



Supporting Japan's Policy Objectives: OECD's Contribution





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For a stronger, cleaner, fairer world economy

Foreword

The world is just emerging from the most severe economic crisis of our lifetimes. The social and human costs are high, and the ability of our economies to grow and prosper will depend more than ever on the quality of government actions, and on vibrant international co-operation. Looking forward, we need to develop a new setting for sustainable growth, taking into account the challenges of climate change in a comprehensive new strategy for a green recovery. Thus the crisis is also a good opportunity to nurture a stronger, fairer and cleaner world economy.

Japan's leadership and contributions in this juncture are crucial. Just when a new government is taking over, Japan is starting to emerge from the crisis, and contributing to defining solutions for the global agenda. This is good news, for the world needs a creative, prosperous and confident Japan.

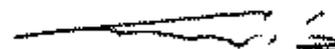
To play this role to the fullest, Japan needs to address a number of policy issues. Major structural hurdles hamper labour productivity and depress employment rates. Population ageing puts pressure on public services and on pension outlays, even as public debt reaches worrisome levels. Many industrial sectors should improve their performance to comply with the required reductions in greenhouse gas emissions.

The good news is that Japan confronts these challenges with exceptional strengths. A high level of investment in human capital and R&D and the outstanding educational results of its students underpin Japan's strong performance in many high-technology industries. Japan is a leader in green technologies. And it has increasingly close ties with a dynamic Asian region that is driving world growth.

Japan can count on OECD support to define policy options at a national and international level. The OECD is a hub for addressing global issues. Drawing on the experience of our 30 member countries, in dialogue with other major economies, such as Brazil, China, India, Russia and South Africa, and interacting with dynamic regions such as South-East Asia, our aim is to advance international economic co-operation and support best economic policy options worldwide.

This brochure presents OECD policy perspectives in nine areas that are critical to Japan's future – a strategy for domestic demand-led growth, the labour market, environment and climate change, education, taxes, health and long-term care, pension reform, regional policy and decentralization and public governance. I hope that they will contribute to the policy debate in Japan, for the benefit not only of this important OECD member, but of the world at large.

Angel Gurría
Secretary-General

A stylized, dark signature of Angel Gurría, consisting of several horizontal strokes of varying lengths and thicknesses.

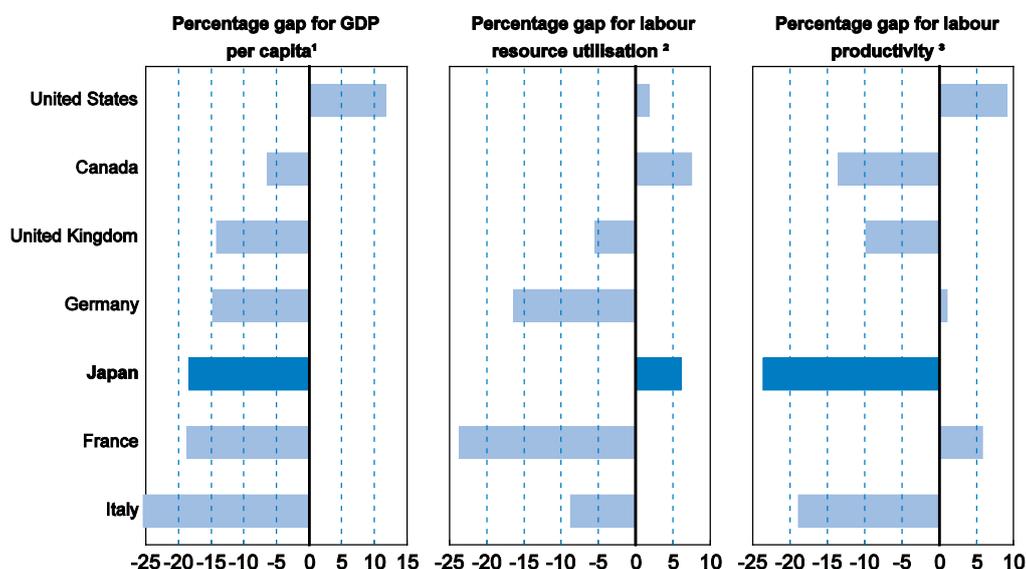
A strategy for domestic demand-led growth

Raising productivity is the key to economic growth over the medium term

Per capita income in Japan was almost 20% below the average of the top 15 OECD countries in 2008. Japan's challenge is to achieve sustained, domestic demand-led growth to help narrow the income gap with leading countries. Labour productivity per hour worked in Japan is more than 20% below the average of the upper half of OECD countries.

Explaining differences in income

Percentage gap with respect to the upper half of OECD countries in 2008



1. GDP per capita is based on 2008 purchasing power parities.

2. Labour resource utilisation is measured as total number of hours worked divided by the population.

3. Labour productivity is measured as GDP per hour worked.

Source: OECD, National Accounts Database, OECD, *Economic Outlook 85 Database* and *OECD Employment Outlook*.

The priority is to boost productivity in the service sector through reform and openness

The service sector, which accounts for more than two-thirds of output and employment, is largely responsible for Japan's low aggregate productivity, according to the 2008 *OECD Economic Survey of Japan*. International competition has driven sustained productivity gains in manufacturing, while services, which are relatively sheltered from both international and domestic competition, have lagged behind. This is particularly true in the case of non-market services, such as health care.

Strengthening competition requires addressing the regulations that limit competition in individual services industries. The OECD's indicator of product market regulation in *Going for Growth* ranks Japan near the OECD average in barriers to entrepreneurship.

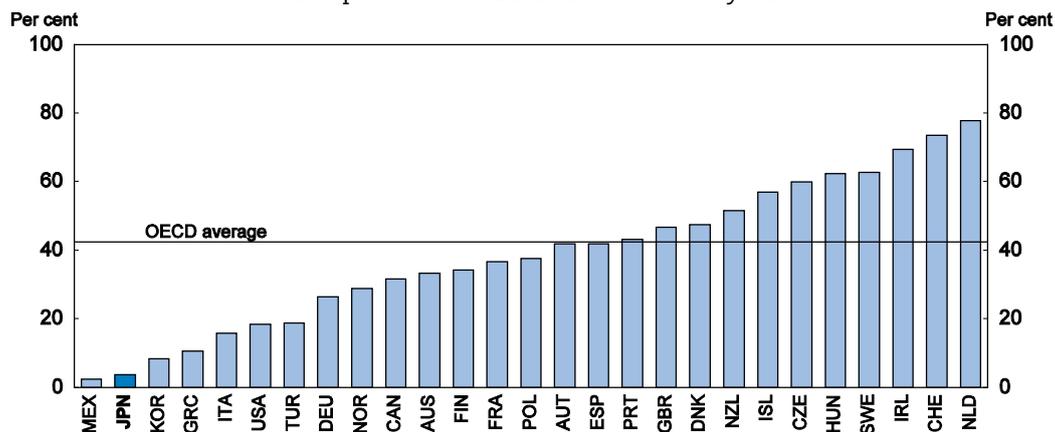
Past regulatory reform in Japan has produced large benefits in terms of reducing prices and raising output in a number of service industries, including electricity, telecommunications and trucking. Further beneficial reforms are needed to strengthen competition, including by reducing exemptions to the Anti-Monopoly Act (AMA) and increasing administrative fines for violations.



The stock of foreign direct investment (FDI) in Japan is the second lowest in the OECD area at 3.6% of GDP in 2008, and a relatively small proportion of that is in the service sector. Consequently, the share of foreign affiliates in total service turnover in Japan is the lowest among OECD countries. The benefits of FDI result from positive spillovers from the presence of foreign firms, which triggers transfers of technology, facilitates the restructuring of firms and promotes international trade. It is important, therefore, to attract more FDI inflows by removing remaining restrictions on foreign investment, reducing entry barriers and ensuring that the market for mergers and acquisitions is fully open.

The stock of inward foreign direct investment in Japan is low

As a per cent of GDP in 2008 or latest year



Source: OECD, *Economic Globalisation Indicators Database*.

Key OECD recommendations

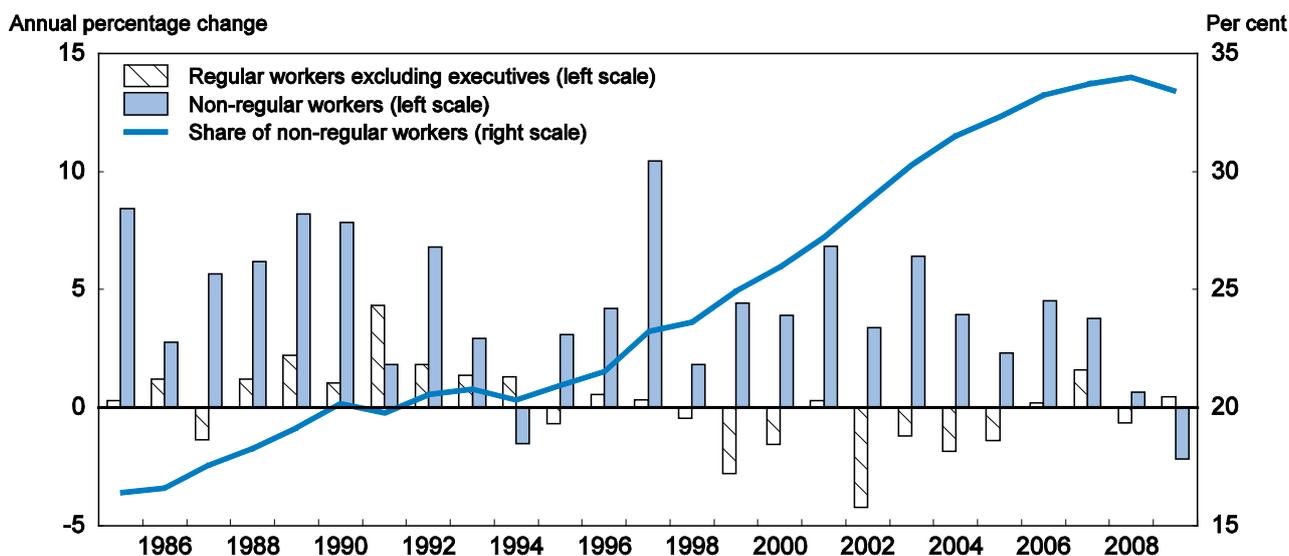
- Implement reforms in major service industries, such as increasing the share of consumers allowed to freely choose their suppliers of electricity and gas and reducing entry barriers in air transport.
- Accelerate the pace of regulatory reform in the service sector to strengthen competition, in part by using the special zone initiative to achieve nationwide reform.
- Pursue a more pro-active competition policy, reducing exemptions to the AMA and further increasing penalties for violations.
- Strengthen international competition by promoting inward FDI by eliminating remaining barriers and creating an environment that is attractive to potential investors.

The labour market

Labour market dualism: a negative impact on economic growth and equity

The steady increase in the proportion of non-regular workers in Japan since the mid-1980s – from 16% in 1985 to over one-third by 2008 – is a major cause for concern. As non-regular workers are paid substantially less than regular workers, the rising share of non-regulars has put downward pressure on wages. Increasing labour market dualism has also negative implications for long-term productivity growth as firms invest less in training non-regular workers.

The share of non-regular workers is rising



Source: Ministry of Internal Affairs and Communications, *Labour Force Survey*.

Equity problems are a major concern, as at least part of the gap in hourly wages between regular and non-regular workers – two-thirds of whom are women – can be attributed to discrimination. Exemption from firm-based health, pension and employment insurance schemes for non-regular employees working less than a certain number of hours leaves them vulnerable to poverty in the event of job loss, ill-health or retirement. The large share of low-paid, non-regular workers may also explain the high incidence of in-work poverty in Japan, which is the fifth-highest rate in the OECD. Although Japan has introduced a number of policies to help non-regular workers hurt by the crisis, this will do little to address the longer-term causes and effects of labour market dualism.

Policies to reverse the trend toward labour market dualism

Reversing dualism requires addressing the factors that encourage firms to hire non-regular workers. Employers report that cutting labour costs, through lower wages and exemption from co-payments for social insurance, is the main reason for hiring non-regular workers. The industries with the greatest increases in part-time employment have recorded the lowest wage growth.

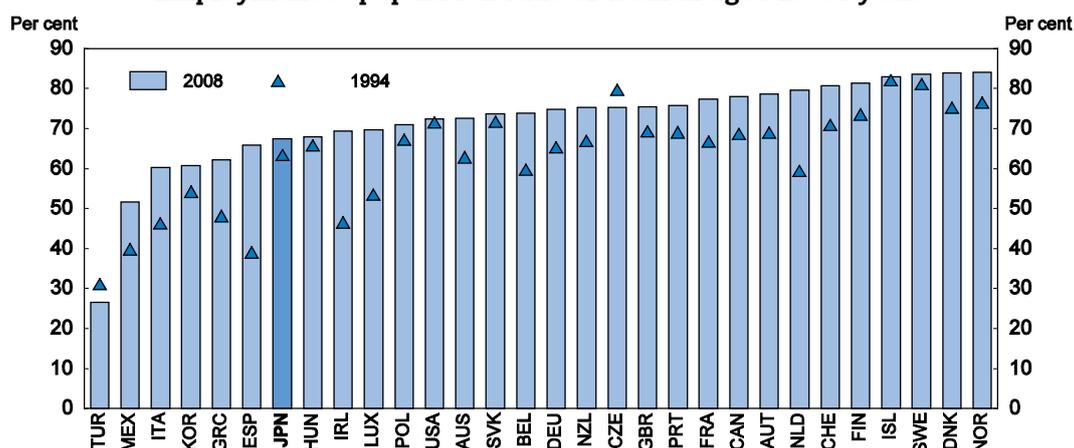
Non-regular workers have been disproportionately affected by job losses during the downturn, accounting for 42% of employment lost in the two years to mid-2009 even though they make up only one-third of employment. While the level of regulation on temporary contracts is below that in most OECD countries, rules for workers on regular contracts are around the OECD average and firm-level agreements make dismissal costs even higher.

Japan needs to implement policies to reverse the trend towards labour market dualism. A comprehensive approach is necessary, including increasing the coverage of non-regular workers by social security insurance schemes, reducing employment protection for regular workers, upgrading training programmes to enhance the job prospects of non-regular workers and ensuring that the social safety net is adequate.

Measures to increase female labour force participation

Population ageing will have the greatest impact on Japan among OECD countries, making it a priority to increase labour force participation. The most obvious target is prime-age women, whose employment rate is among the lowest in the OECD and has increased only marginally since the mid-1990s. Reducing labour market dualism and improving the quality of part-time jobs would encourage more women to join the workforce. Employment practices, such as linking pay and promotion to seniority and tenure rather than performance, have contributed to a gender pay gap in Japan that is twice the OECD average, as explained in the 2008 OECD *Employment Outlook*. Increasing the availability of child care, encouraging family-friendly working arrangements and reforming the tax treatment of secondary earners would make work more attractive to mothers, 60% of whom withdraw from the labour force when their first child is born. Making it easier to combine work and family should also help boost Japan's low birth rate.

Employment to population ratio of women aged 25-54 years



Source: OECD *Employment Outlook*, 2009.

Key OECD recommendations

- Expand the coverage of non-regular workers by firm-based social insurance systems.
- Reduce the disparity in employment protection between regular and non-regular workers through a comprehensive approach including increasing the coverage of non-regular workers by social security insurance schemes, reducing employment protection for regular workers and ensuring that the social safety net is adequate.
- Increase training to enhance human capital and the employability of non-regular workers.
- Take active measures to provide more attractive job opportunities to women.
- Encourage better work-life balance, in part by better enforcing the Labour Standards Act.
- Expand the availability of high-quality childcare and reform aspects of the tax and social security system that reduce work incentives for secondary earners.
- Encourage greater use of performance assessment in pay and promotion decisions.



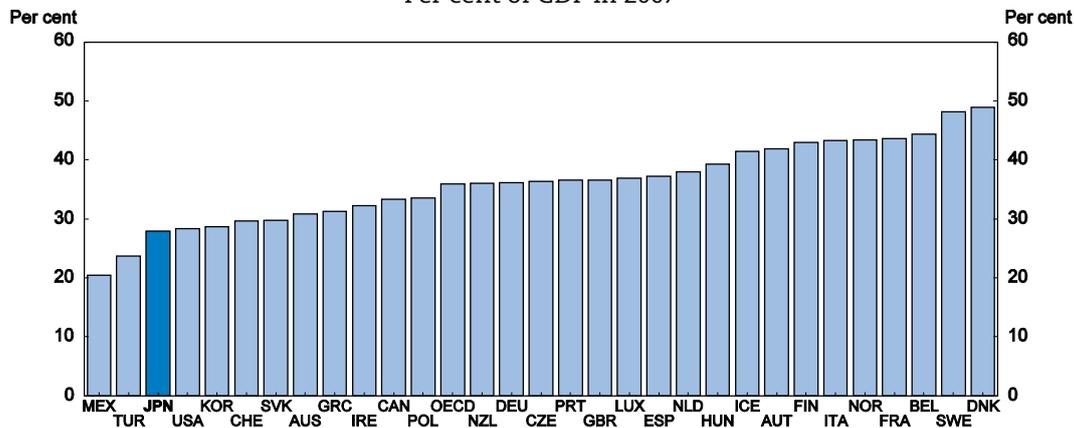
Tax reform

Japan needs a fundamental tax reform to create a fairer and simpler tax system which also promotes green growth while raising additional revenues. Achieving this will require the elimination of many of the special tax provisions which are pervasive throughout the tax system, especially those which were originally intended to be of a temporary nature; to re-examine the tax treatment of the elderly and SMEs; to look at ways of increasing local tax autonomy. Any reforms should be seen in the context of the need to restore fiscal sustainability and the new government's commitment to play a lead role in addressing climate change.

Raising additional revenue in order to restore fiscal sustainability

The government budget deficit is projected to reach almost 10% of GDP in 2010, boosting gross government debt to nearly 200% of GDP, the highest in the OECD area. Achieving fiscal sustainability is likely to require additional revenue, which at present is one of the lowest in the OECD area as a share of GDP.

Tax revenue is among the lowest in the OECD area
Per cent of GDP in 2007



Source: OECD (2008), *Revenue Statistics 1965-2007*, OECD, Paris (<http://dx.doi.org/10.1787/366725334503>).

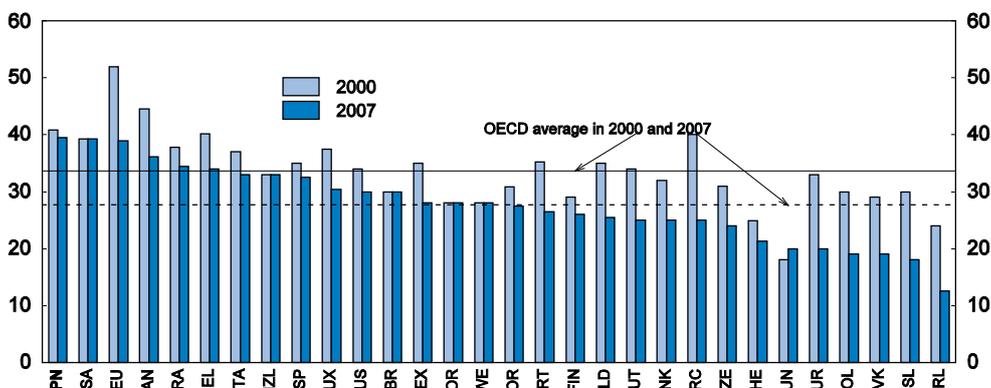
The primary source of additional revenue should be the consumption tax, which at the current level of 5% is the lowest in the OECD area. However, this should only be done once an economic recovery is firmly in place. Japan should maintain a single consumption tax rate applied to a broad tax base and retain flexibility in allocating the additional revenues by avoiding earmarking. At the same time, the government should implement its pledge to raise additional 2.7 trillion yen by eliminating tax expenditures that are ineffective, and could consider raising new environmental taxes, including exploring the potential for a CO₂ tax.

Enhancing Japan's growth potential

The negative impact of taxes on growth can be minimised by shifting the composition of taxes from direct to indirect taxes. One way this could be achieved is by cutting the headline corporate income tax, which is currently the highest among OECD countries at nearly 40%. Reductions could be accompanied by measures to broaden the base through cuts in exemptions and further eliminating corporate income tax expenditures. This would improve the allocation of resources and investment and, if the experience of other OECD countries is a guide, could maintain the revenue yield.

The tax wedge on labour income in Japan was the seventh lowest in the OECD area in 2007 at 29%, well below the OECD average of 38%, thus encouraging employment and output growth. Maintaining a low tax wedge is thus important for long-term growth. The need for additional personal income tax revenue should be met by broadening the base rather than raising rates. Indeed, only half of wage income is taxed in Japan, compared to an average of more than 80% in the OECD area. In addition, aspects of the personal income tax system that discourage female labour supply should be removed.

Japan has the highest corporate income tax rate in the OECD area



Source: OECD (2008), Tax Database (www.oecd.org/ctp/database).

Addressing the widening of income inequality and the rising relative poverty rate

An Earned Income Tax Credit (EITC), which is used in a number of OECD countries, would help reduce inequality and relative poverty, while strengthening work incentives. Such an approach is likely to be effective in Japan, given its relatively wide earnings distribution, low taxes on labour and low benefits for the non-employed. In addition, equity concerns should be met by strengthening the inheritance tax, which is applied very narrowly compared to other countries.

Improving the local tax system and enhancing local autonomy

The local tax system is exceptionally complicated with 23 taxes and only limited autonomy to local governments. Barriers to the effective use of existing powers to set local tax rates need to be re-examined. Local governments could be encouraged to rely primarily on existing local taxes on personal income, consumption and property, as they are relatively stable.

Key OECD recommendations

- Limit the negative impact of taxes on growth by shifting the composition of taxes from direct to indirect taxes, relying primarily on the consumption tax, but balancing this with other changes to improve the overall progressivity of the tax/yield rate.
- Maintain a unified consumption tax rate and avoid earmarking of revenues.
- Reduce the corporate income tax rate to promote growth while broadening the base.
- Increase the share of wage income that is taxed while avoiding hikes in personal tax rates.
- Address concerns about poverty and inequality through the introduction of an Earned Income Tax Credit and reviewing taxes on wealth and property.
- Improve the local tax system, while granting more autonomy to local governments.



Environment and climate change

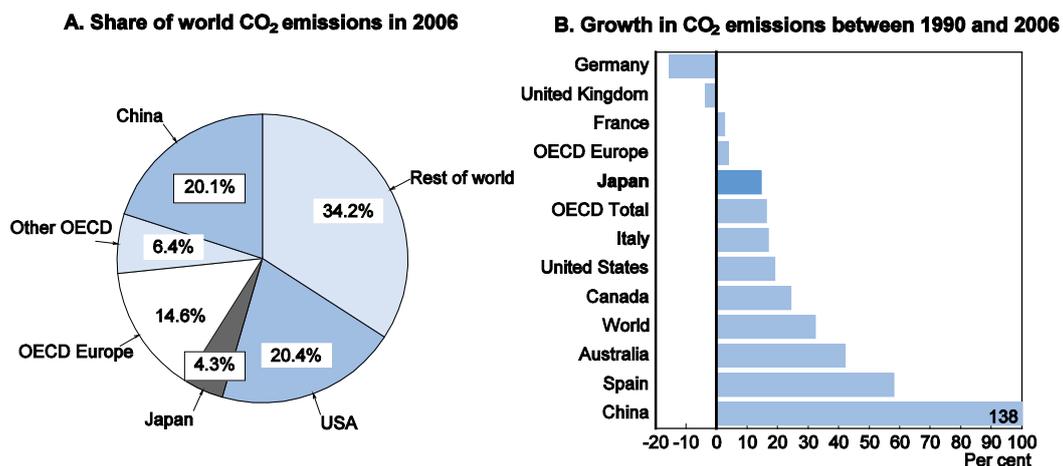
Japan is striving to achieve a “sustainable society” that is low-carbon, resource efficient and in harmony with nature. To achieve these goals, Japan has been proactive domestically and internationally in promoting action on climate change, biodiversity and the “3Rs” (Reduce, Reuse and Recycle). The 2009 *OECD Economic Survey of Japan* analysed Japan’s climate change policies. In addition, the OECD is preparing a review of Japan’s environmental performance that will be discussed in May 2010.

Climate change

Japan has introduced a wide range of measures to reduce greenhouse gas emissions in line with its commitment under the Kyoto Protocol to cut emissions by 6% relative to 1990 by 2012. As of 2007, however, emissions were up by 9%, as a decline in the industrial sector was more than offset by increases elsewhere, notably in the commercial and residential sectors. The policy framework needs to be improved to meet the Kyoto target, as well as the government’s ambitious recent pledge to reduce emissions by 25% by 2020 compared to 1990 levels, which is conditional on agreement on demanding targets by all the major economies.

Japan should consider shifting from voluntary measures to market-based instruments, notably a mandatory and comprehensive emission trading scheme based on cap and trade, supplemented if necessary by carbon taxes in areas not covered by trading. Such an approach would minimise abatement costs and promote innovation and investment to reduce emissions. Indeed, a clear price for carbon is necessary to maintain Japan’s status as a front-runner in environment-related technological innovation. In addition, trading schemes could be linked to those in other countries, while expanding Japan’s use of a well-functioning Clean Development Mechanism. OECD analysis suggests that Japan would be one of the countries benefiting the most from increased use of the Clean Development Mechanism.

International comparison of CO₂ emissions



Source: OECD (2009), *OECD Economic Survey of Japan*.

Green growth

The OECD Ministerial Council Meeting in June 2009 called on the OECD to develop a *Green Growth Strategy* for delivery in 2011. In Japan's April 2009 fiscal stimulus package, "green measures", such as tax incentives for solar power, energy efficient products and vehicles, as well as financial support for green investment and infrastructure, accounted for about 10% of spending. However, some elements in the fiscal stimulus, such as reductions in road tolls, may have negative environmental impacts, while others, such as support to the car sector, may distort competition. The new government's review of the fiscal stimulus package provides an opportunity to ensure that policies support green growth objectives. Green measures should include greater use of environment-related taxes, notably the tax on petrol, which is well below the OECD average. The G20 summit in Pittsburgh mandated the OECD to pursue its analysis on the scope of energy subsidies, including harmful fossil fuel subsidies.

3Rs and waste management

Japan has been a pioneer in promoting efficient use of natural resources through policies designed to achieve a "sound material-cycle society". Japan's overall resource productivity increased by 32% between 2000 and 2006, by increasing recycling and reducing the amount of waste disposed: landfilling of industrial waste was cut in half and municipal waste landfilled was reduced by 35% (compared to a 22% cut in the European Union). However, industrial waste generation continues to grow. There is also an important international dimension related to the increasing trade in recyclable wastes, which is difficult to control. Japan and the OECD have worked together to promote policy dialogue and action on the 3Rs, notably in developing two OECD Council Recommendations in this area. The Kobe 3R Action Plan adopted by the G8 Environment Ministers in 2008 called on the OECD to assess progress in this area by 2011.

Biodiversity

Japan will host the 2010 meeting of Parties to the Convention on Biological Diversity and has placed increasing importance on biodiversity issues. Its updated strategy includes several new laws, a larger number of protected areas and the promotion of "eco-farming". However, greater efforts are needed to converge with the best performers in the OECD, as the coverage of protected areas remains relatively low. Biodiversity loss is increasing, threatening nearly a quarter of mammal species and more than one-third of freshwater fish.

Key OECD recommendations

- The principal means for implementing environmental policy should be significantly strengthened: there has been an over-reliance on voluntary approaches and the provision of subsidies (grants, tax breaks).
- More systematic, cost-effective approaches are needed, such as greater use of environment-related taxes.
- Put a clear, appropriate price on carbon to minimise the cost of reducing carbon emissions and to encourage private actors to make the necessary investment decisions. The price should be complemented by other measures -- *e.g.* investments in R&D, regulations and standards, eco-labelling – to help address market failures.
- The carbon price should be achieved through a comprehensive, mandatory emissions trading scheme based on cap and trade to replace the voluntary scheme currently in place, complemented by a carbon tax for sectors not covered by the scheme.

Education

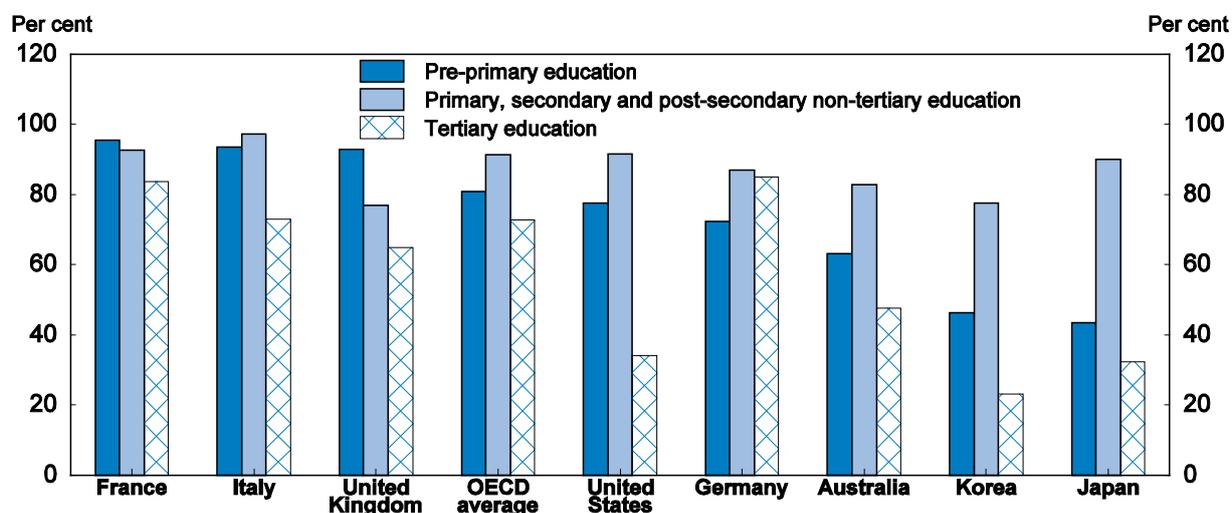
Education is a strategic investment in future economic prosperity. Despite budget pressures, Japan's government now has the chance to strengthen the quality, equity and efficiency of the education system and hence long-term economic growth.

Financing education

Japan has the second highest share of household expenditure on education, which enabled it to finance a rapidly expanding education system. At the same time, this has created a significant financial burden for households, which the economic crisis has reinforced. While Japanese universities charge high average annual tuition fees, Japan does not have a sufficiently developed system for student financial support combining loans, scholarships and grants. Experience in other OECD countries shows this can be achieved without burdening public budgets but instead generating positive fiscal returns in the long run.

Countries use a range of approaches to support students. Few countries have basic universal grants schemes. Means-tested grants are the most common form although some countries also have merit-based scholarships. Loan-based financial support is becoming more common with repayments required only when future earnings make it possible. In contrast, Japan's current student loan scheme involves a fixed repayment schedule. As a result, only around one-third of students currently take out loans. Moving the current loan system onto an income-contingent repayment approach would make student loans much more attractive and improve access to tertiary education. These loans could be complemented with means-tested grants for those students that could otherwise not afford to attend university.

The share of expenditure on education institutions that is financed from public sources



Source: *Education at a Glance* 2009.



Early childhood education and care

Important policy objectives include ensuring a strong start in children's development, reducing the burden of childbirth and childrearing, making work more compatible with family life, encouraging women's participation in the workforce, and fostering equity through early, available and quality childhood education and care.

To achieve those multiple objectives, successful countries have better integrated the relevant sectoral policies (e.g. education, health, tax and employment). It is thus important that Japan carefully analyses the interactions and trade-offs between different policy options, for example between child allowances and other investments in young children, such as early childhood education and care. Japan could also improve policy coherence by integrating early childhood education and childcare services and could invest more resources to increase their availability, quality and accessibility.

Improving schools

OECD's PISA assessments show consistently that Japanese students achieve among the best results in the industrialised world. Reinforcing the current shift in Japan's educational standards from reproducing subject matter knowledge towards enhancing students' capacity to extrapolate from what they know and apply their knowledge more creatively, could help to close the gap to the top performer, Finland. Japan is prioritising the capacity to attract and retain high quality teachers through comparatively high teacher compensation and professional development of teachers over small class sizes. Additional priorities would be to address an increasingly heterogeneous student population and at-risk populations; and foster more positive attitudes of students towards learning, as well as their motivation and capacity to continue learning throughout life.

Key OECD recommendations

- Channel more public resources into pre-primary education and child care and re-examine the purpose and scope of the child allowance proposals.
- Improve early childhood education and care through greater policy coherence and integration of pre-primary education and child care to improve efficiency and reduce waiting lists.
- Improve teacher recruitment, training and professional development, especially to strengthen their competencies in teaching increasingly heterogeneous and at-risk students; and in fostering students' motivation and capacity towards learning.
- Improve access to tertiary education through restructuring of the student support system, allowing student borrowers to repay their loans after graduation based on income and expanding means-tested grants.

Health and long-term care

The health-care system provides universal access to care and contributes to the outstanding health status of the Japanese. Public spending has been kept below the OECD average through high co-payment rates and reductions in medical fees. However, the health-care system faces a number of challenges that were analysed in the 2009 *OECD Economic Survey of Japan*:

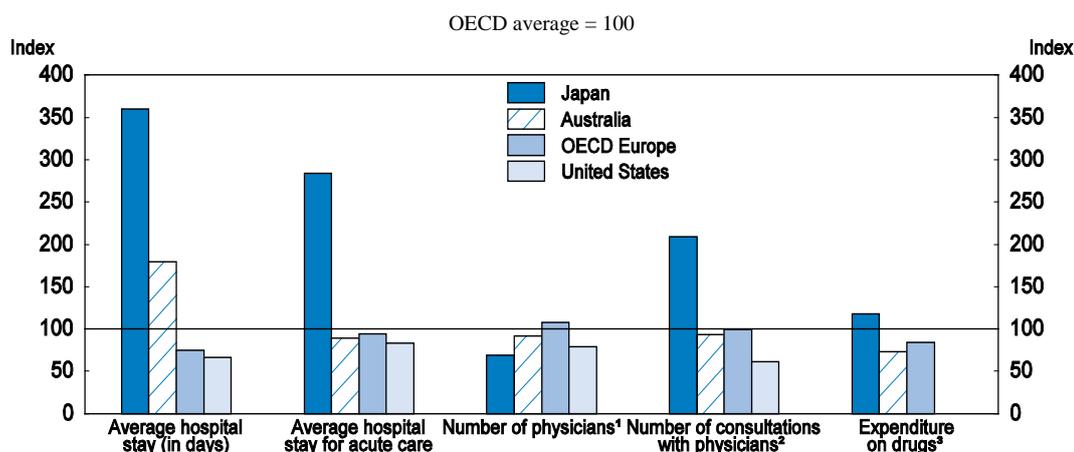
- Rising income, technological change and rapid population ageing are putting upward pressure on health-care spending. With the public sector responsible for 86% of health spending, this has important implications for the fiscal situation.
- There is increasing dissatisfaction with the quality of health care.
- The system suffers from a number of imbalances, such as shortages of emergency care and paediatricians.
- The share of the population not paying premiums threatens universal coverage.

Increasing the efficiency of the health-care system

Enhancing efficiency would limit the rise in spending in the face of the upward pressure on health-care costs and the decision to improve quality. An international comparison of health-care systems suggests a number of areas where savings could be achieved:

- The average stay in hospitals is more than three times the OECD average, owing in part to the important role of hospitals in providing long-term care for the elderly.
- The average hospital stay for acute care and the number of consultations with physicians per person are both the highest in the OECD, reflecting the fee-for-service payment mechanism.
- Expenditure on pharmaceutical drugs is almost 20% above the OECD average, due in part to limited use of less-expensive generic drugs (only a fifth of drug consumption).
- Institutional features, such as the fragmentation of health insurers, the billing system and ownership rules for hospitals limit the scope for efficiency gains.

International comparison of health-care services in 2006 (or latest year available)



1. Per 1 000 persons.

2. The average number of consultations per person per year.

3. Per capita in US\$ PPP.

Source: OECD (2009), *OECD Economic Survey of Japan*.



Enhancing the quality and addressing imbalances in the health care system

Achieving greater efficiency would ease the pressure for cuts in medical fees and prices, which also tends to limit quality. Another concern is the “drug lag”: access to the newest drugs lags behind most other OECD countries. The world’s top-selling drugs in 2004 had taken almost four years on average to be introduced in Japan, compared to around 500 days in some countries. Furthermore, only 60 of the 88 top-selling drugs had been introduced in Japan, the lowest number among the top 40 countries. The situation is similar for medical devices.

Other reforms would help enhance quality. Accreditation standards for physicians and hospitals should be improved. Physicians are allowed to claim any speciality, even without training in that area, while only about a quarter of hospitals are accredited. Also, allowing more mixed billing of covered and uncovered treatments and drugs would increase patient satisfaction by facilitating access to new health services. The present system discourages patients from choosing uncovered treatments and drugs by making them more expensive in practice. This limits the ability of patients to receive the best treatment as the public health insurance cannot fully keep pace with the emergence of new medical technologies and drugs.

Shortages in health-care supply essentially reflect the failure to set prices at the level necessary to elicit the appropriate level of supply for each type of treatment and drugs. The method of revising health-care fees by the government every two years should be replaced by a more rigorous and scientific system that gives more importance to cost/productivity studies.

Maintaining universal coverage of health insurance

Around 20% of households that are supposed to be covered by National Health Insurance (NHI), which provides insurance for 40% of the population, are delinquent in their premium payments. Some of this group, amounting to around 1.5% of total households, have to pay health costs out-of-pocket. The NHI includes a large number of non-regular workers, as only about one-half of them are directly covered by firm-based health insurance. Including more of these workers in firm-based health insurance schemes would improve compliance. In addition, the number of persons receiving health insurance through public assistance, currently 1.2% of the population, could be increased to ensure coverage of low-income households.

Key OECD recommendations

Increase the efficiency of health care

- Promote the shift of long-term care for the elderly from hospitals toward more appropriate institutions or home-based care.
- Improve the payment system for doctors and hospitals to reduce the number of consultations and shorten hospital stays.
- Expand the use of generic medicine by making them the standard for reimbursement.

Enhance the quality of health care

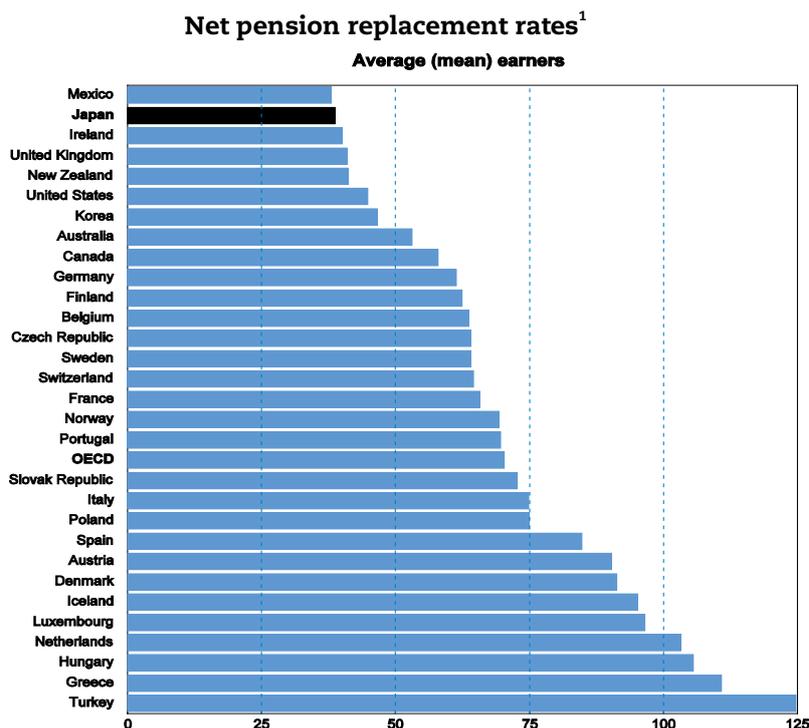
- Shorten the drug and medical device lag by reducing the cost of clinical trials in Japan.
- Expand mixed billing to make treatments not yet covered by public insurance more affordable.

Ensure universal coverage in the context of rising relative poverty

- Increase the coverage of non-regular workers in firm-based insurance systems.
- Ensure that low-income households receive health insurance benefits in practice.

Pension reform

Poverty among Japan's elderly is a concern: 22% of them are relatively poor, compared to an OECD average of 13%. The 2004 reform of the public pension system, triggered by demographic pressure, is likely to further increase the risk of poverty among pensioners. The average replacement rate will be reduced further and the contribution rate will be boosted from 13.6% in 2004 to 18.3% by 2018. The net replacement rate would remain among the lowest in the OECD area, especially for those with low incomes.



1. Individual pension entitlement divided by individual earnings after 40 years of contributions. The rate is calculated for a full-career worker entering the labour force in 2006.

Source: OECD (2009), *Pension at a Glance*.

Helping the elderly poor

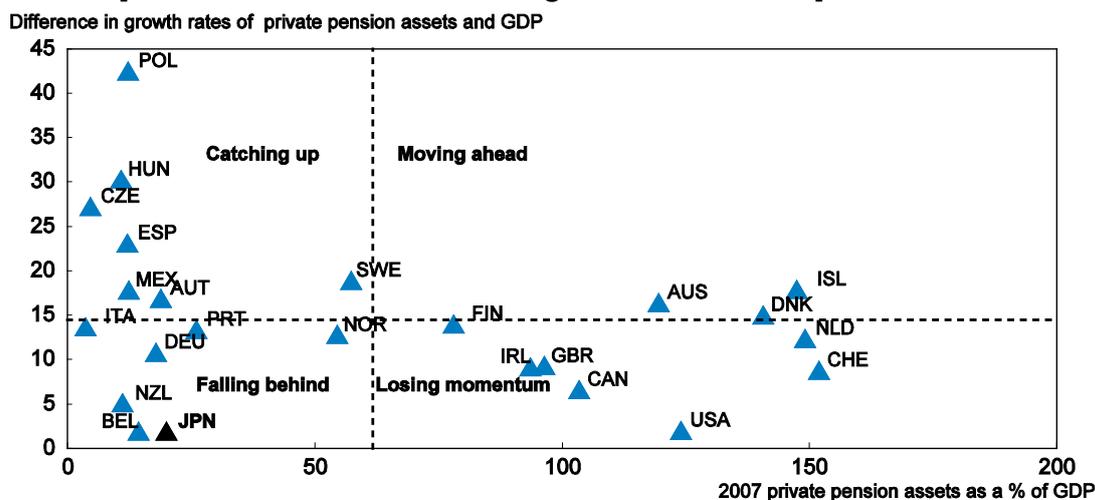
There are several proposals to address elderly poverty, but these need to be balanced against the need to ensure the long-term sustainability of the public pension system. The scope for further declines in the replacement rate is limited as it may encourage relying on social assistance. A second option, a further hike in the contribution rate, would have an adverse impact on the labour market. The best option would be to further raise the pension eligibility age in line with the increase in life expectancy, as is the case in some other OECD countries, accompanied by reforms in the labour market and working environment to encourage the participation of older workers.

The finances of the public pension system could also be improved if a larger part of the assets held by the Government Pension Investment Fund (GPIF) were diversified gradually, and without taking undue risk, into more equities and foreign markets, away from Japanese government bonds that are subject to the same risk as the public pension system.

Encourage the development of private pensions

Given that public pensions are among the lowest in the OECD area, a key policy challenge is to promote private and funded pensions. Currently, private pensions cover less than half the labour force. Moreover, pension fund assets are relatively low compared to other OECD countries (less than 20% of GDP) and growth in recent years has been slow. One option would be to make the provision of complementary private pensions mandatory for all employers above a certain size. For smaller employers, the government could set up a centralised provider, as in the United Kingdom. Another option would be “soft compulsion” (automatic enrolment of employees with a time-bound opt-out option).

Private pension assets in 2007 and their growth rate over the period 2001-07



Source: OECD Private Pensions Outlook 2008.

Improving the regulatory framework

In addition to raising the coverage of private pensions, policymakers need to address structural deficiencies in funding levels of defined-benefit (DB) plans by making the funding regulations more counter-cyclical. This requires providing incentives to plan sponsors so they build funding surpluses to better cushion adverse market developments. They should also be allowed more flexibility in addressing underfunding. It is also essential to adapt regulations and policies to the expanding defined-contribution arrangements where individual members bear investment risks. Although they have been growing in popularity since their introduction in 2001, the regulatory framework is not yet fully developed. Finally, it is important to develop effective financial education programmes.

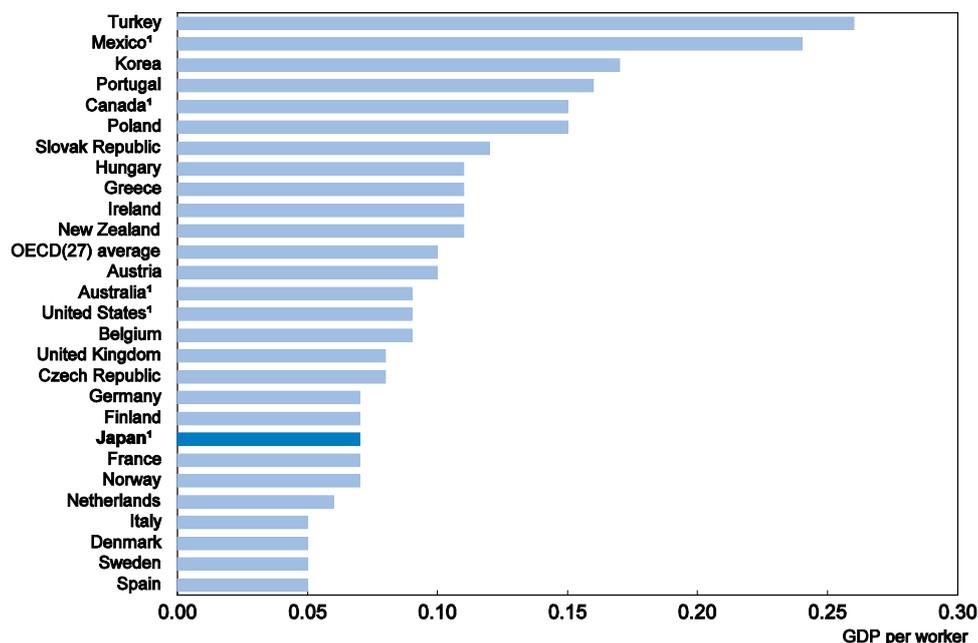
Key OECD recommendations

- Reform the public pension system so as to reduce the rate of poverty among the elderly.
- Ensure the long-run sustainability of the public pension, relying if necessary on increases in the retirement age rather than further cuts in benefits or increases in contributions.
- Improve gradually, and without taking undue risk, the allocation of the Government Pension Investment Fund.
- Encourage the development of private pensions from its current low level to supplement the public pension system.
- Improve the regulatory framework for private pensions and make it more counter-cyclical.

Regional policy and decentralisation

Regional disparities are relatively low in Japan compared to other OECD countries. For example, Japan ranks the second lowest in GDP per capita inequalities and eighth lowest in GDP per worker inequalities among OECD countries. At the same time, a number of challenges confronting the new government continue to have a regional dimension. Population ageing is forcing the government to rethink how public services are delivered in sparsely populated areas. The relocation of investments within East Asia is also likely to influence the spatial distribution of economic activity in Japan. Adjustments in regional policy and multi-level governance mechanisms are thus required.

Gini index of inequality of GDP per worker in OECD regions, 2005



1. The Gini index of regional inequalities in these countries is computed based on data for larger regions.

Source: OECD *Regions at a Glance* 2009.

Build-up a more regionalised, bottom-up territorial planning process

Japan can go further in its efforts to build a more regionalised, bottom-up territorial planning process. The new system needs to link long-term strategic planning and short-term policy objectives, set measurable targets, assign clear responsibilities, define time frames and use outcome indicators. Giving a more active role to regional and local governments can help enhance policy cohesion and complementarity across sectors. The Urban Renaissance Programme and the Community Renovation Grant offer two remarkable examples of such collaborative development schemes. A contract-based approach, such as the *contrats de projet Etat-région* in France and Territorial Pacts in Italy, could help reinforce stakeholder commitment.

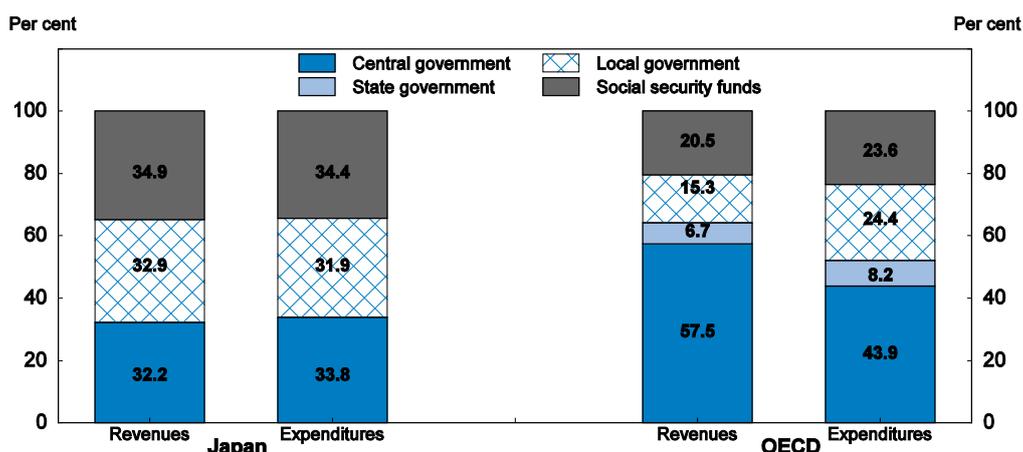
Emphasise innovation-led and cluster-based regional competitiveness policies

Japan's initiatives to use regional policy as a tool for economic development are in line with OECD trends. The Knowledge Cluster Initiative has encouraged universities to work more closely with the business and financial sector and to commercialise new technologies. Continuous efforts to combine innovation-oriented programmes with regional industrial strengths could draw from the experience of regional Centres of Expertise in Finland and Norway, the VINNVÄXT programme in Sweden and the Technology Clusters Initiative in Canada.

Reduce earmarked grants in local finance

Reforms in local finance are a necessary complement to regional economic policy. In Japan, revenues and expenditures are divided almost equally between the central and sub-national governments, in contrast with most other OECD countries. Moreover, more than half of the 2008-2009 fiscal stimulus packages are channelled through sub-national governments (compared with 22% in Portugal, 27% in France and 28% in Korea). Reducing earmarked grants while enhancing general purpose grants could further enhance the capacity of sub-national governments to provide better quality public goods and services and contribute more actively to the recovery from the crisis.

Revenues and expenditures by level of government (consolidated) in 2006



Source: OECD National Accounts

Promote economies of scale

Japan has further scope to exploit economies of scale through municipal mergers. Promoting Regional Blocks and inter-prefectural co-operation could also help internalise territorial spillovers and better integrate national and local government planning. Although it is unrealistic to define an optimal size for public service delivery, some OECD countries such as Denmark have targeted a precise size with a strong involvement of the central government, while others like France have promoted grants as more flexible incentives for various scales of inter-municipal collaboration.

Key OECD recommendations

- Shift from a fairly rigid system to a more regionalised, bottom-up decision-making process of territorial planning.
- Emphasise innovation-led and cluster-based regional competitiveness policies.
- Reduce earmarked grants in local finances for creating more self-sufficient administrative units.
- Promote municipal mergers and take further steps to build regional blocs.
- Adapt the regulatory management framework, including impact analysis, to improve the regulatory environment for business and services at the regional level.

Public governance

The Prime Minister has announced a major reform of the public service combining institutional, procedural and fiscal initiatives. The reform presents significant opportunities and risks to the government. Many other OECD countries are also in the process of reengineering their public service and governance systems to better meet domestic challenges and exogenous shocks.

Improving Public Management Practices

A number of steps could be taken to improve public management practices. For instance, the government's planned reform of post-public employment for bureaucrats in publicly-owned corporations (the so called 'golden parachute' system) could be considered in the context of an overhaul of the whole human resource management system in the public sector, notably the retirement age.

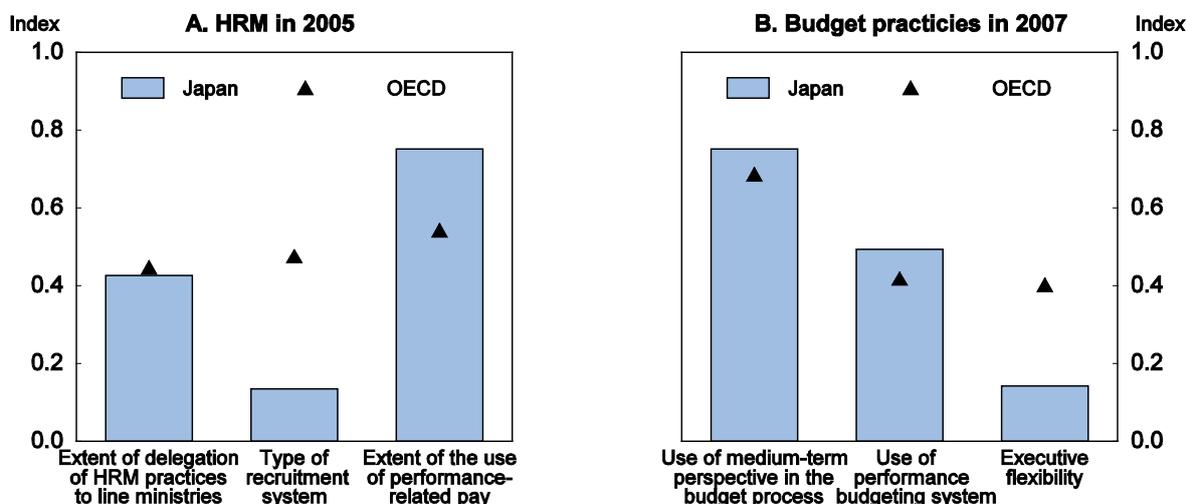
Improving the budgetary process

In order to improve fiscal sustainability, Japan needs a rigorous system to foster discipline in the preparation of the annual budget. This includes having in place a medium-term expenditure framework with challenging goals for deficit reduction which, in turn, set parameters for the annual budget process. Moreover, compared to other OECD countries, Japan grants executive (and line ministries in particular) less flexibility to make changes to budgeted funds during the fiscal year. Increasing this flexibility would be key for a more efficient and effective management of public resources.

A number of steps could be taken to address this problem, including improved performance measures to look at outcomes rather than inputs and processes, and a *quid pro quo* increased expenditure flexibility to allow managers to achieve policy goals. For example, in Sweden, agencies are given a lump sum budget allocation for their whole operating budget, including salaries, in exchange for agreeing to a clear set of performance objectives. This is a very successful aspect of the budgeting process in the Nordic countries, as well as in Australia and New Zealand.

Composite indicators for HRM and budget practices in the central government

Japan compared to the OECD average



Source: OECD *Government at a Glance*, 2009.



Creating a “whole of government” public administration

Japan has announced a number of reforms that aim to strengthen the transparency of decisions taken by Cabinet, including the abolition of the Senior Administrative Vice-minister Council. Japan will need to ensure that as reforms progress, through appropriate and transparent co-ordination mechanisms and structures, coherence and a whole-of-government perspective is maintained and further embedded across the public service, particularly in relation to policy formulation and implementation. Steps that could be taken to ensure a whole-of-government focus include:

- Improved dialogue across government departments. This could be achieved through, for example, the use of networks to bring together relevant actors from across the public service. Japan could take inspiration from what is done in this regard in Canada.
- Improved and more transparent consultation and dialogue with all relevant external stakeholders. To this aim, many EU countries, including France, Germany and Italy, have established social partnership arrangements to institutionalize dialogue between government, business and employee groups, while the United States and Canada have recently strengthened legislation to enhance transparency of lobbying.
- Broadening the use of consultation methodologies to better gather evidence and information *ex-ante* on both benefits, likely costs and unwanted side-effects of planned policies to better inform the Cabinet prior to making final decisions. The UK, United States, Australia and Canada have made extensive use of consultation as part of their evidence-based policy making tools (such as regulatory impact analysis).

Key OECD recommendations

- Support the reform on post-public employment restrictions with a comprehensive human resources reform.
- Increase flexibility and improve the use of performance measures in the budget process for a more efficient and effective management of public resources.
- Develop a more integrated and “whole of government” orientation in policy formulation and implementation.

A decorative horizontal banner with a dark blue background. On the left side, there are white, stylized lines that curve across the banner, resembling a spiderweb or a decorative pattern. In the upper left corner, there are white cherry blossom branches. The text 'www.oecd.org/japan' is centered in the banner.

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