. In addition, the government launched a 10.3 trillion yen (2.2% of GDP) fiscal package in 2013,

Figure 15. **The gap between government expenditure and revenue remains huge**

Central government general account as per cent of GDP[1]



1. The final outcome for FY 1975-2012, the revised budget for FY 2013, and the initial FY 2014 and FY 2015 budgets. Reconstruction spending and bond issuance to finance it are excluded for FY 2011-15.

Source: Ministry of Finance; OECD calculations.

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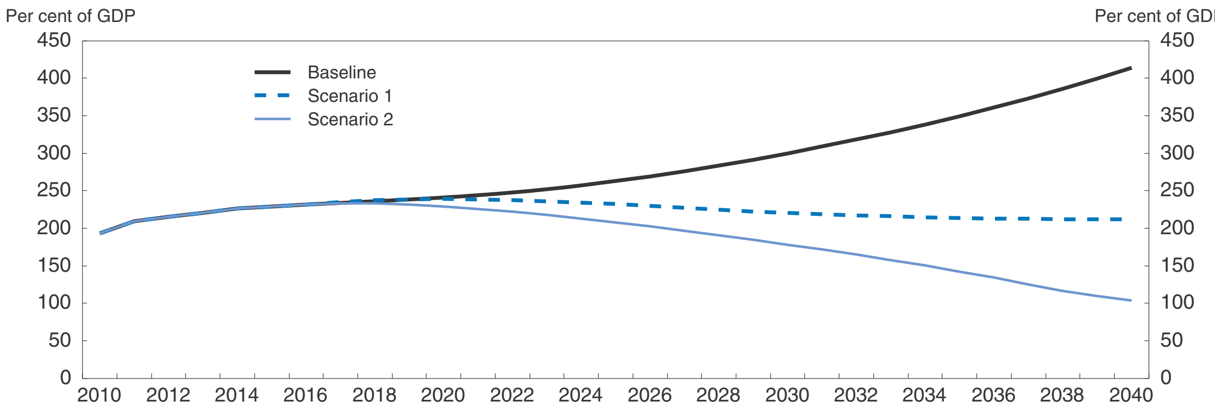
followed by a 5.5 trillion yen package in early 2014, reflecting the "flexible" approach in the second arrow.

Fiscal consolidation advanced with the April 2014 consumption tax hike and the plan for a second increase to 10% in 2015. The doubling of the tax rate would have generated 14 trillion yen (2.7% of GDP) of revenue, of which about one-fifth was to be spent to improve childcare, pensions and healthcare. The remainder was to finance existing social insurance outlays, thereby cutting the deficit. However, with the delay in the second consumption tax hike, planned improvements in pensions and long-term care were postponed. According to the initial budget for FY 2015, which assumes a 9% rise in tax revenue and a 7% increase in non-tax revenue, the FY 2015 primary deficit target can be achieved.

However, Japan remains far from its target of a primary surplus by FY 2020 for central and local governments, according to the February 2015 government projection. It shows a primary deficit of nearly 2% of GDP in FY 2020 (central and local government basis), even assuming the second tax hike in 2017 and nominal GDP growth at an annual average of 3.1% between FY 2013 and FY 2022. The OECD projects a primary deficit of around 5% of GDP in 2016 on a general government basis, which is an important measure as it determines the evolution of public debt. This implies that fiscal consolidation of 1% a year over FY 2016-20 would be necessary to achieve a primary surplus.

In the absence of further measures to reduce the deficit, the government debt ratio would rise steadily to more than 400% of GDP by 2040, according to an OECD simulation (Figure 16), even assuming 2¾ per cent nominal GDP growth. The model is used to simulate

Figure 16. **Simulations of gross government debt as a share of GDP**



Note: In the baseline, there is no fiscal consolidation and nominal growth is around 2¾ per cent (1% real growth, 1¾ per cent inflation). The model shows a rise in long-term interest rates from around 0.25% at present to 7% by 2040. Fiscal consolidation of 7% of GDP over the decade 2017-26 is assumed in the two scenarios, which have different average output growth rates over 2015-40, resulting in varying levels of interest rates:

- Scenario 1: Nominal growth of 1½ per cent (1% real growth, ½ per cent inflation).
- Scenario 2: Nominal growth of 4% (2% real growth and 2% inflation).

Source: *OECD Economic Outlook* Database; OECD calculations.

StatLink http://dx.doi.org/10.1787/888933201879

the impact of fiscal consolidation of 7% of GDP (equivalent to raising the consumption tax rate from 8% to 22%, the average in the euro area) under different scenarios for real output growth and inflation:

- If real growth were around 1% and inflation were around ½ per cent per year (Scenario 1 in Figure 16), the government debt ratio in 2040 would remain above 200% of GDP.
- If the third arrow boosted real growth to 2%, while inflation reached the 2% target, the debt ratio would decline to nearly 100% by 2040 (Scenario 2). With fiscal consolidation, the rise in interest rates is lower than in the baseline, contributing to the lower debt trajectory.

In sum, achieving faster nominal growth through higher real growth and higher inflation is essential to reduce government debt.

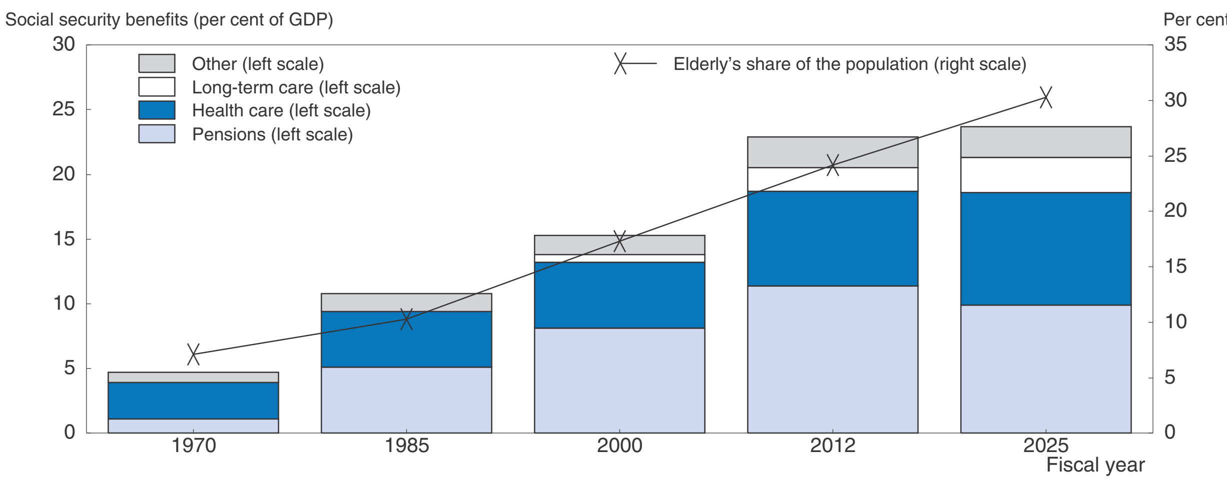
The need for a detailed and credible medium-term fiscal strategy

A fiscal plan should be based on an appropriate target. A primary budget that is close to balance is unlikely to stabilise the debt ratio, let alone put it on a downward trend. Instead, this may require a primary surplus of around 3% of GDP (general government basis), based on the government's projection that the nominal interest rate will be 1.3 percentage points above the nominal growth rate in FY 2023. This is close to the average gap of 1½ percentage points since 1980 (2013 *OECD Economic Survey of Japan*). Given the projected primary deficit of close to 7% of GDP in 2014, this implies that fiscal consolidation of around 10% of GDP is needed to stabilise the debt ratio. A strong institutional framework would help maintain confidence in Japan's fiscal sustainability during such a long period of consolidation. The establishment of such independent fiscal councils in many OECD countries has helped to improve fiscal policymaking, making clear the urgency of the problem and helping build a public consensus for fiscal consolidation (OECD, 2012). In this regard, the role of the Council on Economic and Fiscal Policy, which is headed by the Prime Minister and includes five ministers, the governor of the Bank of Japan, two academic experts and two business leaders, can be expected to increase.

The immediate challenge is to launch a detailed and credible fiscal strategy to forestall, or at least limit, any rise in the long-term interest rate. Such a strategy should take into account that:

- Government revenue in Japan is the sixth lowest in the OECD and well below the average of 43% of GDP, indicating space for higher revenue.
- Government spending in Japan, excluding social security outlays, is the ninth lowest in the OECD, suggesting limited scope for major spending cuts beyond the expected fall in public investment.
- Continued population ageing will put further upward pressure on public social spending (Figure 17).

Figure 17. **Public social spending has been rising sharply in line with population ageing**



Source: National Institute of Population and Social Security Research (2014); Ministry of Health, Labour and Welfare (2012a).

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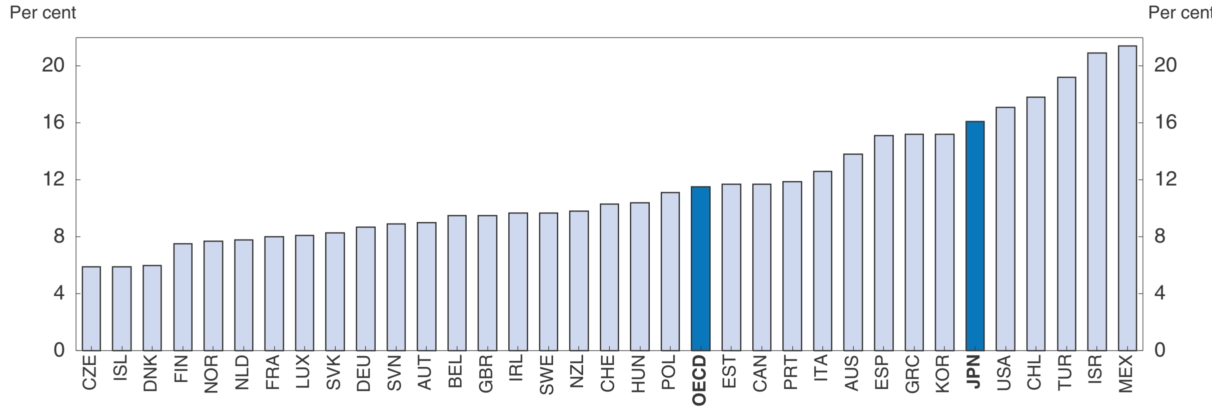
Fiscal consolidation and regulatory reform need to take into account their impact on income inequality and relative poverty, which was the sixth highest in the OECD area in 2012 (Figure 18). The redistributive impact of the tax and benefit systems for the working-age population is weaker than the OECD average (Figure 19), reflecting two factors: i) while total public social spending in 2011 was 23% of GDP, surpassing the OECD average of 21%, spending on the working-age population was only 3% of GDP, compared with the OECD average of 6%; and ii) the tax wedge is high for low-income families with children and relatively flat across the income distribution. Japan is the only OECD country where the lowest income decile has suffered an absolute decline in their real income since the mid-1980s (OECD, 2011a). Moreover, Japan is the only OECD country where the poverty rate for all working households and all households with children is higher after taking account of taxes and benefits (2013 *OECD Economic Survey of Japan*).

Raising more revenue

Raising sufficient revenue will likely require measures to increase receipts from a number of different taxes. Moreover, a steady rise so as to avoid a large increase in any given year would be preferable so as to mitigate the impact on the real economy.

Figure 18. **Japan faces a problem of high poverty**[1]

Relative poverty rate in 2012 or latest year available[2]



1. The relative poverty rate is the share of the population with an income below half the "median equivalent disposable income", which equals household disposable income divided by the square root of the number of household members.
2. Japanese data are based on the Comprehensive Survey of Living Conditions, which is submitted to the OECD by Japan. Another survey, the National Survey of Family Income and Expenditure, shows a much lower relative poverty rate of 10.1%.

Source: *OECD Income Distribution and Poverty Database*; Ministry of Health, Labour and Welfare, *Comprehensive Survey of Living Conditions.*

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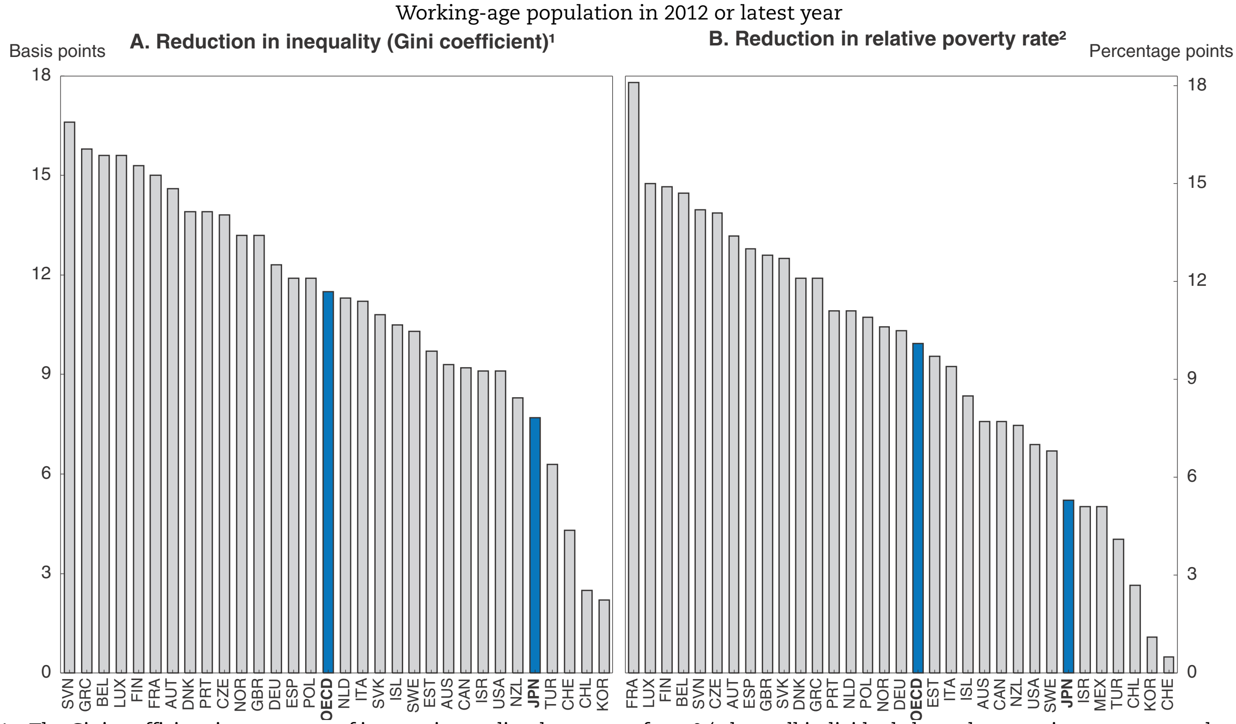
Using the consumption tax, which is a value-added tax (VAT), for additional revenue has many advantages. A VAT is less harmful for economic growth than taxes on labour and capital, as it imposes fewer distortions on employment and investment, and it is a

Figure 19. **The impact of taxes and transfers on income inequality and poverty is weak in Japan**

Working-age population in 2012 or latest year



1. The Gini coefficient is a measure of income inequality that ranges from 0 (where all individuals have the same income, or complete equality) to 1 (where one individual has all the income).
2. The relative poverty rate is the percentage of the population whose income is less than half median income.

Source: *OECD Income Distribution and Poverty Database.*

StatLink *http://dx.doi.org/10.1787/888933201901* relatively stable revenue source (Arnold et al., 2011). Moreover, it spreads the burden across the population, including the elderly, who receive large net transfers from younger generations. Even with the planned hike to 10% in 2017, Japan's VAT rate would still be the third lowest in the OECD and only about half of the 19% average. It is important to maintain a single rate, relying on more effective policies to address the equity implications of a higher VAT rate. Indeed, reduced VAT rates on items such as food and energy products are a poor tool for targeting support to low-income households, as high-income households benefit most (OECD, 2014g). Countries with multiple rates have relatively low VAT revenue, compared with that implied by their standard rate, thus requiring an even higher standard rate. In addition, multiple rates imply higher administrative and compliance costs, opportunities for fraud, and distortions in consumption decisions.

There is also scope to broaden the personal income tax base, which is relatively narrow. Indeed, less than half of personal income is taxable, reflecting income deductions, such as the personal exemption. In addition, there is a large deduction for salaries, which helps ensure more equitable treatment of employees and the self-employed. Better coverage of the self-employed is thus necessary for base broadening, but this requires the effective introduction of taxpayer identification numbers, which is planned for 2016. A broader base could boost personal income tax revenue from 5.3% of GDP in 2012 toward the OECD average of 8.6%, while enhancing its impact on income distribution. In addition, environmental taxes, which are relatively low in Japan, would be a good source of revenue, as they would also help address environmental concerns (Figure 6), while promoting green growth.

The combined corporate income tax rate is the second highest in the OECD area even after the reduction to below 35% in 2014. Cutting the corporate tax rate and widening its base could stimulate economic activity without necessarily reducing revenues, while encouraging inflows of FDI. One of the key reforms of the Japan Revitalisation Strategy is to reduce the rate below 30% over the next few years, bringing it closer to the 25% OECD average (Table 3). It is important that the cut be revenue neutral, notably by broadening the tax base. In particular, the percentage of firms that pay corporate income tax should be increased from the 30% in FY 2012.

Controlling the growth of public social spending

Pensions and health and long-term care, which are mainly focused on the elderly, account for more than 80% of public social spending. The 2004 pension reform introduced "macroeconomic indexation", which adjusts pension benefits based on changes in the number of contributors and life expectancy. Consequently, pension spending is projected to fall from 11.4% of GDP in FY 2012 to 9.9% in FY 2025. However, the reform will reduce the pension replacement rate. In the case of slow output growth, it could drop below 50% (which is not allowed by law). Further reform is needed to ensure the sustainability of the pension system. Additional cuts in benefits should be avoided. In addition, a further hike in the contribution rate, which is set to reach 18.3% in FY 2017, would risk weakening work incentives.

The best option for further reform, therefore, would be to increase the pension eligibility age, as it would improve pension financing by raising the labour participation of older people (Sutherland et al., 2012). The pension eligibility age is now 65 for men (63 for women) for the basic pension and 61 for men (60 for women) for the Employees' Pension Insurance. Although the age is to be raised to 65 by 2025 for men and 2030 for women, it will remain relatively low compared to Japan's life expectancy of 83.4 years. Accelerating the increase in the eligibility age to 65 and raising it further – through a link to longevity – would help ensure the sustainability of the pension system and improve inter-generational equity. Calculations based on government simulations suggest that raising the eligibility age to 70 by 2035 could boost the replacement rate by almost 20 percentage points, creating scope for savings (MHLW, 2014a).

In contrast to pensions, healthcare spending is projected to continue rising as a share of GDP. Over 2000-12, it increased at a 2.2% annual rate. Its share of GDP has risen from 7.6% to 10.3%, surpassing the 9.3% OECD average. The increase is nearly evenly divided between the impact of ageing and rising costs per person. In terms of the type of healthcare, costs are driven by spending on pharmaceuticals and hospital stays. Limiting pharmaceutical outlays requires reducing the number of prescriptions and expanding the use of generic medicine, which lags behind other countries.

A top priority is to reduce the average length of hospital stays, which at 31.2 days, is almost four times the OECD average (Table 5). Long hospital stays are, in turn, linked to long-term care; the average stay for curative care is substantially lower at 17.5 days. Given the higher cost of curative care, reflecting the requirements for medical staff and equipment, shifting those not needing such care to home-based care or specialised institutions would sharply lower costs. Shifting beds to long-term care facilities, which relative to the elderly population have only half as many beds as the OECD average, would help ensure adequate long-term care. The number of people receiving long-term care increased by 8% per year over 2000-12 and is likely to accelerate further.

Finally, it is also necessary to reduce hospital stays for curative care, which are again the longest in the OECD (Table 5), by shifting away from a fee-for-service system in favour of a diagnosis-related group approach and raising the low co-payment rate for the elderly (2013 *OECD Economic Survey of Japan*). This would also help reduce the number of doctor visits, which is double the OECD average.

Well-targeted social spending is essential to promote inclusive growth. The main priority is to introduce an earned income tax credit (EITC), which is effective in promoting work and assisting those on low income, especially in countries like Japan with a relatively wide earnings distribution, low taxes on labour and low benefits for the non-employed (2013 *OECD Economic Survey of Japan*). In particular, an EITC would mitigate the regressive impact of consumption tax hikes. An EITC should be accompanied by effective labour market

Table 5. **International comparison of healthcare shows room for cost savings in Japan**

In 2012 or latest year available

	Average total hospital stay[1]	Average hospital stay for curative care[1]	Total number of hospital beds[2]	Number of acute-care beds[2, 3]	Number of long-term care beds[2, 3, 4]	Number of beds in long-term care facilities[2, 4]	Number of doctor consultations per capita per year
Japan	**31.2**	**17.5**	**13.4**	**7.9**	**2.7 (11.1)**	**6.0 (25.0)**	**13.0**
OECD average	8.4	7.4	4.8	3.3	0.6 (3.8)	7.7 (48.5)	6.7
Highest country	31.2	17.5	13.4	7.9	3.2 (27.4)	13.5 (72.2)	14.3
Lowest country	3.9	3.9	1.6	1.5	0.0 (0.0)	2.4 (17.7)	2.7

1. In days.
2. Per 1 000 population.
3. In hospitals.
4. The numbers in parentheses show the number of beds per 1 000 population aged 65 and over.

Source: OECD Health Database.

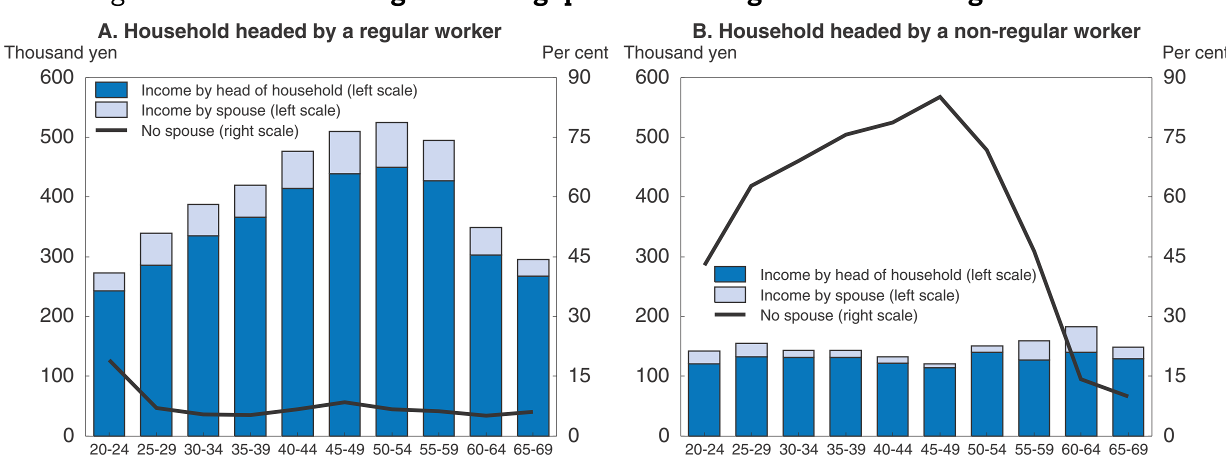
activation policies to help the unemployed find jobs that would allow them to receive the EITC and by steps to enhance transparency about income, particularly of the self-employed.

It is important to break down labour market dualism, which is the major cause of increasing income inequality in Japan, according to the government (Ministry of Health, Labour and Welfare, 2012b). After adjusting for type of job and educational attainment, the wage gap between full and part-time workers is 45% for men and 31% for women. The income of a household headed by a regular worker in the 45-49 age group was more than four times that of a household headed by a non-regular worker (Figure 20). The lower income of non-regular workers also discourages marriage and hence reduces the fertility rate. Dualism has a number of other negative effects (2013 *OECD Economic Survey of Japan*):

- *Less firm-based training:* Only about a quarter of firms provide systematic on-the-job training to non-regular workers, less than half the share for regular workers.
- *Less coverage by the social safety net:* Around one-third of non-regular workers are not covered by employment insurance, even though they have precarious jobs (Ministry of Health, Labour and Welfare, 2011).
- *Limited mobility between regular and non-regular employment:* Non-regular employment is not a stepping-stone to regular employment. Studies show that those who begin their careers as non-regular workers have less success later in life in terms of career stability, incomes and marriage.
- *Reduces well-being:* A 2012 government survey found that the happiness level reported by non-regular workers is below that of regular workers and the self-employed.

Breaking down dualism requires a comprehensive strategy aimed at reducing the factors that encourage firms to hire non-regular workers, including increasing social insurance coverage and upgrading training programmes for non-regular workers and reducing effective protection for regular workers, in particular by increasing transparency. This should include setting clear rules for the dismissal of workers (OECD, 2015).

Figure 20. **There are large income gaps between regular and non-regular workers**



Source: Ministry of Health, Labour and Welfare (2014b).

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Key recommendations to reduce government debt while promoting social cohesion

- Set out a detailed and credible plan to constrain government spending and raise revenues so as to achieve the target of a primary surplus by FY 2020.
- Rely primarily on the consumption tax with a single rate and a broadening of the personal and corporate income tax base to boost government revenue, while raising environmental taxes.
- Reform pensions and health and long-term care to limit spending growth in the face of population ageing.
- Improve the targeting of public social spending and introduce an earned income tax credit for low-income workers.
- Break down labour market dualism by increasing the coverage of social insurance and upgrading training programmes for non-regular workers, and reducing effective employment protection for regular workers, in particular by increasing transparency.

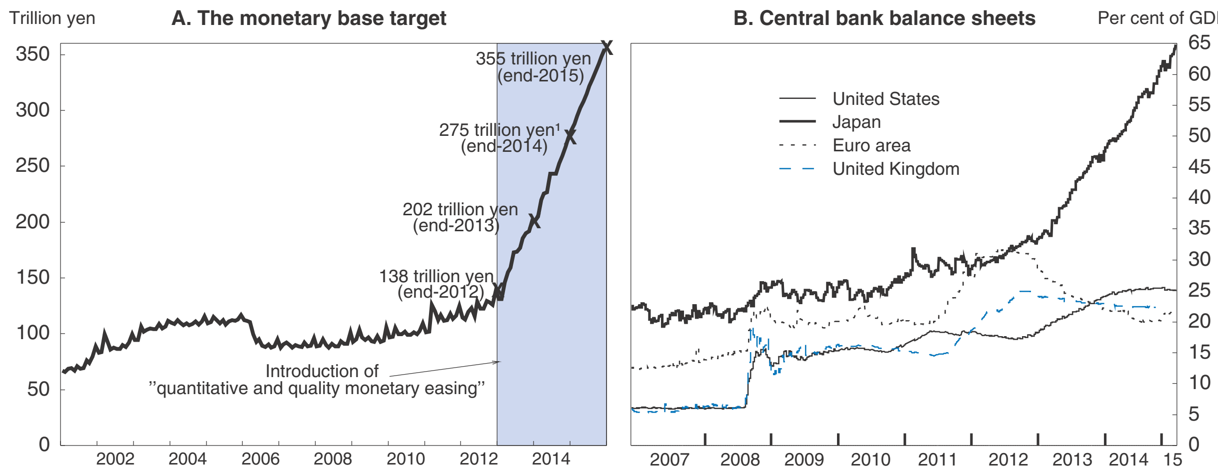
Ending deflation: Bold monetary policy (the first arrow)

Deflation lowers nominal GDP, thereby boosting the government debt ratio and threatening fiscal sustainability. The GDP deflator fell by more than 17% between 1997 and 2013, helping to drive down nominal GDP by 8%. If annual inflation had instead been 1% over that period, the debt ratio would have been only 155% of GDP in 2013 rather than 220%, based on a simple mechanical calculation. It is clear that reducing the debt ratio in a deflationary context is very difficult. Deflation also has a negative impact on growth, partly because it keeps the real interest rate positive at times when ample slack would call for negative real rates. Indeed, a Taylor rule calculation by the OECD for 2014 suggests that a negative policy interest rate was still appropriate in Japan. Given the deleterious effects of deflation, achieving the 2% inflation target should remain a top priority.

In January 2013, the Bank of Japan (BoJ) set a 2% inflation target for the consumer price index and, in April 2013, stated that it would achieve the 2% target as soon as possible, with a time horizon of about two years. To this end, the BoJ launched "quantitative and qualitative monetary easing" (QQE) and pledged to continue until the inflation rate is sustainably at the target level. Such an open-ended commitment by the BoJ should help avoid premature monetary tightening, as in 2006 when the BoJ ended quantitative easing while inflation was around zero, leaving Japan vulnerable to renewed deflation in the wake of the 2008 global financial crisis (2013 *OECD Economic Survey of Japan*).

QQE represents a clear break from past BoJ quantitative easing in terms of its scale, decisiveness and ambition. Previously, the BoJ had declined to set a target, arguing that population ageing made it impossible for monetary policy alone to end persistent deflation. With purchases of 50 trillion yen of government bonds per year, the monetary base was to double from 138 trillion yen (28% of GDP) at end-2012 to 270 trillion yen at end-2014 (Figure 21). The scale of QQE is large compared to quantitative measures adopted elsewhere (Panel B). Indeed, the BoJ's balance sheet reached 65% of GDP in February 2015.

Figure 21. **The monetary base is rising rapidly under quantitative and qualitative easing**



1. The target increased from 270 trillion yen to 275 trillion yen with the increase in QQE in October 2014.

Source: Bank of Japan; Thomson Financial.

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As part of the qualitative aspect of QQE, the composition of asset purchases was changed:

- The BoJ began to purchase government bonds of all maturities, so as to increase the average remaining maturity of its holdings from slightly less than three years to about seven, matching the average maturity of the total stock of outstanding government bonds.
- The BoJ increased its purchases of private assets in order to reduce risk premia.

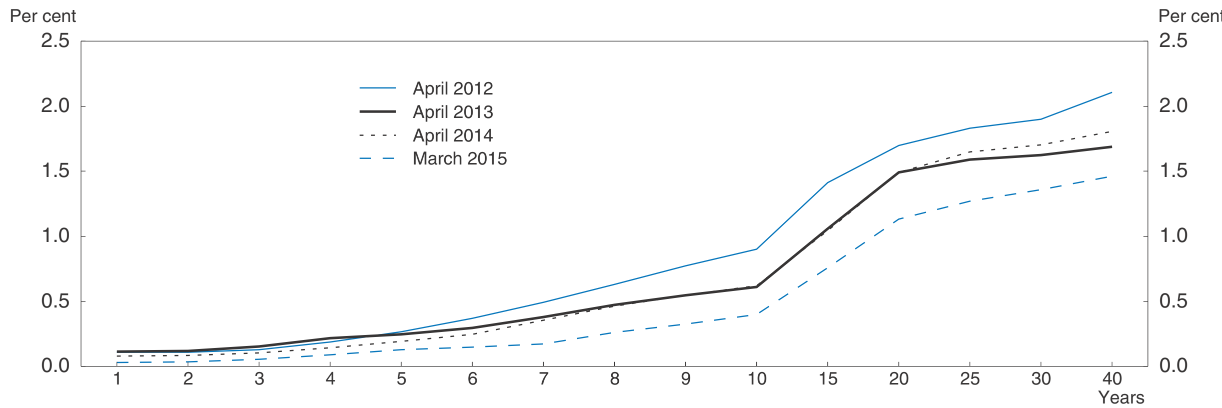
QQE is aimed at achieving the 2% inflation target by reducing long-term interest rates, strengthening the "portfolio rebalancing effect", and raising inflation expectations. All three transmission channels have been effective:

- Interest rates have fallen across the yield curve, with declines of at least 50 basis points for maturities of ten years or more since 2012 (Figure 22).
- The portfolio rebalancing effect is working, as reflected in the increase in bank lending and the rise in equity prices to 15-year highs (Figure 23).
- The BoJ's new approach had an immediate impact on inflation expectations: according to the break-even inflation rate calculated by comparing yields on fixed-rate and inflation-index bonds. Inflation expectations rose from 0.7% prior to the introduction of QQE in 2013 to 2.7% in early 2014, before falling back to around 2% (Figure 24). Survey-based measures show a more modest rise in inflation expectations over two to ten years ahead from 1% to 1.4%. Given the 50 basis-point drop in long-term interest rates, real interest rates have thus fallen by between 1 and 2 percentage points. The increase in inflation expectations, along with high corporate profits (Figure 2, Panel C), is essential for achieving faster wage growth (Figure 2, Panel B), which helps to sustain growth and achieve the inflation target.

However, inflation fell in the second half of 2014. Facing a drop in oil prices, the BoJ announced in October 2014 a pre-emptive recalibration of QQE to maintain the improved inflation expectations. Its purchases of government bonds increased from the initial 50 trillion yen annual pace set in 2013 to 80 trillion yen and purchases of exchange-traded

Figure 22. **Quantitative and qualitative easing has reduced interest rates across the yield curve**[1]

Interest rate on government bonds



1. Market base rate using compounded growth rate. The data refer to the rate at the end of the month.
Source: Ministry of Finance.

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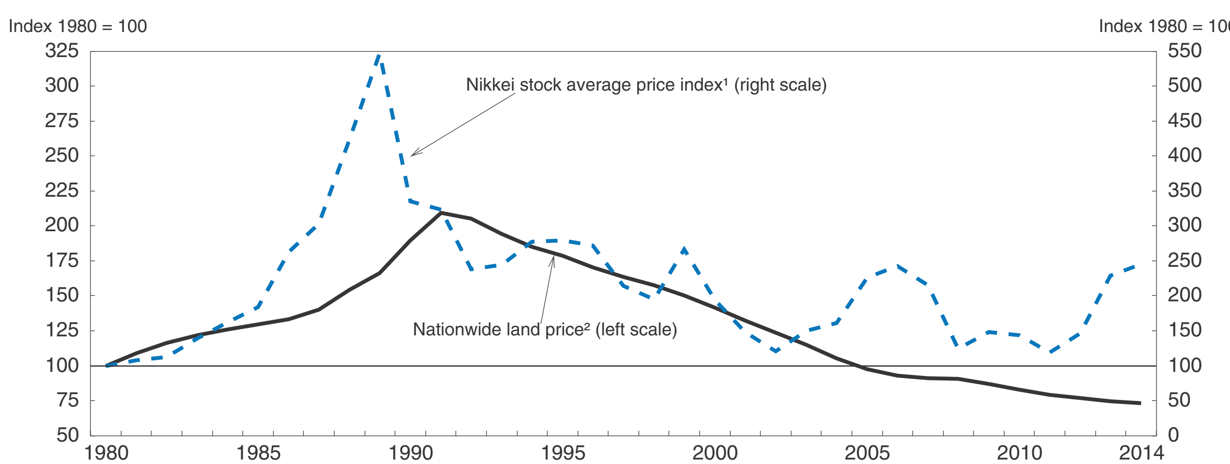
funds (ETFs) and real estate investment funds (J-REITs) tripled. In addition, the BoJ decided to further lengthen the average remaining maturity of its government bond holdings towards ten years. The BoJ recently stressed its readiness to further expand QQE if necessary to achieve its target of 2%. The ramped-up quantitative easing, combined with the delay in the tax hike, should sustain inflation expectations and facilitate a definitive exit from deflation.

Nevertheless, QQE carries a number of risks, in part as its sheer size could disrupt the bond market and fuel asset price bubbles. However, nationwide land prices have fallen for 23 consecutive years (Figure 23), with drops in both commercial and residential land, even though Japan has had a virtually zero policy rate since 1999 (with the exceptions of 2000-01 and 2006-08). However, the pace of decline did slow from 4.7% in 2010 to 1.5% in 2014, as

Figure 23. **While stock prices have risen to their levels in the 1990s, land prices have continued to decline**



1. The annual Nikkei stock price index, which averages the price of 225 individual stocks listed on the Tokyo Stock Exchange.
2. Nationwide urban land prices at end-March of each year for all uses (residential, commercial and industrial).
Source: Ministry of Land, Infrastructure, Transport and Tourism; Nikkei Indexes.

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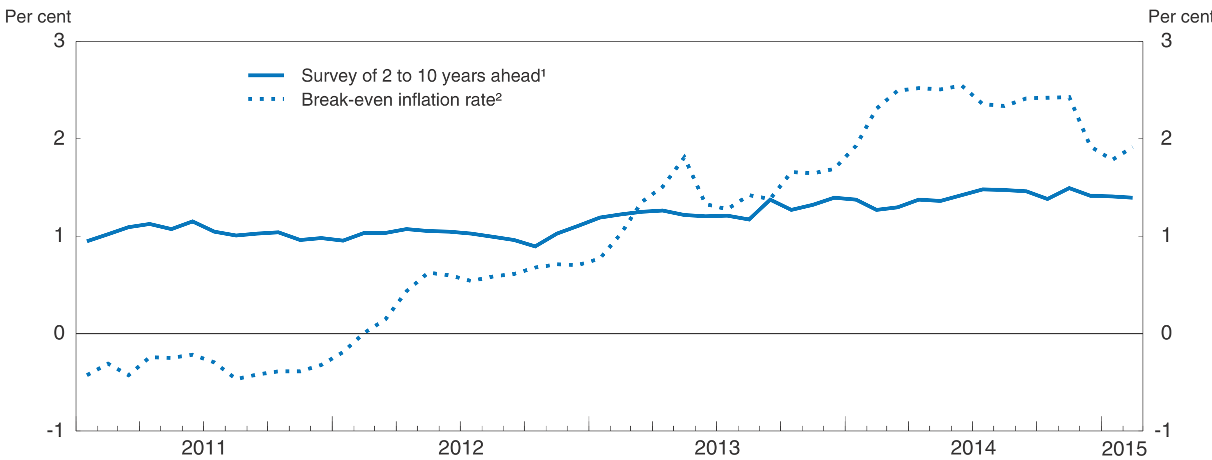
Figure 24. **Inflation expectations have increased**



1. The QUICK Monthly Market Survey
2. Yield spreads between fixed-rate coupon-bearing JGBs and inflation-indexed JGBs.

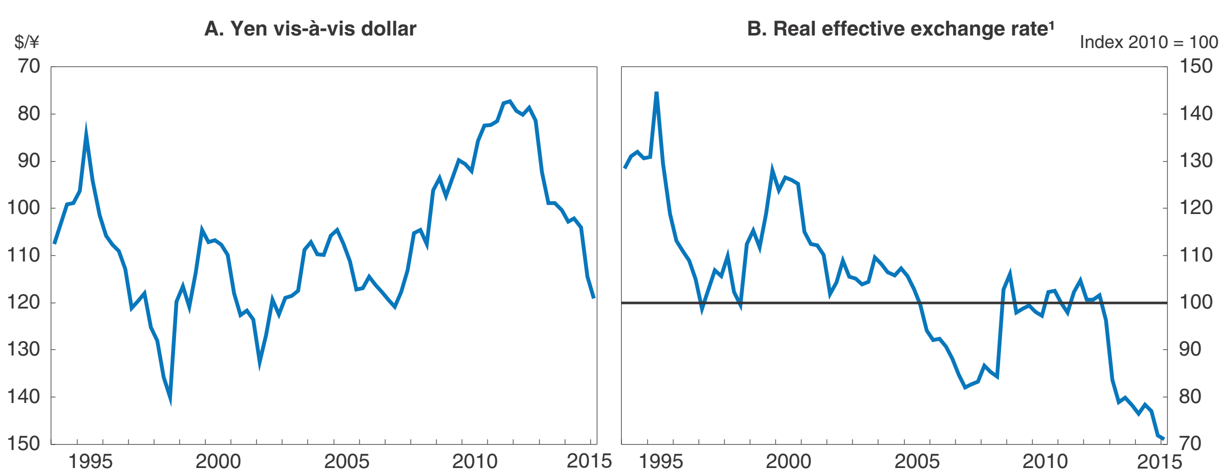
Source: Bank of Japan.

StatLink http://dx.doi.org/10.1787/888933201956

land prices in metropolitan areas rose for the first time since 2008. As for equities, the Nikkei stock price index has doubled since 2011, but remains below its peaks in the 1990s.

Quantitative easing has been accompanied by yen depreciation. Japan joined other G7 countries in 2013 in pledging that it would base its economic policies on domestic objectives using domestic instruments, and would not target exchange rates. The authorities have not intervened in foreign exchange markets since November 2011. Nevertheless, the yen depreciated by 22% against the dollar and in nominal trade-weighted terms between the third quarter of 2012 and July 2014 (Figure 25). The IMF stated in July 2014 that "Japan's external position is … broadly in balance" (IMF, 2014). The government estimates that a 10% depreciation of the currency only raises inflation by about 0.2 percentage points over two years, reflecting imports' relatively small share of

Figure 25. **The yen has depreciated considerably since 2012**



1. Trade-weighted, vis-à-vis 49 trading partners and deflated based on consumer price indices.

Source: *OECD Economic Outlook Database*; Bank of Japan.

StatLink http://dx.doi.org/10.1787/888933201961

GDP at 14%. Since July 2014, the yen has lost another 16% relative to the dollar, with most of the decline coming after the expansion of quantitative easing in October. The yen has also fallen sharply in real effective terms, boosting Japan's cost advantage for exporting companies (Panel B).

The recent expansion of QQE prompted concerns that the BoJ is being forced to monetise government debt, raising the risk of sustained yen depreciation and a run-up in interest rates that could undermine the financing of government deficits. This concern was reflected in the recent decision by Moody's to downgrade Japan's sovereign credit rating to a level below China and Korea. Such risks increase the importance of a detailed and credible fiscal consolidation programme for a primary surplus.

Key recommendation to end deflation

- Continue monetary expansion to durably raise inflation to the 2% target, while monitoring risks.

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ANNEX

Progress in structural reforms

A. Taking stock of structural reforms: Reforming agriculture and promoting Japan's integration in the world economy

Recommendations in the 2013 *OECD Survey of Japan*	Actions taken or proposed by the authorities
Phase out the production adjustment programmes	
End the production adjustment programmes over a fixed and relatively short time period to allow farmers to decide how much and where to produce, thus allowing efficient farmers to increase production, while reducing production costs.	The production quota for table rice will be phased out by FY 2018 and the Direct Payment for Rice will be abolished in 2018. Subsidies for manufacturing and feed rice will continue, along with those for other crops, such as wheat and barley.
Provide temporary support payments to large farmers to compensate for the fall in food prices resulting from the phasing out of the production adjustment programmes.	As a safety net to compensate a certain amount of income loss to business farmers, the government budgeted 74.9 billion yen for the income-based payment under the Act on Farm Income Stabilisation in FY 2014, subject to the appropriate contribution by those business farmers.
Introduce decoupled payments targeted to explicit objectives	
Shift from market price supports to decoupled payments targeted to key policy objectives, thereby reducing the total cost of agricultural policies and shifting the burden from consumers to taxpayers.	In FY 2014, the government introduced a new decoupled payment, totalling 79.3 billion yen ($67 million), for farmers involved in environment-friendly farming as part of an effort to promote the multi-functionality of agriculture.
Integrate existing support for the production of specific commodities into the transitory income support for large farmers.	The government abolished the price-contingent payment for rice in the 2014 crop year and the Direct Payment for Rice will be abolished in 2018. However, subsidies will continue for other crops such as wheat and soybeans.
Introduce new decoupled payments targeted to specific beneficiaries and outcomes, such as environmental services for water buffering in areas not suitable for large farms.	In FY 2014, the government introduced a new decoupled payment to promote the multi-functionality of agriculture.
Promote the consolidation of farmland to lower production costs	
Promote the consolidation of farmland so as to cut production costs by lifting obstacles to land transactions.	In 2014, the government established “regional government-supported institutions” in each prefecture, which rent land and lease it to business farmers.
Ensure the transparency of land-use regulation and provide a more predictable framework for the conversion of farmland to other uses.	No action taken.
Develop an efficient farmland market to remove obstacles to needed structural adjustment, in part by allowing non-farm corporations to own farmland.	The government will promote the leasing of land to non-farm corporations through the “regional government-supported institutions” established in 2014.
Reform the tax system to discourage the holding of idle farmland near urban areas.	No action taken.
Make the “farmland use facilitation groups” in each municipality an effective force promoting farm consolidation.	The “regional government-supported institutions” created in each prefecture in November 2014 leased around 500 hectares (0.01% of Japan’s farmland) to business farmers in the six months following their establishment.
Increase Japan’s integration in the world economy	
Remove border measures on agricultural products as reforms advance, thus reducing prices and costs for consumers and accelerating Japan’s participation in comprehensive multilateral, regional and bilateral trade agreements.	The Japan-Australia EPA entered into force and the Japan--Mongolia EPA was signed in 2015. Japan continues to participate in trade negotiations for eight EPAs/FTAs including the Trans-Pacific Partnership (TPP), Japan-EU EPA, the Regional Comprehensive Economic Partnership (RCEP) and the Japan-China-Korea FTA.

Ensure food security	
Ensure adequate food supply through a more competitive agricultural sector, access to stable supplies of imports and emergency reserves.	The June 2014 Japan Revitalisation Strategy is launching an "aggressive agricultural policy" to enhance the competitiveness of the agricultural sector. The government is also taking measures to diversify trade partners and increase stockpiles.
Use a decoupled payment for environmental services to preserve paddy land to cope with any future risks to food security.	In FY 2014, the government introduced a new decoupled payment to promote the multi-functionality of agriculture.
Focus on food security based on a dynamic agricultural sector, a diversification of trade partners, reserves and the preservation of the agricultural resource base.	The decoupled payment introduced in FY 2014 to promote the multi-functionality of agriculture will help preserve the agricultural resource base. The Japan-Australia EPA entered into force and the Japan--Mongolia EPA was signed in 2015. Japan continues to participate in negotiations for eight EPAs/FTAs,

B. Taking stock of structural reforms: Promoting green growth and restructuring the electricity sector

Recommendations in the 2013 *OECD Survey of Japan*	Actions taken or proposed by the authorities
Upgrade supervision of the nuclear industry and electricity sector	
Ensure that the newly-created Nuclear Regulatory Agency (NRA) is independent from line ministries responsible for energy issues.	The careful and deliberate consideration of nuclear plants' compliance with new safety regulations by the NRA, which is legally independent, provides evidence that it is independent in practice.
Require nuclear plants to meet the criteria to be established by the NRA before being allowed to reopen.	The NRA is carefully reviewing the applications of 21 nuclear power plants to ensure that they meet the new regulatory requirements. As of end-January 2015, only two had received partial approval to meet the new regulatory requirements, which is a prerequisite for re-starting.
Create an independent regulator for the electricity sector that is at arms' length from line ministries.	The current regulator is to be transformed into a new regulatory authority with independence and high-level expertise in 2015.
Improve and expand market mechanisms in the energy sector	
Introduce ownership unbundling to create a level playing field between regional monopolies and new entrants.	The government plans to implement legal unbundling, along with a code of conduct, around FY 2018-2020. If this proves insufficient, the Advisory Committee for Natural Resources and Energy suggests that ownership unbundling will be considered.
Expand interconnection capacity, including frequency converters, and introduce real-time pricing to break down regional monopolies and create a competitive, nationwide electricity market.	Expansion of the capacity of the frequency converters is planned for 2019-21. The Organisation for Cross-regional Co-ordination of Transmission Operators was established in 2015 to promote open access to the transmission system.
Shift to definite-quantity contracts and real-time pricing to promote a competitive, nationwide market.	No action taken.
Promote the role of renewable energy to accelerate green growth	
Ensure that the feed-in-tariff (FIT) system established in 2012 provides appropriate incentives, including for R&D.	The FIT resulted in a 70% expansion of renewable energy capacity by end-October 2014. The government manages the FIT with the dual objectives of facilitating the maximum use of renewables and reducing the cost burden.
Expand interconnections and use of smart grids to effectively manage electricity produced from renewable sources.	METI has decided to introduce a new output control system for photovoltaics and wind by 2021 in order to expand grid capacity.
Introduce carbon pricing through an emissions trading system in combination with a carbon tax to promote investment in green technologies, including renewables.	The second stage of the "Tax for Climate Change Mitigation", a tax on fossil fuels, was implemented in 2014, with the third stage set for 2016. It will generate about 260 billion yen, which will be used to support renewable energy and energy conservation.

C. Taking stock of structural reforms: Boosting labour participation and improving the education system

Recommendations in the 2013 *OECD Survey of Japan*	Actions taken or proposed by the authorities
Encourage labour market participation of women, the elderly and youth	
Reform aspects of the tax and social security system that reduce work incentives for secondary earners.	In 2014, childcare leave benefits were increased from 50% to 67% of wages (prior to the leave) for the first six months.
Increase the availability of affordable, high-quality childcare and encourage better work-life balance, in part by reducing working hours and enforcing the Childcare and Family Care Leave Law.	The number of childcare places is being increased by about 0.4 million by March 2018. After-school childcare centres will provide care for 0.3 million children by March 2020. The government established a new certification system for employers that creates an employment environment favourable to raising children.
Reduce labour market dualism, which makes employment less attractive, particularly to women and youth, through a comprehensive strategy that includes upgrading training programmes, increasing the social insurance coverage of non-regular workers and reducing effective employment protection for regular workers.	The law was revised in 2013 to ban unreasonable working conditions for fixed-term workers. The government expanded subsidies in 2014 to support the shift of non-regular workers to regular status. Employment Insurance is providing training support for young non-regular workers. An expansion of Employees' Pension Insurance and health insurance will extend coverage to 250 thousand non-regular workers in 2016.
Encourage greater use of flexible employment and wage systems to improve working conditions for older workers, in part by abolishing the right of firms to set mandatory retirement at age 60.	The continued employment system, which allows all employees who wish to, to work to age 65, was made universal in 2013 by abolishing the scheme that had allowed firms to exclude some employees from the system.
Emphasise practical training, combining on-the-job and classroom learning, in part through expanding the Job Card system, to equip youth with skills needed in the labour market.	The Job Card system provided employment training programmes, combining classroom learning and practical training, for 40 000 people in FY 2013.
Improve vocational education, in part by creating a standard qualifications system that is recognised by firms.	Vocational qualifications were expanded nationwide in FY 2013 in new growth areas, such as nursing care, energy and farming.
Improve educational outcomes	
Invest more in early childhood education and care to expand quality and integrate childcare and kindergarten.	A total of 0.5 trillion yen from the 2014 consumption tax hike will be used to increase the capacity and quality of childcare.
Expand the autonomy of primary and secondary schools and increase school choice to encourage schools to excel.	No action taken.
Improve the quality of the tertiary sector by increasing transparency about performance to strengthen competition.	A new system for providing information on colleges and universities will be launched by 2015 March.
Promote the internationalisation of the tertiary sector by increasing the number of foreign students and encouraging the establishment of more foreign tertiary institutions in Japan.	The government is shifting its budget to the "Top Global University Project (2014)" to enhance the international competitiveness of Japanese universities.
Enhance the role of the tertiary sector in innovation, in part through greater co-operation between universities and the business sector, including enhanced labour mobility of researchers.	In 2013, the government implemented programmes to promote the commercialisation of academic research and enhance the labour mobility of researchers. Cross-appointments of researchers in universities, government labs and firms will be promoted.

D. Taking stock of structural reforms: Restoring fiscal sustainability

Recommendations in the 2013 *OECD Survey of Japan*	Actions taken or proposed by the authorities
Develop a new fiscal consolidation plan	
Develop a more detailed and credible fiscal consolidation plan, including spending targets by category and a timetable for tax hikes, to maintain confidence in the fiscal situation and prevent a run-up in interest rates.	A concrete fiscal consolidation plan to achieve the target of a primary surplus by FY 2020 will be prepared by the summer of 2015.
Aim for a sufficiently large primary budget surplus – around 4% of GDP – to stabilise the debt ratio by 2020.	No action taken.
Limit government spending	
Achieve spending cuts in such areas as public investment and the government wage bill to offset rising social security outlays.	Primary spending, excluding social security expenditure, fell by 1.7% in nominal terms in the FY 2015 budget.
Implement approved reconstruction spending before creating new budget plans.	The government is making efforts to smoothly implement the reconstruction budget in affected areas.
Continue the screening process to find ways to reduce low-priority and ineffective spending programmes.	Audits, budget execution surveys, policy evaluations, and administrative project reviews are being used to improve budget efficiency and effectiveness.
Reform social security to limit spending increases, particularly in the areas of health and long-term care.	The fees for long-term care suppliers were cut by 2.27% in the FY 2015 budget. The out-of-pocket share for patients aged 70-74 will be increased from 10% to 20% for people who reach the age of 70 after April 2015. As for long-term care insurance, the out-of-pocket share will be increased from 10% to 20% in August 2015 for patients aged 65 and above, whose income is above a designated level.
Ensure the sustainability of the public pension programme by accelerating the hike in the retirement age and then linking it to longevity.	The continued employment system, which allows all employees who wish to, to work to age 65, was made universal in 2013 by abolishing the scheme that had allowed firms to exclude some employees from the system.
Increase government revenue	
Implement the planned doubling of the consumption tax rate in two stages to 10% by 2015.	The government increased the consumption tax from 5% to 8% in April 2014, but postponed the planned hike to 10% from October 2015 to April 2017.
Maintain a single rate for the consumption tax to avoid the distortions associated with multiple rates, while introducing measures, notably an earned income tax credit, to address the regressive nature of the tax.	The coalition parties agreed at the end of 2014 to introduce a reduced tax rate scheme when the consumption tax rate is 10%.
Rely primarily on the consumption tax and other indirect taxes, such as environment-related levies, as well as the broadening of income tax bases, to boost government revenue.	The consumption tax rate is to be increased to 10% by 2017 and the government is implementing the "Tax for Climate Change Mitigation". It also broadened the personal income tax base for high salary earners in 2014.
Improve the fiscal policy framework	
Ensure that the Council on Economic and Fiscal Policy (CEFP) functions as an effective impartial body to monitor and evaluate progress in fiscal consolidation.	The functioning of the CEFP was improved in 2014. The CEFP has had many discussions on the progress of fiscal consolidation, including concerning bi-annual economic and fiscal projections for medium to long-term analysis The CEFP is now working to prepare the new medium-term strategy to achieve a primary surplus by FY 2020.
Reform the fiscal policy framework through a multi-year budgeting plan and a stronger legal basis for fiscal targets.	The 2013 Medium-term Fiscal Plan set an improving path for the primary balance in the central government general account for FY 2014-15. The government is formulating a concrete plan to be adopted by the summer of 2015 to achieve a primary surplus for central and local governments by FY 2020.

E. Taking stock of structural reforms: Reducing income inequality and poverty

Recommendations in the 2013 *OECD Survey of Japan*	Actions taken or proposed by the authorities
Enhance the redistributive power of the tax and benefit systems by increasing the share of net benefits received by low-income households.	A new policy to support low-income pensioners is scheduled to be implemented in 2017. With the consumption tax hike in 2014, temporary benefits for low-income people have been provided.
Introduce an earned income tax credit, initially for wage earners, while expanding it to the self-employed as transparency about their income is enhanced.	No action taken.
Upgrade public assistance by ensuring that those capable of working are enrolled in training, while promoting incentives to leave assistance and coordinating such programs with the existing safety net.	An in-work benefit – a lump-sum benefit to people leaving the Basic Livelihood Protection Programme – was launched in 2014. The working-income deduction for BLPP recipients was made more generous in August 2013 to encourage work.
Address the underlying causes of inequality through reforms in the education system and the labour market.	Employment Insurance is providing training for young non-regular workers. The Employees' Pension Insurance and health insurance will be expanded to provide coverage to 250 thousand non-regular workers (1.3% of the total) in 2016.
Ensure adequate coverage of public assistance and co-ordinate the Basic Livelihood Protection Programme (BLPP) and the "second safety net".	In order to promote self-reliance of persons in poverty, the government will provide them with consultation services, benefits for securing housing and other services from April 2015.
Provide training programmes for recipients of public assistance who are capable of working, while ensuring that there are incentives to leave assistance.	An in-work benefit – a lump-sum benefit to people leaving the Basic Livelihood Protection Programme – was launched in 2014. The working-income deduction for BLPP recipients was made more generous in August 2013 to encourage work. The government has expanded efforts to help benefit recipients who can work to find jobs.
Implement a comprehensive strategy to break down labour dualism, including increasing the social insurance coverage of non-regular workers and reducing employment protection for regular workers, while upgrading training programmes.	Employment Insurance is providing training for young non-regular workers. An expansion of Employees' Pension Insurance and health insurance will extend coverage to 250 thousand non-regular workers in 2016.
Ensure access to high-quality early childhood education and care for children from low-income families.	The central government will expand financial support in the FY 2015 budget for municipal governments that provide subsidies to children from low-income households who enter kindergarten.
Reduce reliance on private, after-school lessons, particularly in juku, in part by increasing school quality, and increase the accessibility of students from low-income families to after-school lessons.	No action taken.
Expand public loans for tertiary education to encourage students from low-income households to invest in higher education.	Public loans under the interest-free scholarship loan programme increased from 277 billion yen in FY 2012 to 307 billion yen in FY 2014, covering almost all students who qualify.
Build on the national surveys of well-being to identify the priorities and policies to improve well-being.	Experimental surveys of well-being were conducted in 2013 and 2014.

Chapter summaries

Chapter 1. Enhancing dynamism and innovation in Japan's business sector

Innovation is key to boosting economic growth in the face of a rapidly ageing population. While Japan spends heavily on education and R&D, appropriate framework conditions are essential to increase the return on such investments by strengthening competition, both domestic and international, and improving resource allocation. Upgrading corporate governance would encourage firms to maximise profits and invest their large cash reserves. To promote open innovation in a global framework, it is necessary to improve universities and expand their role in business R&D, while increasing international collaboration in R&D from its current low level. Venture capital-backed firms and start-ups should play a key role in commercialising innovation. To make venture investment a growth driver, it is important to expand the role of business angels and foster entrepreneurship. SMEs, which account for 70% of employment, should contribute more to innovation.

Chapter 2. Achieving fiscal consolidation while promoting social cohesion

With gross government debt of 226% of GDP, Japan’s fiscal situation is in uncharted territory and puts the economy at risk. Japan needs a detailed and credible fiscal consolidation plan, including specific revenue increases and measures to control spending to restore its fiscal sustainability. The major concern on the spending side are social spending pressures in the context of rapid population ageing, making reforms to contain such spending a priority. Much of the consolidation, though, will have to be on the revenue side, primarily through hikes in the consumption tax rate beyond the 10% now planned for 2017. Fiscal consolidation should be accompanied by measures to promote social cohesion through the tax and benefit system and by breaking down labour market dualism. In particular, an earned income tax credit is a priority to assist the working poor.

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 2 March 2015. 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 20 March 2015.

The Secretariat's draft report was prepared for the Committee by Randall S. Jones, Kohei Fukawa and Myungkyoo Kim under the supervision of Vincent Koen. Research assistance was provided by Lutécia Daniel.

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