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Competitiveness Under a High-Burden Economy: Case Study of Nokia

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In Japan, the ratio of taxes and social security premiums to gross national income is projected to increase substantially as a result of the world's fastest aging population. How will this trend impact the international competitiveness of Japanese companies? If the burdens stemming from social security, taxes and other sources sap the energy of the corporate sector and encourage companies to move their businesses overseas, there are potential dangers for the economy as a whole to lose its vigor. The question here, then, is how Japan can sustain corporate competitiveness under the "high burden economy."

Worthy of attention in this area are the Scandinavian economies. The ratio of taxes and social security premiums to gross national income in Denmark is 72.7%, ranking it No. 1 among the countries in the Organization for Economic Cooperation and Development (OECD). In second place on this same list is Sweden at 71.0%, while Finland comes in No. 4 at 64.3%. Japan's 37.7% is roughly half of the ratios of the leaders. Despite the high burdens, however, the economic growth rates from 1995 through 2003 in Finland (3.6%) and Sweden (2.8%) far outstripped Japan's 1.3%.

The Stellar Business Competitiveness of Scandinavian Economies

On a separate front, according to *the World Competitiveness Ranking 2005-06* published by the World Economic Forum (more commonly known as the "Davos Conference"), the United States is No. 1 under the business competitiveness index. Two Scandinavian countries, Finland (No. 2) and Denmark (No. 4) finished above Japan (No. 8) in this ranking. Sweden also ranks high, and was No. 4 the previous year.

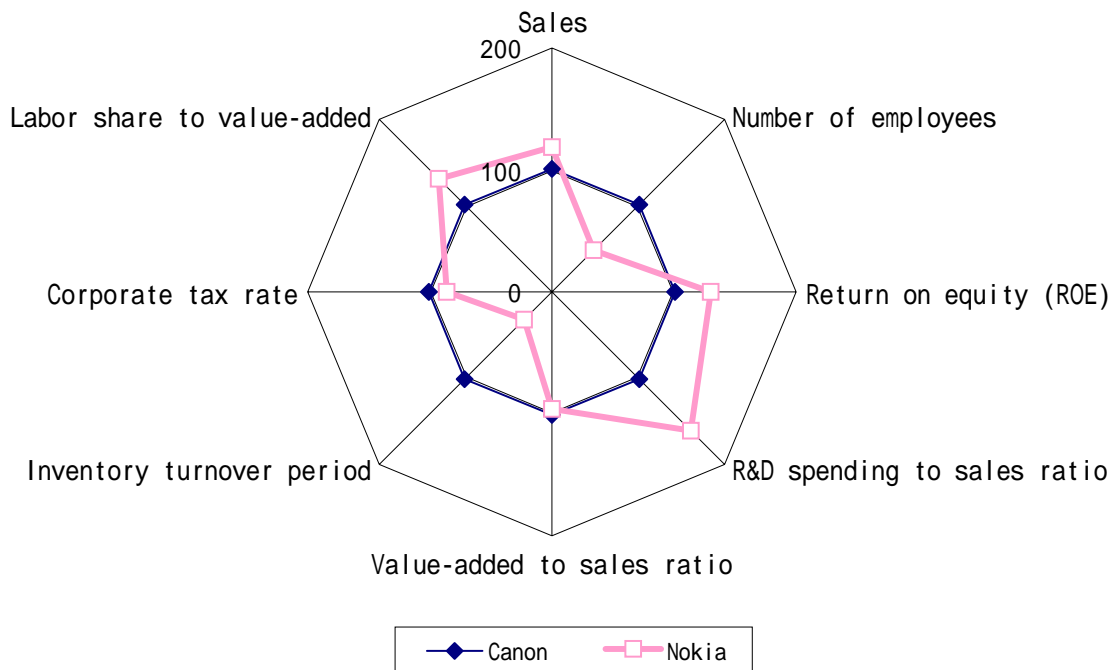
In this report, I analyze Finland's Nokia, one of the excellent companies in the world, as a case study to shed light on how that firm has managed to maintain its competitive strength under the high social security burdens.

Nokia is the world leader in mobile telephone production, accounting for some 30% of the global market. Its sales in 2004 were approx. 4.1 trillion yen (converted at 1 euro=140 yen), and it was ranked No. 130 on the Fortune 500 ranking of the world's largest companies. The company's net profits for the same year were approx. 450 billion yen, surpassing the 343.3 billion yen figure for Canon of Japan.

The graph compares the financial performances and other indexes of Nokia and Canon. Though Canon is one of Japan's most profitable companies, it takes a backseat to Nokia in the return on equity (ROE) column (Nokia 21.8% versus Canon at 16.8%).

Nokia and Canon Management Index Comparison

(Canon treated as 100; figures for 2004)



Source: Prepared from disclosed materials from both companies.

Investing in Education for High Value-added

It is pointed out that the first factor of Nokia's high profitability is the company's stellar value-added to sales ratio. On a consolidated basis, the Nokia's value-added to sales ratio is 29.5%. This is just below that of Canon at 30.7%, (non-consolidated basis) but far above the average of the Japanese electronic industry (19.8% for FY2004).

Deserving attention as a key factor in this high value-added ratio is the strength of Nokia in the research and development. The ratio of R&D to sales at Nokia is 12.8%, far above the 7.9% at Canon (consolidated basis for both companies). Regarding human capital, 20,722 of Nokia's total workforce of 55,505 employees are active in R&D – a whopping 37% share.

Originally, Nokia was not a high-tech company, which maintained business divisions in paper and pulp, rubber and other products. This changed with the 1977 appointment of Kari Kairamo as CEO, who led Nokia's successful expansion into the mobile phone business. A critical factor in this transition has been Nokia's employee education policy. Kairamo enlisted the cooperation of universities in establishing the "Nokia University," advancing a campaign to raise the academic degrees held by each Nokia employee by one rank. It is the establishment of an in-house infrastructure geared to disseminate the cutting

edge technology brought onboard through corporate acquisitions and partnerships that generated the driving force to transform Nokia into a high value-added company¹.

In this connection, Kairamo was also active on the public education front, including leadership in international student exchange programs, adult education, industry-academia collaboration efforts and other areas. In this way, the CEO had a major impact in setting the stage for Finland's current national commitment to education.

Nokia's Labor Share to Value-added Below 40%

The second factor behind Nokia's high profitability lies in its low labor share to value-added – which on a consolidated basis is at 39.8%. While this fails to measure up to Canon's parent labor share of 30.1%, it is far below both the 54.0% for the Japanese manufacturing industry (tracking listed companies only) and the 60.7% for the electronic sector (in FY2004).

Nokia's per-capita personnel expenses and labor costs are 8.97 million yen, which under a simple comparison ranks the company about midway down the list of Japanese major electronic firms. Of this total, 22% is comprised of the social security contributions (including pensions). Based on these figures alone, we may say that while the social security burden is definitely heavy for Nokia, the company has a structure, absorbing the burden through compressing employees' take-home pay. Besides that, Nokia curbs the labor share through high value-added product mix, thereby upholding the status of its international competitiveness.

As a third factor, much attention has come to focus on the differences in the corporate tax rate. Nokia's consolidated corporate tax burden is only 30.5% of its pretax profit (24.9% for the parent alone). In contrast, Canon shoulders a considerably heavier corporate tax burden of 35.1% on its pretax profits (consolidated basis). While Japan's effective rate of corporate tax (including the local government component) is about 40%, Finnish statutory corporate tax rate was previously 29%, and further lowered to 26% in 2005. The tax rate gap of 10 percentage points creates a difference in free cash flow exceeding 60 billion yen each year, a figure that certainly cannot be overlooked.

Considering the above, the first step that Japan should take to bolster its international competitiveness is to lower the corporate tax rate. It is true that the Japanese government can generate tax revenues through corporate taxation because Japanese companies gain greater profits on the domestic market and find it more difficult to move overseas than their Scandinavian counterparts. In the case of Nokia, however, though only 1.2% of its sales are generated domestically, 38% of its assets and 43% of its personnel are in Finland. Under these circumstances, the impact of losing international competitiveness and jobs through

¹ Nokia fell into financial difficulties in the early 1990s, and rebuilt its business by selling off all divisions other than the mobile phone sector.

high corporate taxes should be just as serious.

In addition, as we can see in Nokia's case, the social security burden is ultimately to be absorbed through compressing worker take-home pays. Accordingly, the major premise for this formula to work is the willingness of workers to accept the cuts in take-home pay in compensation for the generous social security benefits. Another critical component of this prescription consists of considerations to earmark the funds generated by consumption tax hikes for use in social security, thereby reining in major cuts in take-home compensation.

In this regard, Finnish value-added tax rate is 22%, and the rates in Denmark and Sweden are both 25%. As an approach to tax and social security systems that does not undermine international competitiveness, and as the preferred method of operation for high value-added companies rooted in the infrastructure of a nation committed to intellectual property and education, I believe this is a model from which Japan has much to learn.

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