

New Industries Can Be Created Through Regulatory Reform

–Report on Creation of New Markets

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Summary

An expansion of domestic demand without relying on government fiscal stimulus is necessary to realize sustainable economic growth. Medical care and welfare, areas where long waiting lines are constantly formed, indicating that large potential demands exist, may well grow as new industries to create lots of demand and employment through reform of their systems and regulations.

Although the economy is recovering, it is premature to conclude that the recovery is sustainable on a medium-term basis because factors that have caused the long-lasting economic stagnation since the early 1990s have not been necessarily resolved. Rather, fiscal and current-account imbalances have expanded.

In the Japanese economy, demand remains small in comparison with supply and deflation continues. But the gap between supply and demand cannot be filled simply by creating demand through an increase in the larger budget deficits. Sustainable recovery will be difficult unless various institutional reforms are promoted and unless the economic structure, heavily reliant on the government, is converted into a market-oriented one that matches new economic and social environments. This is the principal message of a “Report on Creation of New Markets” compiled by the Japan Center for Economic Research in March.

Major Factors For Long-Lasting Economic Stagnation

For explaining the long-lasting economic stagnation, demand-related factors are often emphasized. Among them is a delay in the adoption of macroeconomic policy to cope with financial unrest that took place through the problem of bad loans caused by a plunge in asset prices in the early 1990s. But supply-side restrictions are also important such as a sharp slowdown in the pace of changing industrial structure resulting from the toughened rigidity of the market for production factors.

While an increase in the quantity of labor and capital and an improvement in their quality are basic factors for economic growth, it is equally important for them to enhance the efficiency of the economy as a whole through their smooth movement in the market. The inter-industry movement of production factors was a key element to support the high economic growth of the past. But the flexibility of labor movement, as viewed from percentage changes in the number of the employed in each industry, already started to decline in the middle of the 1980s when it was supported by brisk demand. This situation and the contraction of demand resulting from the bursting of the economic bubble produced synergetic negative effects and are regarded as the main cause of the long-lasting deflation.

During the high-growth period through the 1980s, changing industrial structure without creating unemployment was possible because big companies entered new industries by establishing subsidiaries. This presupposed the availability of ample funds provided by banks against the security of companies' latent assets and of high-quality laborers under the practice of long-term employment.

But these long-lasting practices in the financial and labor markets, which supported the postwar system of catching up with the world, have become obsolete amid the globalization of economic activities and the rapid aging of the population.

Shift To Market-Based Trading Practices

The need for structural reform to convert those direct trading practices to market-based ones was already mentioned on such occasions as in the so-called Maekawa Report of the mid-1980s. But enthusiasm for the reform was buried amid the adoration of the Japanese style of management under the financial bubble.

"Structural reform is important but should wait for an economic recovery" is a view supported by the majority. Indeed, reform is easier in a high-growth period than low-growth period and during inflation than deflation. But incentives to reform are also strong, whether in the government or private sector, at a time of recession, but tend to be gone with the economic recovery.

During a relatively brief period of recession in high-growth days in the past, investment in public works projects was meaningful in the sense that top priority was

given to the maintenance of employment. Supplementation of demand by the government, however, hinders an improvement in productivity of the economy as a whole by fixing resources to low-productive sectors, and results in low growth.

Many of the reforms needed now are related to the excessive redistribution of income through the government. Public pension programs that pass burden on to the future generation and local allocation taxes that hamper local self-support efforts presupposed high economic growth of the past and redistributed fruits of the growth to people left behind. In addition, government regulations to guarantee the equal level of medical care and education were needed in the poor days in the past.

But although Japan has become a country with which Asian nations are trying to catch up, there are no major changes in the diagram where certain big companies and affluent laborers support small and midsize companies and the aged. The creation of an efficient safety net unrelated to the scale of companies and the age of individuals is needed along with a shift to a system that guarantees free trades and choices.

High-quality manufacturers that supported the Japanese economy in the past are going abroad and importing their products back into Japan at an increasing pace. By nature, the development of free trade and investment is desirable for Japan poor in natural resources. But it is described as the negative image of industrial hollowing-out largely because new industries and employment opportunities fail to grow as a result of restrictions on free trade in the domestic market.

The basis of producing new demand and employment is to develop new services industries responsive to an aging society while making the labor market efficient through regulatory and system reforms.

The creation of demand through regulatory reforms is especially effective in the fields of medical care and welfare where long waiting lines are always found. As these fields are financed by mandatory taxes and social insurance premiums collected by the government, a further increase in burden will be difficult. In the meantime, waiting queues are chronically formed because burdens for beneficiaries are low on the surface and thus create excessive demand, which was a typical phenomenon in many socialist countries.

When a chaotic situation is produced by excessive demand in a general market, the mechanism of boosting supply through price increases come into play. But in medical care, welfare and other “government-controlled markets,” where the government is wholly involved in supply and demand, the shortage of supply becomes severer due to fiscal restraints.

As an example of this case, Japan's medical insurance imposes a restriction on reimbursement rule of the public health insurance which bans mixed use of public and private health insurance -- if a medical treatment beyond the coverage of public insurance, no matter how small it may be, is made, not only patients are required to pay for the uncovered portion but also the public health insurance is not applied to the formerly insured treatment unified with the uncovered portion. This is thoroughly controlled medical treatment that bans choices by doctors and patients under the name of “equality of patients.”

Household spending on medical services in Japan does not show so much difference in accordance with an income levels as in the U.S. While this is said to be a result of “egalitarian medical care,” potential demand for high-quality medical services is suppressed. If the elasticity of demand with respect to income for medical care in the Japanese households is assumed to be the same as that in the U.S., an extra demand worth 3.8 trillion yen for health service would be created by removing the ban on the reimbursement rule (See table).

As additional medical expenses resulting from advances in medical technologies cannot be fully covered with fiscal spending on social security, the allotment of roles to the public and private sectors by defining an area the government is responsible for and farming out the rest to the private sector is necessary to increase the number of high-quality hospitals. Through such a system reform, new markets with strong growth potentials, supported by private-sector demand, can be created in an aging society.

Although the number of employed workers decreased in 2003 for the sixth consecutive year, nearly 300,000 job opportunities were created a year in the fields of medical care and welfare largely because private corporate firms' entry into the area of home nursing care was liberalized when the nursing care insurance system was introduced in 2000.

Even now, long waiting queues are being formed for entry into nursing homes for the aged and nursery schools in the urban area. And as the situation is only partially recognized by the government, there exists bigger potential demand. If private-sector vitality is injected into such an area, new demand and employment will be created and high-quality services will be offered.

In many cases, regulations on the rate of building volume to lot prevent the replacement of antiquated high-rise apartments with new ones. While the number of antiquated buildings is increasing rapidly, many of them fail to clear current earthquake-resistant standards and so need to be quickly replaced. But it is difficult to win consent from many owners. Rebuilding will be promoted if the floor-space ratio is expanded and if owners can cover a large portion of rebuilding costs by selling the increased portion of floor space to third parties.

Mobile phones and door-to-door parcel delivery, which are indispensable for current national life, stemmed from the deregulation of telecommunications and truck transportation services in the past. There are many areas in which the development of new markets is curbed by government regulations despite the presence of huge potential demand. Prompt reform in such areas holds the key to sustainable economic growth.

(Table)

Some Economic Effects Of Deregulation

Effects of Deregulation	Affected Number	Value
• Rise in demand for medical care after removal of ban on reimbursement of mixed treatment		3.8 trillion yen
• Elimination of waiting list for entry into special nursing homes for the aged	113,000 people	0.7 trillion yen
• Privatization of public nursery schools and elimination of potential waiting list of children	1,513,000 people	1.9 trillion yen
• Replacement of antiquated buildings prompted by rise in floor-area ratio (30-year and older buildings in Tokyo's 23 wards)	80,000 units	2.4 trillion yen

(Source: Japan Center for Economic Research)

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