CHARTING A NEW COURSE FOR GROWTH

Recommendations for Japan's Leaders

ACCJ WHITE PAPER

ACCJ

Growth Strategy Task Force

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ACCJ President's Message

This year the American Chamber of Commerce in Japan (ACCJ) chose Japan's economic growth strategy as a major focus in recognition of the Japanese government's initiative to identify new ways to strengthen the national economy.

The ACCJ subsequently formed the Growth Strategy Task Force, comprised of nearly seventy members under the leadership of Nicolas Benes and Kumi Sato. The Chamber also engaged two of Japan's most authoritative experts on productivity and innovation—Professor Kyoji Fukao of Hitotsubashi University and Professor Hyeog Ug Kwon of Nihon University—to conduct an objective analysis and identify the drivers of economic growth in Japan. The report the professors generated, entitled "In Search of the Engine of Japan's Economic Recovery," offers many fascinating facts. Two of their most crucial findings: 80 percent of Japan's GDP now comes from services, and foreign companies and young firms contributed the most to net job growth from 1996 to 2006.

The task force then prepared the white paper you are holding: "Charting a New Course for Growth—Recommendations for Japan's Leaders." This policy document builds on the empirical analysis and conclusions of Professors Fukao and Kwon and the recent independent analysis by Stanford University researchers to highlight the initiatives that will enable Japan to achieve its goal of enhancing economic growth.

The ACCJ appreciates the outstanding analysis of Professors Fukao and Kwon and commends its members for bringing this project to fruition. In particular, the ACCJ is grateful to Mr. Benes for coordinating with the researchers and drafting key sections of the ACCJ policy document. His leadership, energy and creativity were critical to the success of this undertaking.

I would also like to thank all the team leaders for their contributions of time and talent to this exceedingly complex project, as well as a special thanks to the following task force members: Douglas Jackson, Bryan Norton and Aaron Forsberg. I also want to extend our sincere gratitude to the sponsors who underwrote the project, listed on page 3. A list of others who drafted and refined the text in both English and Japanese and otherwise assisted at critical junctures appears on page 4.

Finally, our thanks to the ACCJ staff members under Executive Director Samuel Kidder who put in long hours and great efforts to ensure that the project went smoothly: Ryan Armstrong, Noriko Ijichi, Asami Ide and Yuiko Noda.

Sincerely,

Thomas W. Whitson
ACCJ President

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Charting a New Course for Growth

Recommendations for Japan’s Leaders

ACCJ Growth Strategy Task Force

EXECUTIVE OVERVIEW

Premise

Successful economic growth policy is based on a vision of the future grounded in analysis, not wishful thinking. It requires strong political leadership to articulate that vision.

Core Analysis

An independent economic analysis commissioned by the American Chamber of Commerce in Japan (ACCJ) shows that Japan faces the following challenges:

- Japan has lost millions of jobs as more and more manufacturing moved offshore, mainly from companies established before 1996. Manufacturing now accounts for only 20 percent of GDP. Services now account for fully 80 percent of Japan’s economy.
- With a shrinking workforce, and capital that is already abundant, raising productivity is the key to Japan’s future economic growth.
- Japan's labor productivity is less than 60 percent of the U.S. level, and is no longer catching up to the latter. In services, labor productivity is even lower, at less than half the U.S. level. These weaknesses are holding down growth in overall productivity.
- Lagging investment in information and communications technology (ICT) in many industries has been a major reason for sluggish productivity growth. The ICT and internet revolutions did not boost productivity in Japan as much as they did in the United States.
- Japan’s low rate of economic “metabolism,” or resource reallocation, is a structural problem that has held back productivity growth for decades.
- To allocate resources to their best uses, Japan needs to attract more new entrants to industries. It also needs poor performers to exit non-core businesses and invest more in core businesses where they are competitive.

Signs That Change Is Under Way

Japan’s economy, however, still has great potential. The nation has a rich, potent technology base that should help drive significant gains in productivity and economic growth. Fully utilizing this technology base by accelerating “spillovers” and dispersion of know-how, both domestically and from abroad, is the key to Japan’s future growth. In fact, the economic analysis the ACCJ received revealed that Japan might already be reinventing itself based on the contributions of newcomers to its economy:

- Foreign-held companies in Japan have the highest average productivity, and very high job creation rates. Based on firm-level data, they increased their employment from 249,000 to 405,000 persons between 1996 and 2006. That all of this net job growth took place through greenfield market entry or simple business expansion, rather than mergers and acquisitions (M&A), points to significant additional potential if foreign firms can gain better access to M&A markets.
- Domestic entrepreneurship and “intrapreneurship”—operating in

an entrepreneurial fashion within a large organization—made even larger contributions to growth and job creation in the same period. Companies established after 1996 had created about 1.2 million new net jobs as of 2006.

- Younger Japanese companies have recently had higher job creation rates, and higher survival rates, than older ones. Young, internationalized and R&D-intensive small companies exhibit higher levels of productivity and productivity growth than other newly established firms.
- About 5 percent of the high-tech firms incorporated between 2004 and 2008 booked annual revenues of over 500 million yen by 2008. Since the average firm in this group had only been around a little over two years, this suggests that the time needed for ventures to succeed is shortening.
- Foreign companies and newly established firms were the only two groups that consistently increased employment on a net basis between 1996 and 2006. In contrast, both large independent companies and companies established before 1996 employed several million fewer people in 2006 than they did in 1996.
- There are signs that the broad-based legal and regulatory reforms of the past fifteen years had a positive impact on entrepreneurship and the growth of foreign direct investment (FDI).

Suggested Growth Strategy—Core Themes

To be persuasive and effective, Japan's growth strategy should reflect the reality that young firms and FDI are now driving job growth. The formulation and implementation of strategy needs to be led by the prime minister and a united Cabinet, not a single ministry, and should focus on the following core themes:

1. **New entrants and entrepreneurs**—Facilitate the entry of new participants in Japan's economy, and by M&A as well. Not only startups, but also many cases of spin-offs and intrapreneurship, and incoming FDI, are often "new entrants" to markets here.
2. **Technology spillovers** and the introduction of new, "disruptive" technologies and business models.
3. **"Inward globalization"**—Accelerate the benefits of inward globalization through FDI, corporate governance improvement, education, and immigration policies.
4. **Market-based policies** that make markets more attractive for investment, while avoiding the urge to pick winners or provide indiscriminate support that distorts competition.
5. **Tax policies that provide incentives** for startups and new market entrants (including FDI), long-term productive investment, and technology spillovers.
6. **Regulatory transparency**—By increasing fairness, lowering costs and making the regulatory environment and markets more accessible and "user-friendly," Japan can attract new entrants and more investment.
7. **"Open convergence" in the Internet Economy** through deregulation and the convergence of telecommunications and broadcasting. Avoid the "Galapagos syndrome."
8. **Services productivity enhancement**—Deregulate, and remove obstacles to using ICT (including the internet) to increase efficiency.

9. **Labor market mobility and immigration**—Fortify the safety net so that workers can retrain themselves, while allowing for fairer and more flexible hiring and dismissals. Make it easier for new entrants to hire the staff they need to grow.

The Opportunity

The ACCJ is confident that, with the right policies, Japan can become:

- A more vibrant center for entrepreneurship, innovation and finance in Asia.
- A nation with the higher rates of growth in GDP per capita that it needs to cope with its demographic and fiscal challenges.
- A fast-moving economy that creates many more exciting job opportunities for its young people.
- A market that attracts immigrants who invest in Japan and add to the nation's skilled workforce, tax base, vitality and competitiveness.

Forging a New Growth Strategy

As the twenty-first century begins its second decade, Japan's economy is stuck in a demographic and fiscal quagmire. GDP and productivity growth have been significantly weaker during the past two decades than the preceding four. The GDP gap, defined as the difference between actual and potential GDP, has been negative since 1993. The country's workforce is aging and shrinking, its youth are dispirited, its tax base is eroding, and the domestic stock market is mired in a long-term slump. Public debt will soon exceed 200 percent of GDP.

Japan must find a way to grow faster, and soon. To avoid the flat-line scenario the Japan Center for Economic Research has projected in Figure 1 below, the nation must forge a completely new growth strategy.

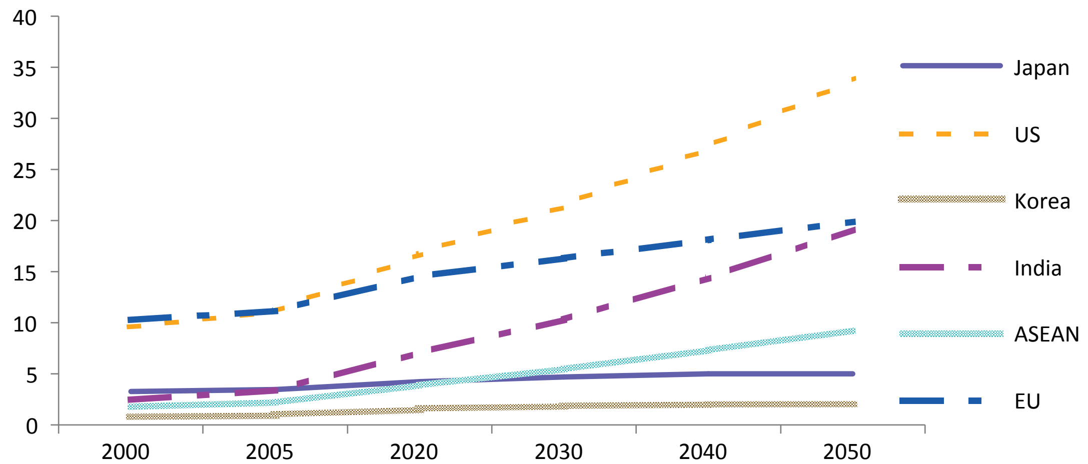
Many of the aforementioned challenges are of course not unique to Japan. In Japan's case, however, they are occurring at a particularly swift pace, and have been for a number of years. Low birth rates and tight immigration policies have combined with Japan's fast-aging society to create one of the toughest demographic hurdles any developed economy will have to overcome in the foreseeable future.

Japan is rightfully proud of the rapid, long-term economic growth and strong social and industrial stability that have famously defined its economic past. Prior successes and stability naturally generate confidence and political support for incremental policy improvements. However, they can also lull a nation into protecting incumbents and the status quo, rendering a government unable to confront realities and implement urgently needed changes.

Recent political events have revealed that most Japanese are deeply and legitimately apprehensive about the harsh challenges Japan faces. They realize that many of the old policies and

Projected GDP ($US Trillions)
(PPP Basis, Constant 2000 $US Trillions)

Figure 1



Source: Japan Center for Economic Research (JCER), W*orld Economic and Population Outlook 2006-2050;* details in *Demographic Change and the Asian Economy,* March 2007.

public spending habits no longer work, as evidenced by the recent sluggish rate of GDP growth shown in Figure 2. This has stimulated more transparent and concrete debates about future public policies.

While pointing out the successes and shortcomings of past economic policies is easy, charting a clear course for the future in heavy weather is not. The rapidity of recent changes and the sudden rise of more open and substantive political debate seem to have generated more confusion about what should be done.

One reason for this, the ACCJ believes, is that there has not been enough in-depth analysis to inform Japan's political leaders. All too frequently, unproven assumptions are used to support political rhetoric, crowding out a full examination of the data. As a result, political philosophies, rivalries and emotional preferences tend to dominate, even when they lead to policies that are not optimal or even feasible.

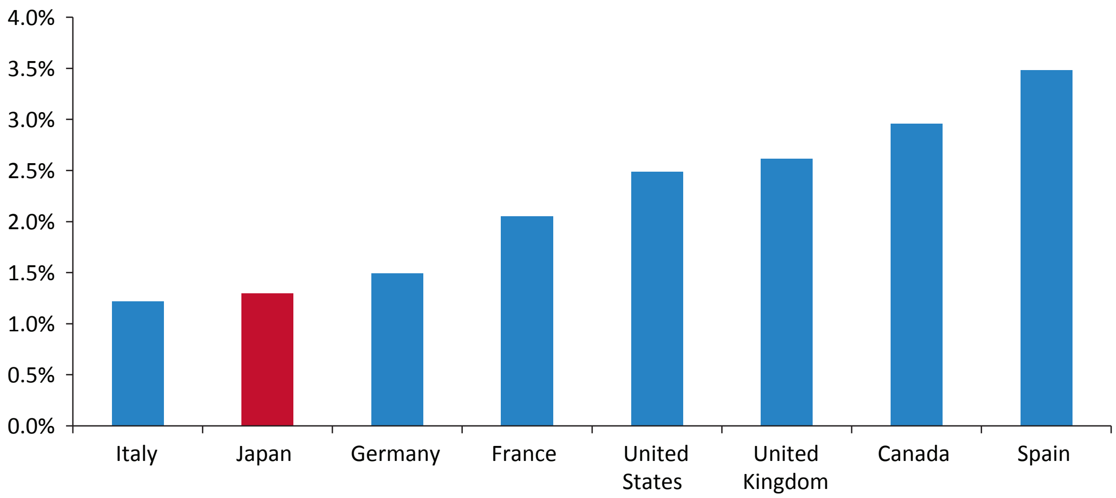
The ACCJ's Growth Strategy Task Force Project

The ACCJ and its members are full "stakeholders" committed to making Japan's future a bright one. We can only succeed in our long-term goals if this country's economy recovers and thrives again. Because we are deeply concerned about the issues noted above, we formed a Growth Strategy Task Force early in 2010 and commissioned an independent, in-depth econometric analysis of the realities and dynamics affecting Japan's economy. We believed that this analysis would help dispel some of the current confusion.

The report you are reading is an economic growth strategy for Japan that was created by combining the principal conclusions of the original commissioned econometric research (available as a standalone document) and an independent report by Stanford University researchers (also available separately) with our own on-the-ground knowledge of current circumstances in many industries. The ACCJ offers up both these empirical research results, and its specific strategy recommendations based on them, to Japan's leaders to use in policymaking. Our core message is this: There is no time to waste in the quest to implement a more compelling and effective national growth strategy for Japan.

Annual GDP Growth 1999-2008

Figure 2



Source: World Bank. Average nominal GDP growth based on local currency.

Policy Based on Analysis, Not Wishful Thinking

The Growth Strategy Task Force began by assessing the current reality that Japan faces, which Figure 3 shows is less than optimal. The task force asked Professors Kyoji Fukao of Hitotsubashi University and Hyeog Ug Kwon of Nihon University—two of Japan's foremost experts on the economics of growth, productivity analysis and innovation—to analyze the recent "two lost decades" of Japan's economy and identify the key trends and changes during this period that are likely to continue. Cognizant of the impact of slow growth on Japan's fiscal position, we asked them to analyze *why* growth has been sluggish, what factors might change that for the better, and what types of companies and investment have been contributing the most to net job growth and economic activity in recent times.

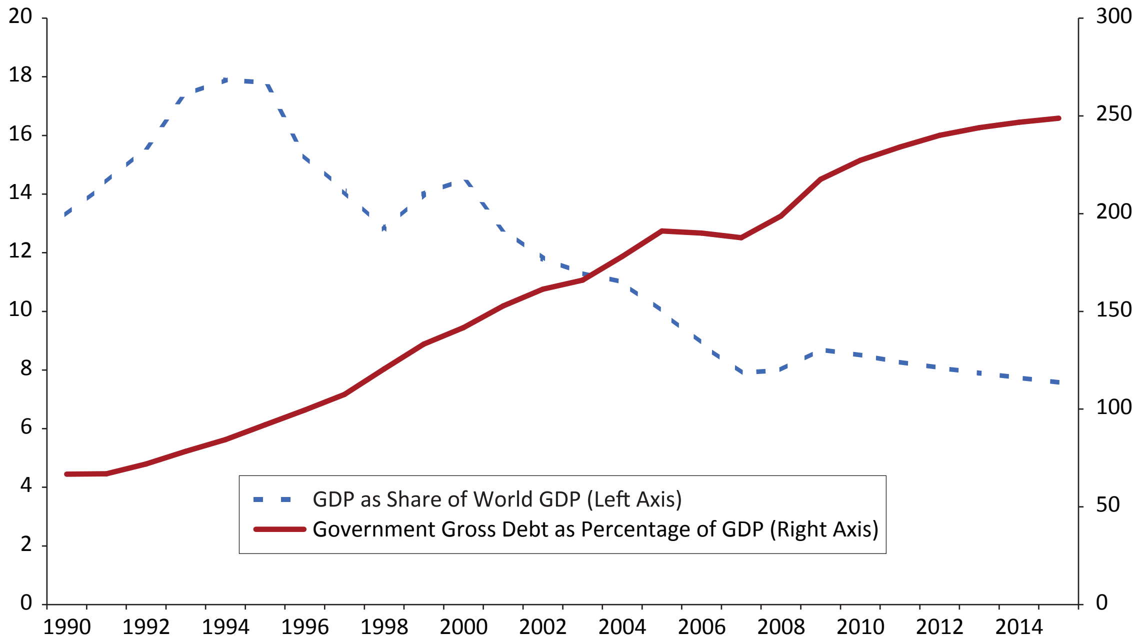
The ACCJ believes that the empirical, fact-based answers the professors have supplied to these questions can help Japan break political deadlocks and implement policies that are based on the deepest possible understanding of the economic shifts that are already under way. Their insightful analysis, called the Fukao-Kwon Report and available in Japanese, provides clear guidance for future growth policy.

The task force was also privileged to receive recent findings on newly incorporated independent Japanese firms from Robert Eberhart and Michael Gucwa, researchers at the Stanford Program on Regions of Innovation and Entrepreneurship. Their results—compiled in the Eberhart-Gucwa Report—gave us a valuable empirical understanding of the progress and challenges of entrepreneurs who have recently started companies in Japan.

Economic growth policy should be formulated after carefully analyzing current trends. The major reason we commissioned Professors Fukao and Kwon was because there was a pressing need

Changes in Japan's GDP Share and Debt Position

Figure 3



Source: *JMF World Economic Outlook,* 2010. Values after 2009 (for GDP) and values after 2008 (for gross debt) are IMF estimates.

for an analysis that addressed bottom-line questions such as these: What kinds of companies have been contributing to growth and new job creation, and how are they doing it?

Moreover, we could not identify a comprehensive national economic growth strategy—either articulated by the Japanese government or its major constituents—that was methodically based on an in-depth analysis of the answers to the above questions. Since recent political changes have injected a sense of urgency and the need to consider fresh alternatives, the ACCJ hopes that "analysis-first" approaches will inform policymaking more in the future.

The Measure of True Political Leadership

Growth takes place whenever a challenge evokes a successful response that, in turn, evokes a further and different challenge.

—Historian Arnold J. Toynbee

Growth strategy is not just about acknowledging realities. Leadership has to accept and act on the challenges those realities present, and create a virtuous cycle of change. Therefore, at the outset we also recognized another issue that might affect our recommendations regarding Japan's growth strategy: national economic strategy in Japan is still largely uncoordinated, fragmented between Japan's various ministries, perhaps because this worked during Japan's rapid growth up until the early 1990s.

To its great credit, the Ministry of Economy, Trade and Industry (METI)—traditionally viewed by many as the nation's chief industrial strategist—presently generates the closest thing Japan has to comprehensive growth strategy proposals. However, METI is only in charge of regulating certain industries—primarily manufacturing and retailing—so inevitably there are major gaps. It is therefore no surprise that Japan's professed "growth strategy" still focuses on exportable manufacturing products, because those have historically been METI's greatest concern. It is also predictable that policies in Japan traditionally support certain political constituencies and industries perceived to be potential global "winners" with subsidies and tax breaks.

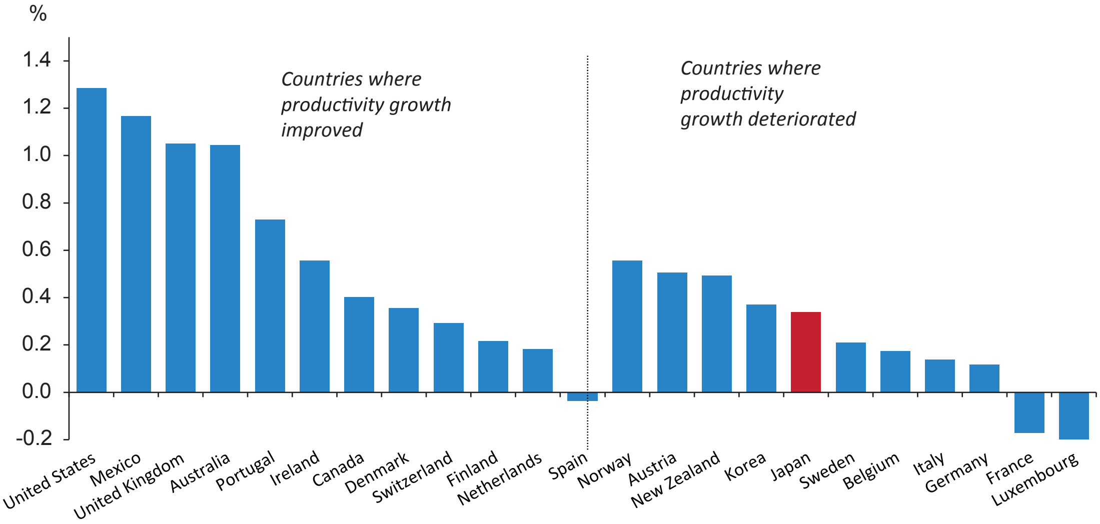
Unfortunately, the reality of the twenty-first century is that 80 percent of Japan's GDP now comes from services, not manufacturing. Moreover, heavily regulated sectors such as healthcare and telecommunications, and other industries in which information and communications technologies (ICT) investments increase efficiency, are major contributors to GDP growth in every developed country. This is true in Japan as well, except that Japan is trailing other countries in both GDP growth and the productivity contributions that ICT investment provides (as shown on the next page in Figure 4).

Another fundamental problem is that no single ministry or other empowered body coordinates growth strategy in these and many other sectors, although METI often makes constructive suggestions with regard to them. Instead, separate agencies such as the Ministry of Internal Affairs and Communications (MIAC), or the Ministry of Health, Labor and Welfare (MHLW), are in charge, thus creating "silos."

Objective, in-depth economic analysis is essential. But for maximum effectiveness, Japan's growth strategy must be based on more than that. Destructive inter-ministry rivalries—and the lack of coordination that occurs as a result—cannot continue if Japan is to thrive. The country needs a unified economic growth strategy designed and implemented by strong central political leadership, and neutral structures within the Cabinet to induce the ministries to march in unison to key

Contribution of ICT-Using Services to Value Added (Per Person Engaged), 1995-2002

Figure 4



Source: OECD Key ICT Indicators, OECD Productivity Database, September 2004.

economic growth policy themes in the interests of the entire nation.

Technology Is the Wellspring of Growth

The most important job for economic policy is to create an institutional environment that supports technological change.

-- Paul Romer, Professor of Economics, Stanford University

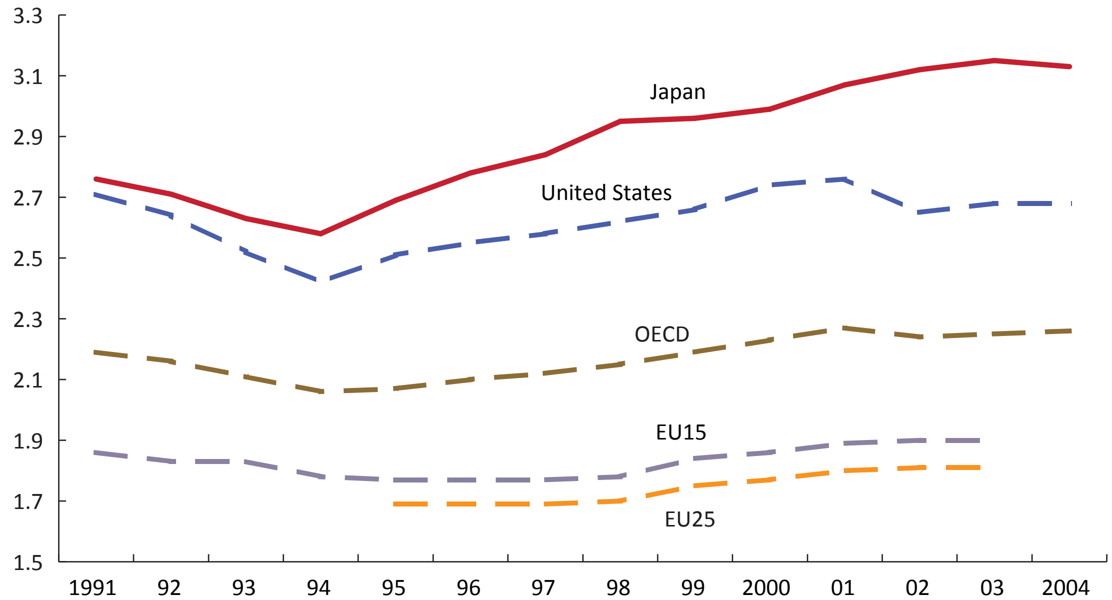
There are a number of economic growth theories. While their mathematical formulas may differ, they all incorporate the notion that a very large proportion of growth occurs because of technology advances, as well as subsequent dispersion and "spillovers" of technology throughout national and global economies. A 1 percent increase in productivity, for example, produces much more growth than a 1 percent increase in invested capital.

As Professor Fukao often reminds us, it should be clear that merely investing more capital in Japan is not the answer. If it were, Japan's challenges would not be so daunting. Rather, what is needed is more *productive* investment. That includes more investment in technology that is quickly utilized, exploited and dispersed, and the creation of more game-changing, "disruptive" technologies. In particular, these disruptive technologies and their applications in the form of completely new products and services increase Japan's global competitiveness, and bring larger and more widespread dispersion and spillover benefits than incremental technology improvements do.

Fortunately, Japan is blessed with a technology base as rich and potent as any in the world. For many years, Japan's R&D intensity (R&D/GDP) and patent applications/GDP rates have ranked at or near the top among OECD nations, as Figure 5 (following page) shows. It also has one of the highest rates of tertiary education in the OECD, and an impressive and growing list of Nobel laureates, most

Trends in R&D Intensity by Area, 1991-2004
Percentage of GDP

Figure 5



Source: *OECD Science, Technology and Industry Outlook 2006.*

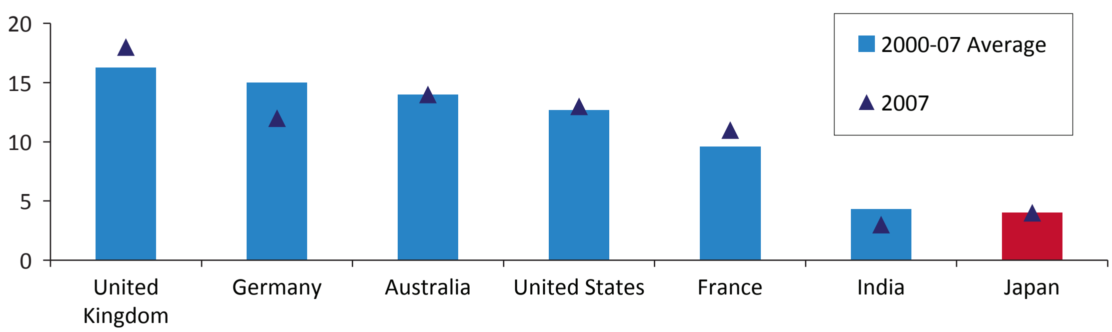
of whom have been recognized for their achievements in science.

If Japan has such potent reserves of technology and human capital—the essentials for accelerating productivity and therefore economic growth—what is holding the country back? Based on the research we reviewed and discussions with experts, Japan is not fully capitalizing on its massive technology base, primarily for the following reasons:

- The entry rate of newly incorporated firms in Japan continues to be very low compared to all other developed nations (see Figure 6). The level of cumulative foreign direct investment (FDI) as a percentage of GDP is also very low. Result: Fewer new entrants

Average Entry Rate, 2000-07
Number of Newly Registered Corporations as a Percentage of All Registered Corporations

Figure 6



Source: World Bank, Entrepreneurship Database (2008) and the OECD's *Measuring Innovation: A New Perspective 2010*. Data not available for all years. Chart shows Germany (2002-05), Australia (2004-07), United States (2003-05), France (2000-06), India (2001-06), Japan (2002-05).

are bringing new business methods and disruptive technologies and strategies to market in Japan.

- Much of Japan's technology base lies fallow. According to experts, Japanese companies do not commercialize, license or utilize many of their technological advances rapidly enough. (Task force members were surprised at how many observers immediately mentioned this point when discussing technology, and OECD surveys reflect this as well.) Japan's rate of international collaboration in R&D is only about half of the EU average, and changes in Japan's industrial structure (for instance, offshore production) also appear to have reduced the pace of technology dispersion from large to smaller firms.

Japan Still Has Plenty of Potential

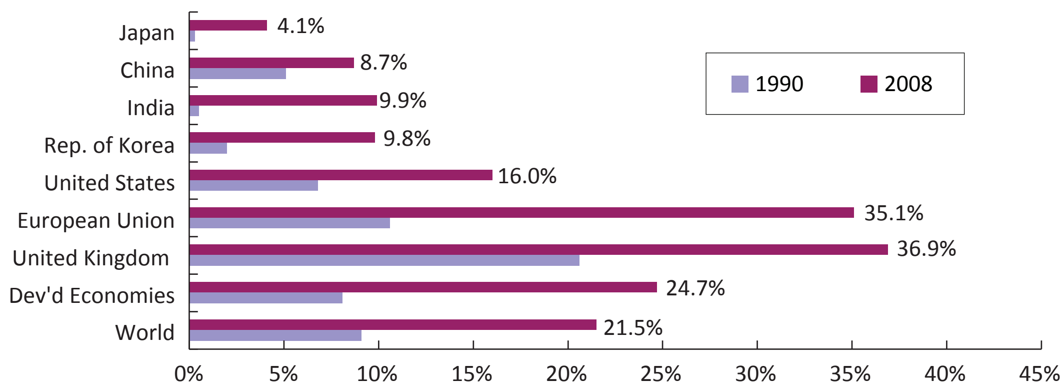
Depending on the policy course it pursues, Japan's excellent technology and human capital base mean its economy still has great growth potential. Moreover, precisely because Japan now benefits the least from those factors, a lot of good things will result if entrepreneurship, FDI, international R&D collaboration, faster asset reallocation rates, and immigration and greater labor mobility are encouraged. There has already been some progress in FDI and immigration (as shown in Figures 7 and 8), but the levels are still very low by international standards. This means there is still plenty of "upside."

This potential will only become a reality, though, if Japan can fashion policies that take advantage of these opportunities.

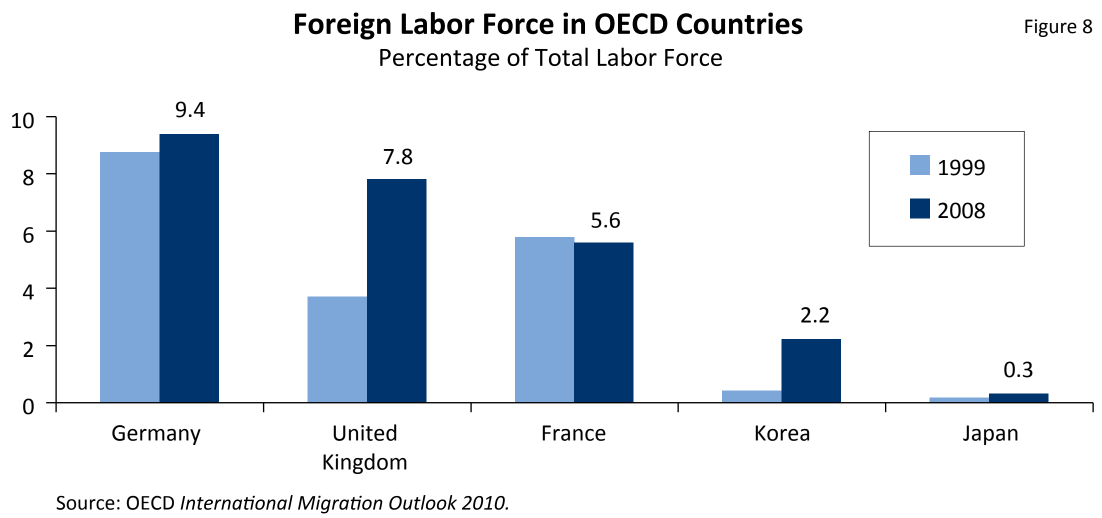
Indeed, the findings of both the Fukao-Kwon Report and the Eberhart-Gucwa Report suggest that the myriad reforms Japan launched in the late 1990s have already had a positive and significant impact on the business environment and opportunities for new market entrants, and should therefore be extended and refined. Those broad-based reforms affected corporate and labor law, ease of establishing new companies and hiring staff, deregulation of industries, and

Inward FDI Base as a Percentage of Nominal GDP

Figure 7



Source: OECD.



university technology ownership and collaboration.

Other Nations Have Done It

There is a country with few natural resources and a relatively small population that is located in a militarily and politically unstable part of the world. Just twenty years ago, the nation in question had far fewer entrepreneurs, high-tech startups and innovative patents per capita than Japan.

Yet in only two decades this country now boasts thriving centers of entrepreneurship, high rankings in innovation, the largest number of initial public offerings on the NASDAQ stock exchange by startups from another country, and the world's largest volume of venture capital investment per capita.

That country is Israel. Although Israel has a much smaller economy than Japan does, its example holds valuable clues for the latter. Israel succeeded in reinventing itself because it encouraged venture capital partnerships with foreign funds to learn their know-how, embraced massive immigration from the Soviet Union when the Berlin Wall fell, and quickly integrated those immigrants into its society. Moreover, Israel discovered that the uniquely "flat" organizational structure of its military, combined with universal conscription, socialized and educated its youth as confident leaders imbued with entrepreneurial resourcefulness, critical thinking skills and flexibility.

The keys to Israel's remarkable transformation: FDI, immigration, reallocation and integration, and education.

The Fukao-Kwon Report: Analytical Gold

The Fukao-Kwon Report reminds us that there are only three "drivers" that nations can use to make GDP grow faster. A country can expand the size of its workforce and/or the total number of hours worked; increase the amount of capital invested; and/or use research, innovation and creativity to increase the productivity of labor and capital inputs.

Given that Japan's workforce is shrinking and aging while investment is already at a fairly high level, Professors Fukao and Kwon have concluded that finding ways to increase Japan's "total factor productivity" is absolutely vital to a full recovery of GDP expansion. In other words, accelerating productivity growth is the principal driver—and virtually the only one—that Japan can use to create more economic growth and better jobs for its people.

This by itself is not a new or startling conclusion. The real question is, "*How* can Japan recover its former high rates of productivity growth?" In this regard, the report's analysis revealed that, among all types of companies analyzed, foreign companies exhibited the highest total factor productivity growth rates between 1996 and 2006. The analysis also showed that foreign-held firms created 156,000 new jobs on a net basis during the same period. These results are logically consistent, since only productive firms can consistently grow their employment.

Furthermore, the analysis in the Fukao-Kwon Report revealed that the current drivers of net jobs growth in Japan's economy are foreign companies and young, newly established firms. During a period when total employment in Japan declined by more than 3.5 million jobs, these two groups were the only ones that consistently generated jobs on a net basis.

These ongoing trends confirmed in the report strongly suggest that increasing FDI, entrepreneurship, "intrapreneurship"—i.e., behaving as an entrepreneur while working in a large organization—and other new market entrants to industries will be essential to expanding Japan's economy. These are the flows that most rapidly bring new business models and technologies to market, and reallocate resources to more productive uses. They also serve to stimulate greater competition among existing competitors, which benefits both the economy and consumers.

Below, we have briefly summarized the most important findings of the Fukao-Kwon Report.

Why did the "two lost decades" occur? What key trends and dynamics will continue to affect Japan?

Japan's "two lost decades" were the result of legal and demographic changes that produced a damaging combination of low productivity, weak demand, and simultaneous declines in total workers and average working hours. Overall, labor productivity stopped catching up with the United States around 1997, and currently stands at less than 60 percent of the U.S. level.

Two other factors compounded the damage.

First, even before the stock market "bubble" burst in 1989, Japan's economic "metabolism" was dangerously low, reallocating capital, labor and technology resources to their best uses at a very sluggish pace. As a prime manifestation of this, for many years more productive companies exited industries while less productive ones remained, thereby reducing average productivity. Normally the opposite would occur. As a result, much of the labor force in the "staying" firms was frozen in place, retooling itself and changing jobs less than Japan needed.

The second complicating factor was that Japan's service sector has continued to grow, to fully 80 percent of GDP. But Japan's service sector has been plagued by low productivity growth for decades, a trend that persists. Labor productivity in Japan's non-manufacturing sectors is still less than half the U.S. level. Hence, about 80 percent of Japan's economic activity now consists of low-productivity services.

Contributing to this shift to a predominantly service-based economy, over the last twenty years many large manufacturing companies have shifted production offshore to take advantage of lower labor costs and cope with the strong yen and global competitive pressures. The Fukao-Kwon Report shows that many listed parent companies and multinationals expanding offshore experienced a slump of only four or five years rather than two decades in the doldrums. Even as they reported consolidated profits, however, they generated few new jobs *in Japan,* which kept consumer demand here low.

Professor Fukao's extensive analysis suggests that low productivity in Japan's service sector is the result of low (or late) investment in ICT, which may be related to Japan's low level of investment in "intangibles." Japan invests a lot in R&D in the services sector, but comparatively little of it is in the area of cost-effective ICT, or ICT services and aspects such as brand equity, business models and organizational structure. It also invests relatively little in "off-the-job" training of employees.

Therefore, the key trends and dynamics that will continue to affect Japan are:

- A continuing decline in the supply of labor, which will further reduce demand and lower the tax base unless the country offsets it through immigration and bringing more women and retirees into the workforce, and higher productivity that raises GDP, wage levels, and tax revenues.
- Low "metabolism" and resource reallocation rates, unless an influx of new market entrants and increased capital markets efficiency accelerates entry by productive firms and exits by unproductive ones. Related to this, excess savings in the corporate sector will continue to have a deflationary effect.
- Continued fast growth in many service industries, but low growth in services productivity. A broad solution for increasing productivity would be an influx of new business models, new entrants, along with greater investment in ICT and improved organizational structures to use that ICT investment.
- More "hollowing-out" and shrinkage due to globalization in manufacturing industries. This will increase the urgency of improving productivity in the service sector because it will raise the proportion of low productivity services in total GDP.

Japan's economic growth strategy should be designed to correct and counteract these ongoing trends.

What types of companies and investments are generating economic activity, net job growth, and higher productivity rates?

The Fukao-Kwon Report's analysis showed that foreign-held companies, new entrants, and R&D-intensive companies and internationalized companies (meaning those with exports or a foreign investor) tend to have significantly higher productivity rates during the recent periods analyzed than other types of investors. In general, they also created more jobs, and their economic activity contributed more to Japan's growth. Furthermore, the analysis revealed that startups and other newly created enterprises are now contributing to significant job growth in Japan. In contrast, large independent companies, and companies established before 1996, each employed several million fewer persons in 2006 than they did in 1996.

Foreign companies

Professors Fukao and Kwon estimated that in the service sector, the total factor productivity of foreign firms was on

Net Change in Employment, 1996-2006*
(Fukao-Kwon Report Estimates, based on Firm-level Data)

Figure 9

Independent Japanese companies	-3,752,215
Subsidiaries of Japanese companies	+96,501
Foreign companies	+147,248

average 21 percent higher than that of all independent Japanese firms, holding all other factors constant.

In line with their significantly higher productivity, between 1996 and 2006 foreign firms increased their employment in Japan by close to 60 percent, from about 249,000 to 405,000. Almost all of this 156,000 gain in net job growth by foreign firms took place through greenfield market entry or simple business expansion. This is clear from Figure 9, which shows the result of more detailed calculations based on excluding the effect of M&A transactions.

Investment and employment by foreign firms was broadly distributed across many industries, and often occurred in markets different than those that Japanese companies chose for expansion. Moreover, during the 1996-2006 period, foreign firms invested in a host of new industries. Of the 112 industries the Fukao-Kwon Report covers, foreign-held firms were unrepresented in only 37 as of 1996; this figure had dropped to just 19 as of 2006.

Startups and other new entrants

Excluding foreign firms and Japanese companies' subsidiaries, as of 2006 "new entrant" domestic companies established after 1996 had created approximately 1,210,000 new jobs on a net basis over the preceding five years, as compared to a loss of about 3,100,000 net jobs by all companies established prior to 1996 (as shown in Figure 10).

Unlike older companies, young companies increased their average number of employees in almost every industry. They also had higher survival rates than older companies. R&D-intensive firms and those with international strategies such as exports or a foreign investor exhibited higher rates of productivity and productivity growth than other new companies.

Independent Japanese Firms,
Net Change in Employment, 2001-06
(Fukao-Kwon Report Estimates, based on Firm-level Data)

Figure 10

Companies established before 1996	-3,102,648
Companies established 1996-2001	+409,488
Companies established after 2001	+795,813

Subsidiaries

Between 1996 and 2001, subsidiaries and affiliates of larger independent firms reduced their employment by 607,000. During the next five years they grew their employment by about 703,000 on a net basis, but a significant portion of this occurred because their parent companies restructured. For example, between 2001 and 2006 the combined net change of employment by all subsidiaries and their parent companies was a reduction of 1.13 million jobs. Since such restructuring often involves transfers of employees to affiliates with lower salary levels, it does not represent true net job creation, and is a one-time event. However, in other cases the net job creation of subsidiaries was probably the result of successful intrapreneurship by parent companies, which spun off divisions to speed their decision-making processes, focus their strategies, and impose more rigorous corporate governance.

Japanese multinationals

Multinational Japanese companies exhibited the next highest productivity rates after foreign companies. However, there was a significant gap, and most of them did not generate any net job growth in Japan.

Japan may already be reinventing itself

Especially in younger industries, often in services, or where there was deregulation or structural change, large numbers of companies established after 1995 reached the top quartile in terms of employment by 2006. (Telecommunications, insurance, and home services are examples.) This indicates that dynamic change is occurring in some industries.

Another sign of dynamism: although there were 24 industries that cut employment by more than 15 percent—mainly in manufacturing—19 industries boosted employment by more than 10 percent, mainly in services. These industries also attracted FDI entrants, who expanded those new markets. Moreover, the contribution to job creation by new entrants to any particular industry (whether by startup, or existing company) was large.

What are the present and future drivers and sources of growth and productivity in Japan's economy? What are the major challenges and obstacles?

The conclusions and implications of the Fukao-Kwon Report are that the major potential drivers and sources of growth in Japan are:

- Inward FDI, which has extremely high productivity and generates new jobs as a result. Since most of FDI's contribution to net job growth currently comes from greenfield entry or simple business expansion, this contribution could be significantly increased if more M&As by foreign companies were occurring.
- Entrepreneurial activity. When young companies grow to have a thousand employees or so, their contribution to net job growth is very high.
- New entrants in general, including spin-offs and intrapreneurship. Such firms bring new business models and productivity with them, especially when regulatory reform has made a market more attractive.
- Utilizing market mechanisms to make it easier for entrepreneurs to compete, such as by offering "set aside" budget allocations on a competitive basis.
- Faster commercialization and dispersion of technology, which might be improved by expanding the scope of the Japan Bayh-Dole Law so that small firms have better access to more university technology.

- Increased R&D and exports by domestic startups and mid-size companies. Japanese firms need to "think global" from day one.
- Greater fairness, mobility and liquidity in the labor markets, which would make it easier for small firms to hire staff, and reduce exit costs. Improvements in the safety net may be complementary, by allowing workers more time to retrain themselves.
- Greater investment in productivity-enhancing ICT and related intangibles in all ICT-using industries.

Challenges and obstacles to accelerating economic growth will likely include:

- The presence of entrenched competitors with low productivity who contract or exit slowly.
- Excess savings and a tendency for many large firms to pay down debt rather than invest or pay dividends, which may point to dysfunctional aspects of corporate governance that hamper the reallocation of resources to their best use.
- Imperfections and illiquidity in the labor market, which slows the reallocation of labor resources.

The Eberhart-Gucwa Report: More Signs of Progress

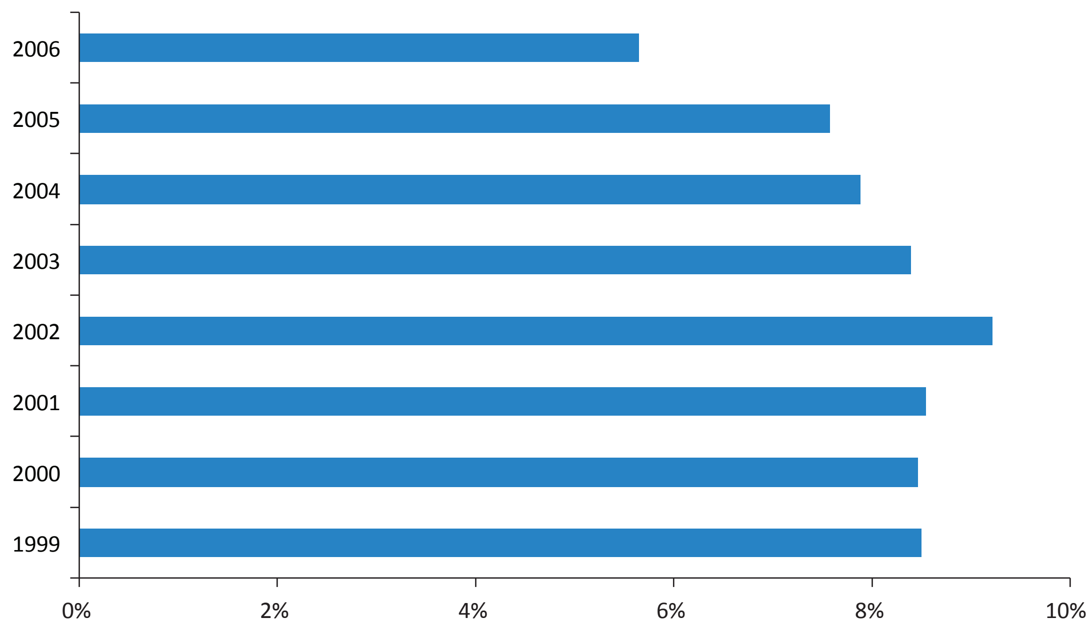
Written under the auspices of the Stanford Program on Regions of Innovation and Entrepreneurship, the Eberhart-Gucwa Report presents a detailed analysis of newly incorporated, independent firms founded in Japan between 1999 and 2008—a dataset of 50,000 companies derived from Teikoku Databank data.

Similar to the results of the Fukao-Kwon Report, their analysis also suggests that the recent broad-based reforms affecting

National New Company Sales Rank

(% of Founding Year Firms in 90th Percentile Sales Rank as of 2008)

Figure 11



Source: Robert Eberhart, Research Fellow, SPRIE at Stanford University.

corporate and labor law, industry deregulation, and university technology ownership and collaborations are having a positive impact on entrepreneurship in Japan. Some examples:

- A notable proportion of startups in Japan now rapidly reach a high level of success. Over 5 percent of the survivors the dataset covers that were founded as recently as 2006 were in the 90th percentile in terms of revenue ranking for their respective industries at the end of 2008. Close to 9 percent of the firms founded in 1999 had reached the same high level by 2008 (Figure 11, facing page).

  Notably, this trend is relatively broadly distributed rather than being restricted to just a few industry categories.

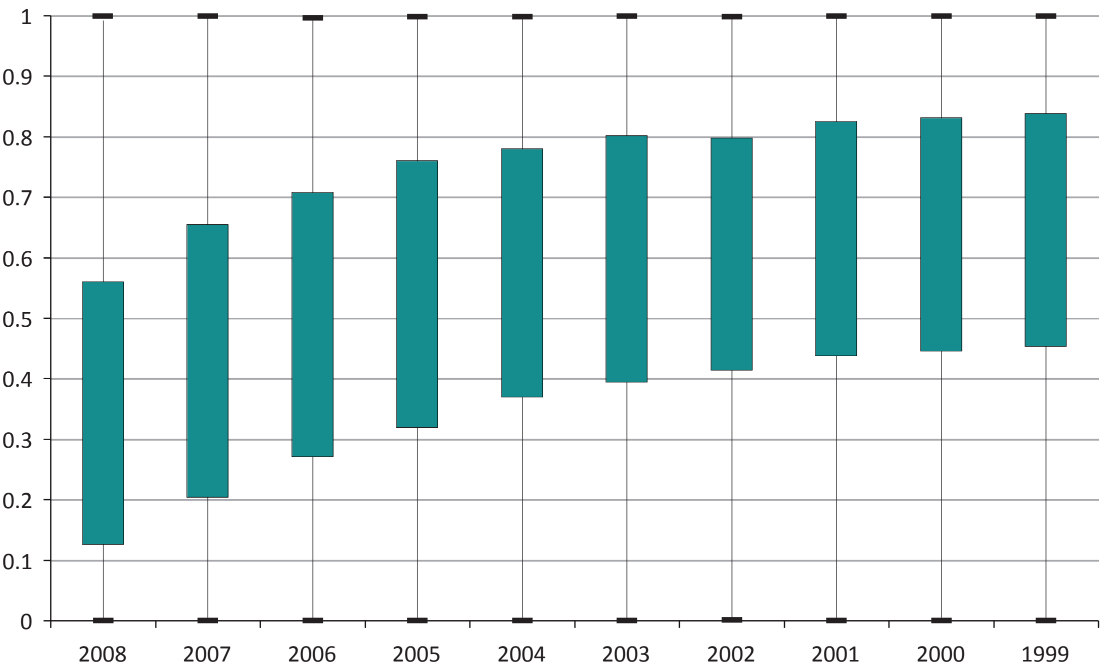
- On average, recent startups seem to be gaining market sales rank compared to older competitors (Figure 12). The report suggests that, on average, these startups reached industry rankings in the 50th percentile (median) level of sales in just two to three years. By 2008, the median level for companies formed in 1999 was at about the 70th percentile in revenue terms. This trend is also relatively broadly distributed.

  These results are surprising if one assumes the absence of significant changes in the business environment and more opportunities for new entrants. Instead, the expectation would be for new firms to slowly gravitate to the median level.

- About 5 percent of the high-tech firms incorporated between 2004 and 2008 had booked annual revenues of over 500 million yen by 2008. Since the average firm in this group had only been around a little over two years, this also suggests that ventures now need less time to succeed.

National Percentile Sales Rank of Firms by Establishment Date, as of 2008

Figure 12



Source: Robert Eberhart, Research Fellow, SPRIE at Stanford University.

- Technical universities in Japan are the alma mater for a disproportionately large share of high-tech startup CEOs. In addition, foreign universities produce many high-tech startup CEOs.

Key Analytical Conclusions and Policy Implications

In discussions with our task force, Professors Fukao and Kwon pointed out that Japan's core problem is a lack of *productive* investment, exacerbated by a structurally low rate of "metabolism" and an aging, shrinking workforce. As the data indicates, more productive firms grow faster and hire more employees. Raising productivity would attract more investment to Japan and accelerate economic growth and new job creation in a virtuous cycle.

Japan therefore needs to adopt policies that speed up the allocation or reallocation of capital, labor and technology to higher-productivity uses. As previously noted, economists generally recognize that the potential benefits of R&D and technology can be very large in this respect. The faster that knowledge and technology is dispersed, marketed and commercialized, the faster total factor productivity will rise.

So the name of the game is speed. The faster reallocation occurs, the more "disruptive" the technology, and the larger the market—both domestically and globally—that investment addresses, the better. Since no government can possibly pick winners in today's fast-changing business realm, another key is to promote more efficient market processes. A coherent competition policy is vital, but the labor market and the education system that feed into it are equally crucial, because in today's world, new businesses and new market entrants require a mobile, flexible labor market and capable educational institutions from which to hire skilled and resourceful personnel who can function on a cross-border basis.

In the absence of a bold economic growth strategy that better addresses these needs, many Japanese companies—especially small and mid-size companies and independent companies—have been slow to improve their competitiveness. The entry rate of new firms is still low, too, partly because low-productivity entrenched competitors do not exit the market. Much viable and potentially profitable technology appears to be underutilized. Because Japan is perceived as an unattractive market for investment by many foreign and domestic firms alike, FDI expansion and "inward globalization" are still sluggish as well.

The data in the Fukao-Kwon Report and the Eberhart-Gucwa Report suggest that reforms over the past fifteen years are starting to have a beneficial effect. They also make it clear, though, that much remains to be done on the policy front.

Charting an Economic Strategy for Japan

In announcing and implementing a bold new national economic policy, Japan's leaders should publicly acknowledge and clearly address the following key issues that the analyses by economists Fukao, Kwon, Eberhart and Gucwa have raised:

- **The Key Players: FDI, Entrepreneurs, and New Entrants.** Many large Japanese firms have gone offshore or restructured themselves. Looking ahead, the greatest untapped growth will continue to come from new market entrants, foreign investors, and entrepreneurs. These new players have already contributed the greatest combined increases in both net job creation and productivity over the past fifteen years, often in the service industries that hold the key to Japan's future growth. Unlike restructuring measures, the productivity they bring is of a recurring nature.

- **The Key Resource: New Technology and Know-How.** Japan has to do a better job of enlisting and activating more of the investors mentioned above, and Japan's education institutions wherever possible, to commercialize the nation's impressive technology base, whether via entrepreneurship or industry-university collaboration. The country needs to attract parties who bring even more new know-how and technology, and to take better advantage of the benefits of the Internet Economy. But in the process of fortifying and using its technology base, Japan should allow the market to pick winning technologies rather than attempt to guide it from above.

- **Reaping More Benefits From "Inward Globalization."** These benefits can come in the form of increased FDI, education policy changes, cross-border R&D collaboration, and immigration. They can fill the gaps now appearing in Japan's workforce and provide more access to new technology, business methods and strategies.

- **Regulatory Environment: Cultivating an Attractive Market for Investment.** Japan needs to become a more attractive market for FDI and domestic investors alike. That includes market-oriented tax policy reform and harmonization of practices, regulations and standards, as well as easing or clarifying rules and regulations that complicate transactions and make them more expensive. It also means acknowledging foreign companies in Japan as crucial stakeholders in the Japanese economy, and inviting them to serve as full members of the deliberation councils known as *shingikai, kenkyukai* and other similar bodies. And it means improving corporate governance and the M&A market so that Japanese companies will invest more in the core businesses where they have a competitive edge, while exiting those markets where they are poor competitors and are shutting out new entrants.

- **Services Productivity Growth Is Essential.** Since 80 percent of Japan's GDP now comes from services, not manufacturing, the days when Japan could depend on export-led manufacturing growth to support the rest of its economy are long gone. Increasing services productivity and efficiency is now the name of the game, as well as promoting ICT and ICT services investment.

- **Labor Market Improvement.** Japan's labor markets will require more mobility, complemented by a better safety net so employees can have time to get training between jobs. Moreover, Japan's universities will need to turn out graduates that are more international, resourceful and flexible of mind to fill the employment needs of the nimble new market entrants and investors that the country's maximum growth trajectory depends upon. Since much of this new employment will be in services or service-related industries, where reaction times and constant readjustment are paramount, the need for flexibility in employee mindsets and hiring practices is particularly high.

- **Workforce Realities.** The hard reality is that Japan's workforce is declining, requiring the nation to draw more from the pool of women, retirees and immigrants to fill the gap. Japan has to offer an environment where these potential workers can obtain employment more easily, and find better opportunities.

The ACCJ recommends that the government of Japan recognize these issues as being central to developing an effective new strategy and vision for accelerating economic growth. This overview chapter of the white paper is followed by the eight policy viewpoints listed below, which provide further analysis and propose concrete measures.

1. Harness Entrepreneurship to Bring Innovation to Market and Create the Firms and Jobs of the Future
2. Expand Foreign Direct Investment into Japan to Stimulate Growth and Create Jobs
3. Mobilize Education to Internationalize Japan, Reignite Its Youth, and Promote the Knowledge Economy
4. Revitalize Growth and Competitiveness with Tax Policies That Spur More Productive Investment and Innovation
5. Make Regulations and the Legal System More Transparent and Accessible to Promote Investment in Japan
6. Promote “Open Convergence” and Take Maximum Advantage of the Internet Economy
7. Improve Labor Mobility to Enable Japan to Better Compete in the Global Economy
8. Modify Japan’s Immigration Policies to Stimulate Investment and Growth

Later this year, the ACCJ will also publish a white paper focusing on how Japan can strengthen its financial sector and its role as a global financial center.

Harness Entrepreneurship to Bring Innovation to Market and Create the Firms and Jobs of the Future

I. EXECUTIVE OVERVIEW

Japan's entrepreneurs have long been admired at home and abroad for their contributions to the nation's economic development and global consumer culture. Many of the country's leading brands are linked forever with business pioneers such as Soichiro Honda of Honda, Konosuke Matsushita of Matsushita/Panasonic, and Akio Morita and Masaru Ibuka of Sony.

When Japan's economy was booming during the sixties and seventies, such startup firms were joining the game at a tremendous pace. By 1989, however, the rate of new market entrants was plunging—almost as many firms were exiting the market as entering it, slowing a potent engine of economic growth. Rather than nurturing startups, Japan's political leadership and policies were focusing primarily on preserving existing companies.

Despite that steep drop in entry rates and Japan's sluggish economic metabolism, the Fukao-Kwon Report reveals that new firms still contributed a major portion of Japan's net job growth between 1991 and 2006. Moreover, young companies doing business internationally and spending more on R&D boasted substantially higher productivity, productivity growth and capital accumulation.

Japan's economic vitality depends on its ability to produce the next generation of entrepreneurs and supply them with the knowledge, skills and networks needed to grow innovative, sustainable enterprises. That involves building a supportive market-led ecosystem for entrepreneurs and fostering a culture that publicly recognizes them as prime drivers of economic and social prosperity.

Japan also needs to set complementary policies on capital markets and competition, make the labor market more fluid, and enable risk capital to tap the country's vast technology base and intellectual property more readily. These changes will help drive industry-university collaboration and the market-led creation of new businesses able to introduce game-changing, "disruptive" new products and technologies and sell them globally.

II. ISSUES AND ANALYSIS

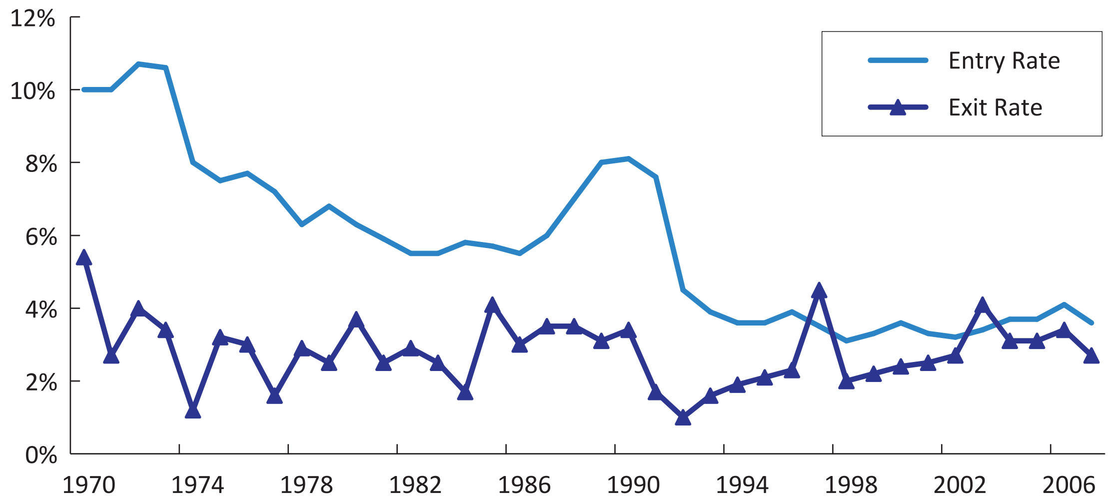
Postwar Entrepreneurship Policy in Japan: Misplaced Priorities

Once-small firms like Honda, Sony and Matsushita became household names during Japan's postwar growth spurt. Japanese government policy, however, neglected to acknowledge the vital contribution such startup firms made to economic growth and their potential to become market leaders that bring completely new concepts and products to consumers. Instead of encouraging the creation of more new ventures, the government attempted to narrow the productivity gap between big firms and existing small and medium enterprises (SMEs) by supporting SMEs that often served larger entities. Many of these SMEs were not newly established companies.

The 1989 *White Paper on Small and Medium Enterprises in Japan* warned that a slowdown of entrepreneurial activity could lead to economic stagnation. The prediction was accurate, and after enterprise entry rates slumped

Trends in Firm Entry and Exit Rates

Figure 1



Source: *2009 White Paper on Small and Medium Enterprises in Japan: Finding Vitality through Innovation and Human Resources* (p. 322)

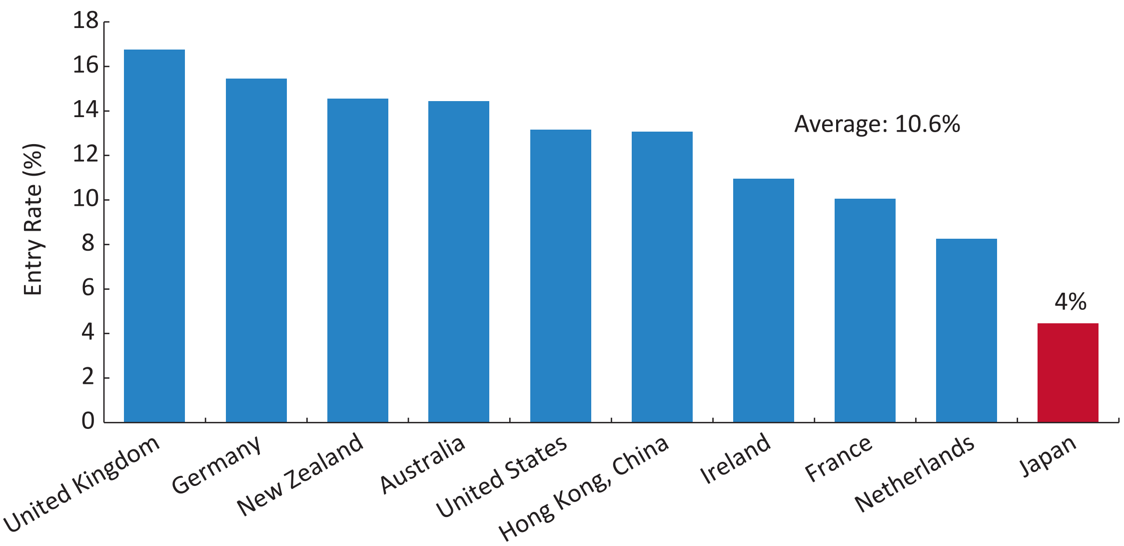
from 11 percent to about 6 percent (as shown in Figure 1 above), Japanese officials began to seriously reexamine their policy toward young and newly formed companies.

Growing awareness of the stimulus that startup firms had given the U.S. and U.K. economies in the 1980s reinforced this reappraisal. A global comparison of recent entry rates presents a stark contrast, as seen in Figure 2, with Japan ranking last in the Organisation for Economic Co-operation and Development (OECD).

New firms and emerging growth companies are now widely recognized as essential to bringing technological

Corporate Entry Rates: Global Comparison
(Average Entry Rates for 2000-2007)

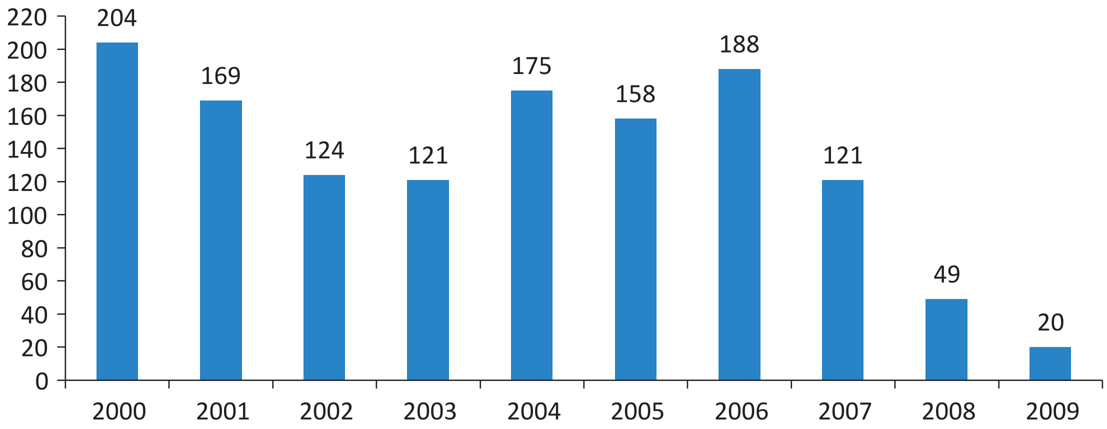
Figure 2



Source: WorldBank, Entrepreneurship Database WBGES08 (2008), StatLink http://dx.doi.prg/10.1787/835584771745, Unleashing Innovation in Firms-Entry and Exit (p.64).

Total Number of IPOs in Japan

Figure 3



Source: KPMG Japan.

innovations to market, and generating new employment, and efficiently reallocating of resources in mature economies. Moreover, they are a vital source of the game-changing technologies and knowledge "spillovers" that boost growth and competitiveness.

The Superficial View of Japan's Recent Record

Beginning in the late 1990s, this recognition spurred numerous policies to encourage entrepreneurship, such as the effective elimination of minimum capital requirements to establish a company and the creation of *godo gaisha* and *yugen sekinin jigyou kumiai*—Japanese versions of a limited liability company (LLC) and limited liability partnership (LLP), respectively. At the same time, it was also a major factor driving a range of reforms that started to introduce greater flexibility in structures for corporate organization and mergers and acquisitions (M&A) transactions, labor contracting and compensation, and cooperative R&D efforts between industry and universities.

Despite these reforms, most observers would say that Japan has yet to witness a sustained boom in the creation or growth of venture firms. Similarly, opportunities remain limited for appealing exit strategies via buyouts or initial public offerings (IPOs) of shares. Figure 3 shows the recent sharp drop in IPOs.

Established Japanese companies have generally not provided attractive "exits" to investors either, because they do not regard acquisition of venture firms as critical to their survival.

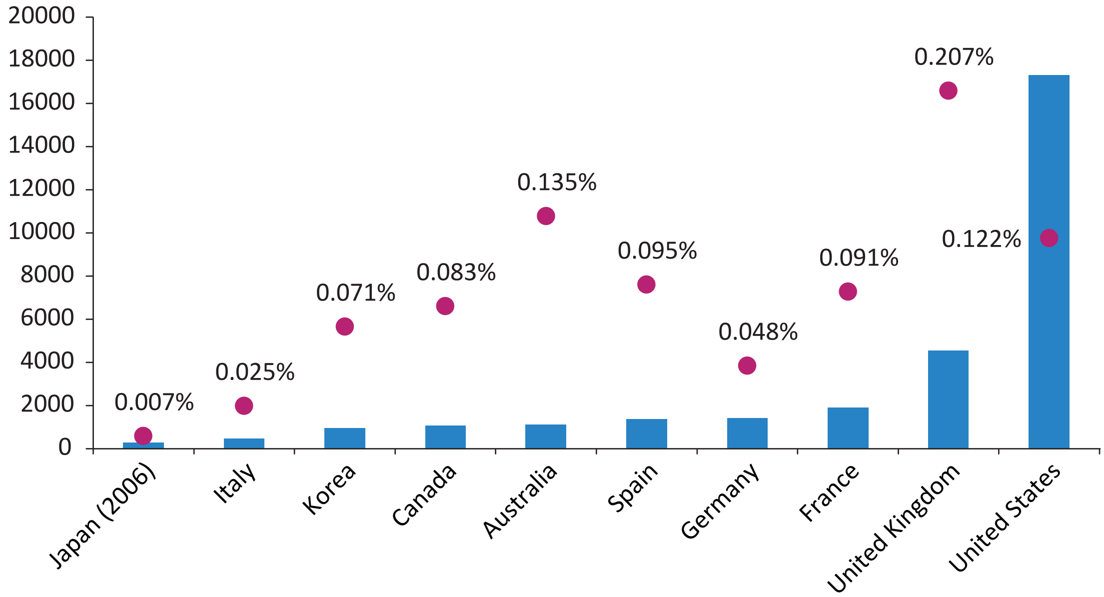
The small size of Japan's venture capital market reflects this relative scarcity of near-term exit options. In fact, annual investment volume runs at a small fraction of U.S. levels, both in absolute volume and as a percentage of GDP (see Figure 4, following page).

There are several reasons these trends persist. First, weak horizontal linkages among private groups such as venture capital firms with strong industry expertise, providers of legal services and angel investors make for inefficient "relational networks."

Second, popular attitudes—such as an intense fear of failure and the greater prestige that employment at a large firm brings—have not changed much. Would-be entrepreneurs therefore tend to stay

Venture Capital Investment, 2008
US$ Millions, and % of GDP

Figure 4



Source: OECD Science, Technology and Industry Scoreboard 2009. Data refers to equity investments.

on at big companies or in academia. Media scrutiny of wrongdoing by recent corporate upstarts has also overshadowed the success stories.

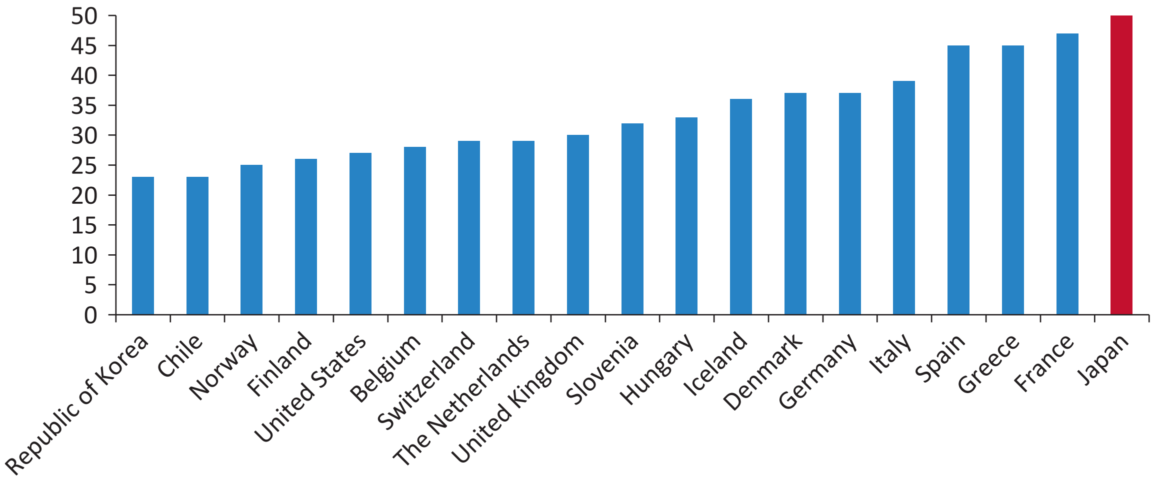
Last, and perhaps most crucial, political support for the reform and deregulation movement of the "two lost decades" dissipated just as those policies began to create opportunities and ease transactions for new businesses.

The results of the 2009 survey by Global Entrepreneurship Monitor (GEM) on attitudes toward entrepreneurship clearly reflect these issues. Japan's citizens exhibit the greatest fear of failure among the twenty "innovation-driven" economies the GEM survey analyzed (see Figure 5), and ranked dead last in the number of its citizens who perceive opportunities for entrepreneurship (shown in Figure 6). The other unsurprising result: Japan has the lowest proportion of people who consider becoming an entrepreneur a smart career move.

As a result, new firms in Japan often face severe difficulties in hiring experienced management. They also find it difficult to acquire customers, compounding the difficulty they face in attracting capital. Exacerbating this problem, young Japanese born after the collapse of Japan's bubble economy have never known the economy to boom, and have shied away from opportunities that involve any kind of risk. Promoting entrepreneurship is difficult when so few people *want* to become entrepreneurs or work for startups.

But there is good news on this score. The positive recent experiences of countries as diverse as Israel, Ireland, Chile and Korea demonstrate that government leadership can change attitudes toward entrepreneurship by pursuing deregulation, supporting new entrants and immigration, and setting a policy tone that promotes new business formation and the rapid introduction and dispersion of new technologies as high priorities. Thirty years ago in Chile and Ireland,

Fear of Failure Figure 5



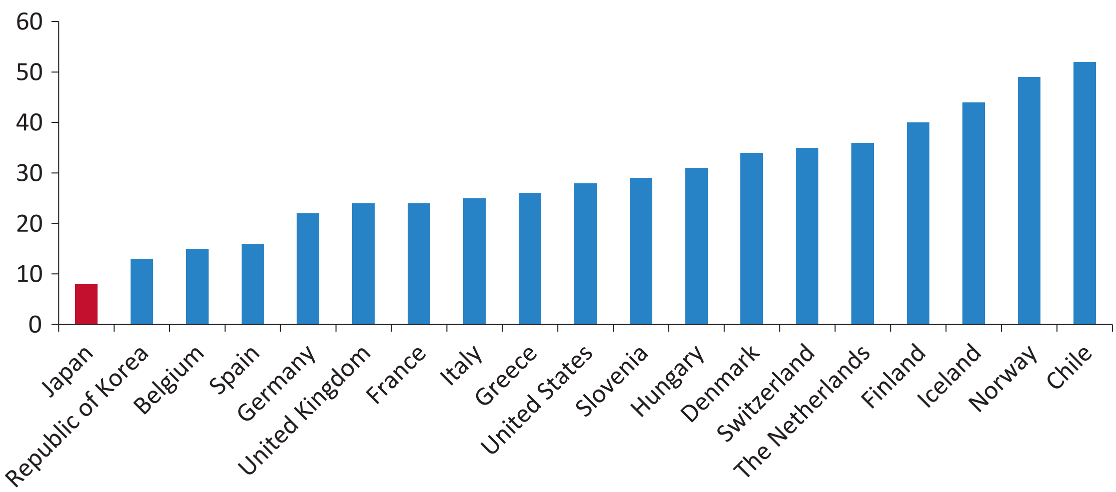
Source: Global Entrepreneurship Monitor, 2009 survey.

for example, government jobs were considered the most desirable; in Israel, military jobs topped the list. Now these countries have significantly improved their markets for venture capital and entrepreneurship, and attitudes related to them. Government policy can make a difference.

Recent Signs of Progress

Despite the superficial impression that little has improved in Japan's entrepreneurship environment, there are signs that the myriad reforms Japan launched in the late 1990s have already made a positive and significant

Perceived Entrepreneurial Opportunities Figure 6

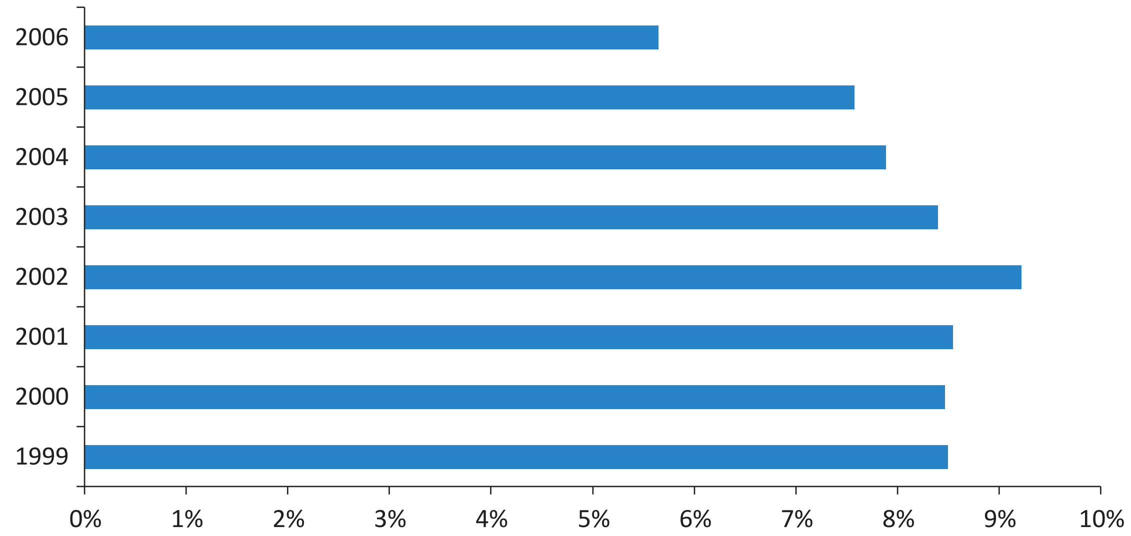


Source: Global Entrepreneurship Monitor, 2009 survey.

National New Company Sales Rank

Figure 7

(% of Founding Year Firms in 90th Percentile Sales Rank as of 2008)



Source: Robert Eberhart, Research Fellow, SPRIE at Stanford University.

impact on the business environment and opportunities for new entrants.

The Eberhart-Gucwa Report, written under the auspices of the Stanford Program on Regions of Innovation and Entrepreneurship, presents a detailed analysis of newly incorporated, independent firms founded in Japan between 1999 and 2008—a dataset of 50,000 companies derived from Teikoku Databank data. According to that analysis:

- A notable proportion of startups in Japan now rapidly reach a high level of market success. Over 5 percent of the survivors the dataset covers that were founded as recently as 2006 were in the 90th percentile in terms of revenue ranking for their respective industries at the end of 2008. Close to 9 percent of the firms founded in 1999 had reached the same high level by 2008, as Figure 7 above shows.

  This trend is not restricted to just a few industry categories; it is relatively broadly distributed.

- On average, recent startups seem to be gaining market sales rank compared to older competitors established earlier. The report also suggests that, on average, they reached rankings in the 50th percentile (median) level of sales in their industry in just two to three years. By 2008, the median level for companies formed in 1999 was at about the 70th percentile in revenue terms, as Figure 8 shows. This trend is also relatively broadly distributed.

  Normally, these results could not be predicted in the absence of significant changes in the business environment and more opportunities for new entrants. Instead, the expectation would be for new firms to slowly gravitate to the median level, at the 50th percentile.

- About 5 percent of the high-tech firms incorporated between 2004 and 2008 had booked annual revenues of over 500 million yen by 2008. Since the average firm in this group had only been in business for a little over two years, this also suggests that the time needed for ventures to succeed is shortening.

- Technical universities in Japan are the alma mater for a disproportionately large share of high-tech startup CEOs. In addition, foreign universities produce many CEOs at high-tech firms.

The results from the Eberhart-Gucwa Report suggest that the recent broad-based reforms affecting corporate and labor law, deregulation of industries, and university technology ownership and collaborations are having a positive impact on entrepreneurship in Japan.

Since new opportunities attract new entrants, new companies usually emerge to introduce or take advantage of a new and "disruptive" technology or method, or to take advantage of opportunities arising from changes in the status quo in particular industries. The ACCJ believes that such dynamics are accelerating in Japan, but they will only continue if necessary reforms, deregulation and leadership are brought to bear on economic policy.

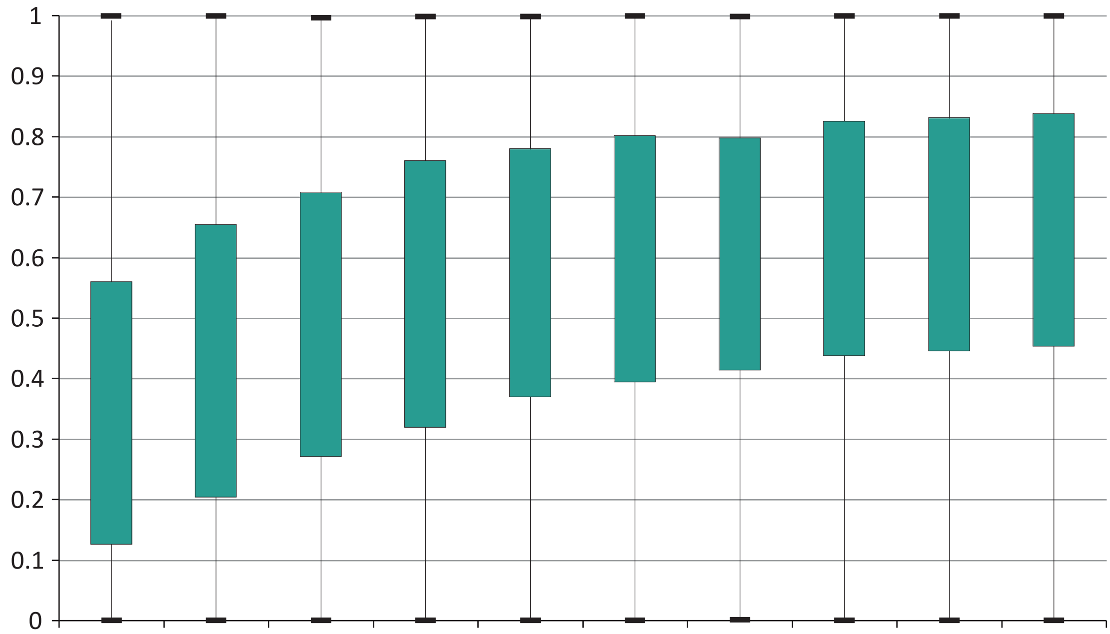
Note to Japan's Leadership: Multiply Opportunities and Reduce Risks

Japan's government needs to take the lead and create more fertile ground for entrepreneurship to produce the new firms and creative new technologies and products the nation's future prosperity depends on. While the success of entrepreneurial businesses ultimately rests with the private sector, government can serve as a catalyst and enabler that unleashes a country's unrealized potential.

The first task for Japan's leaders is to declare entrepreneurship a worthy endeavor and a key focus of national growth policy. Such leadership can support entrepreneurs as they build the cross-border linkages they need

National Percentile Sales Rank of Firms by Establishment Date, as of 2008

Figure 8



Source: Robert Eberhart, Research Fellow, SPRIE at Stanford University.

from the start to go global in the new industries of the twenty-first century.

Acknowledgement and praise of thriving entrepreneurial businesses will also play a pivotal role in rallying Japanese enthusiasm and building the political support for needed policies. Senior corporate and political leaders need to point to entrepreneurs as valuable contributors to the future of Japan's economy. They also need to dispel images of them as being mercenary because they seek profit, or unimportant because they are small.

Growing markets are indispensable to the success of startup firms. The prospect of going head-to-head with established competitors in a mature market without a new product, service, or business model is unlikely to generate interest. The Japanese government can create new business opportunities by pursuing regulatory reforms in heavily regulated sectors such as agriculture and healthcare, or in the converging internet, media, and communications sectors. (Please see the chapter in this white paper on the Internet economy.)

The government can also create opportunities by pursuing competition policy that blunts attempts by vested interests to undermine entrepreneurial competitors. This would inspire more new entrants to compete with the incumbent lower-productivity firms or "stayers" that Professor Fukao describes. OECD studies have found that competition policy significantly influences the entry rate in many countries.

Last, the government can lead by example, helping startup firms acquire new customers through the use of small business set-aside and preference programs, rather than by spending public funds on subsidies. As mentioned in the chapter on immigration policy, the government can also send out positive signals by making it easier and faster for foreign entrepreneurs to immigrate to Japan and get visas.

The Significance of Labor Mobility

Workforce mobility is critical to the success of startups, both individually and collectively. Besides engineers, scientists, and other technology experts, venture businesses depend on veteran personnel with expertise in fields such as management, finance, law, intellectual property and marketing.

One of the biggest challenges new ventures in Japan face is assembling a savvy management team. Because the average tenure at Japanese companies is up to two times longer than at U.S. companies, capable employees at established firms have much to lose if they launch or join a startup. They have no way to return if the startup fails, nor is it easy for them to go elsewhere. And without the benefit of experienced hands, first-time entrepreneurs all too often repeat common mistakes and fail.

A 2005 Mitsubishi Research Institute study revealed, for example, that researchers in Japan's economy are virtually immobilized (Figure 9).

One urgent task is to devise flexible ways for full-time employees to join venture businesses without losing their affiliation with their original organization, thereby providing a fallback option in case of failure. Strengthening Japan's safety net would also help immensely. (Please see the chapter on the need to improve labor mobility and the safety net.)

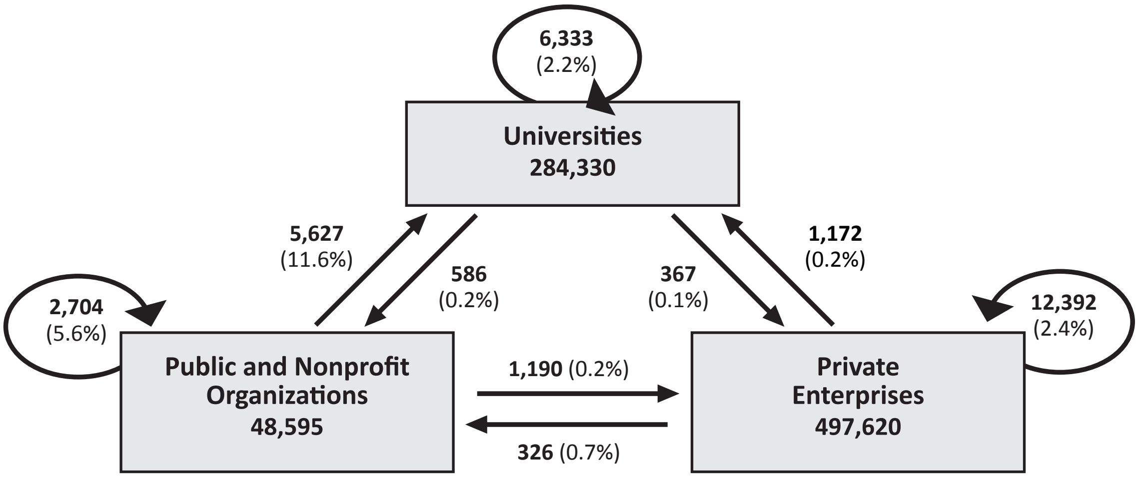
Deepening Capital Markets Without Displacing Them

Capital is also necessary to launch and grow startup firms, but the government has to get policy right. The evidence demonstrates that too much easy money coming directly from the government stifles entrepreneurship by crowding out private sector financing and creating a

Mobility of Researchers

Figure 9

Number of researchers and job changes within and between organizations in FY 2003



Source: National Institute for Scientific and Technological Policy (NISTEP) and Mitsubishi Research Institute (2005).
Note: Includes liberal arts and social studies, and postdoctoral students. Figures in parentheses show the proportion of researchers in each sector that changed positions in 2003.

crippling dependence that wastes public funds.

Government's most fundamental role in capital markets is to set the proper incentives to ensure that private capital flows to new businesses that demonstrate the capacity to turn a profit and grow. When the government steps in with direct subsidies, loan guarantees or other measures that can completely displace private sources of finance, it paradoxically deprives new firms of the chance to cope with market forces. Learning that hard lesson makes businesses more attractive as investments as well as better competitors at home and abroad.

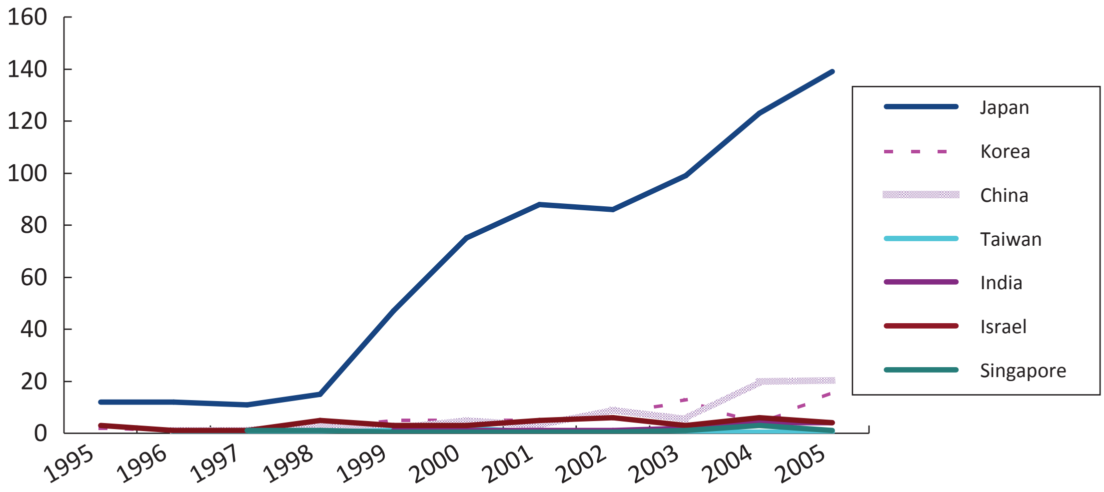
Japan is often said to suffer from a shortage of "risk money." This perception is inaccurate. The country actually has a surplus of capital and savings, a significant portion of which is invested in emerging markets and alternative investments. Nevertheless, it is true that new Japanese businesses have trouble attracting private investment from institutional investors. In fact, only about 3 percent of funding comes from institutional investors, compared to about 80 percent in the United States.

Under these circumstances, the best way for the Japanese government to help is to relax policy and permit a small proportion of public pension money to be invested in venture businesses—but only when private fund managers are making the decisions. At present, leading government pension funds allocate essentially none of their portfolios to venture capital investments.

If these pension funds were to distribute a small portion of their holdings to worthy new businesses selected and managed by private fund managers, the signaling and "vouching" impact would be significant. In addition, private-sector fund managers would then have the incentive to identify superior managers and innovative technologies that need funding and have potential, and to introduce foreign and domestic partners when they are needed.

Number of US Patents in Renewable Energy

Figure 10



U.S. Patent Office data, courtesy of Glenn Hoetker, Director, Center for International Business Education and Research, University of Illinois

At the same time, the pension funds' portfolios would be better diversified. At present, they are overexposed to the threat of domestic interest rate increases from their holdings of Japanese government bonds.

Capitalize on Technology, and Do It Quickly

Fortunately, Japan possesses a vast store of technological knowledge that can serve as the basis for launching thousands of new businesses. This technology base includes both existing patents as well as research under way at universities, research institutes and private corporations. Japan's rate of R&D "intensity" is the highest in the OECD, running at 3.2 percent of GDP as of 2003 versus an average of 2.2 percent. As the Eberhart-Gucwa Report points out, Japan's technology and patent base is much more potent than in other Asian countries in the key area of renewable energy (see Figure 10 above).

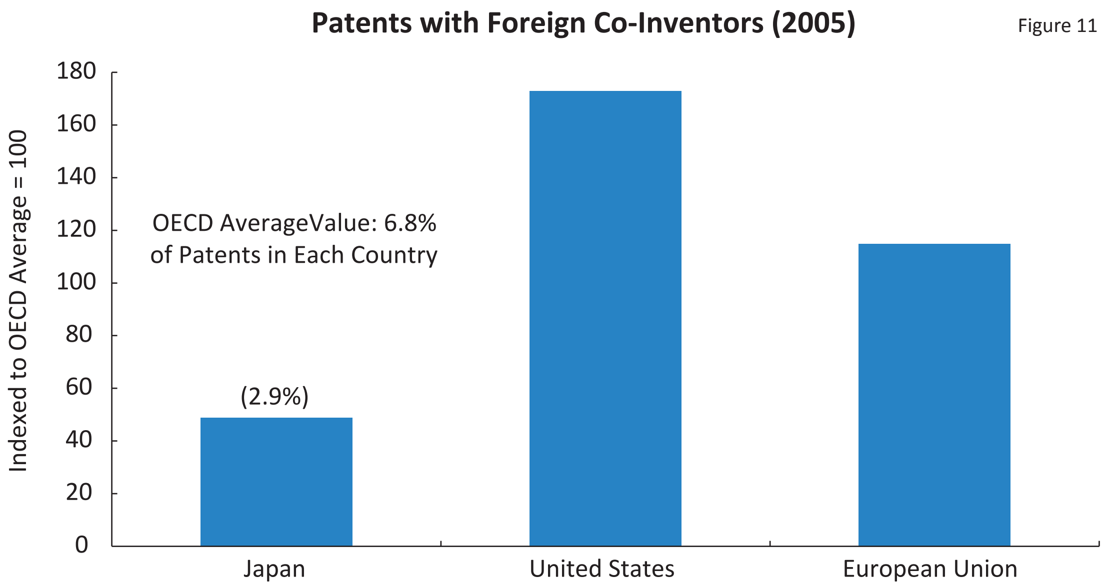
But Japan's huge technology base faces some issues on the way to generating profits and jobs. As Professor Fukao has pointed out, most of Japan's R&D is done by large companies or universities and is not dispersed among small companies. The Fukao-Kwon Report's productivity analysis suggests what many technology experts believe: too much of Japan's technology base appears to be underutilized or uncommercialized. Then again, vertical business groups have declined, reducing technology spillovers to small firms. Last, only a small portion of Japan's R&D benefits from international collaboration, as Figure 11 reveals.

Despite the high rate of R&D intensity, R&D efficiency in manufacturing has declined (OECD report cited above, p. 12), and Japan scored lowest in a survey comparing self-perceived success in innovation (Figure 12, next page).

Against this background, startup firms represent an attractive way for Japan to better capitalize on its technology base, by allowing large firms to acquire technology and new business models, and universities to profit from their research successes.

In addition, finding ways to decrease the time and expense of the patent application process would facilitate the commercialization of research performed

Figure 11



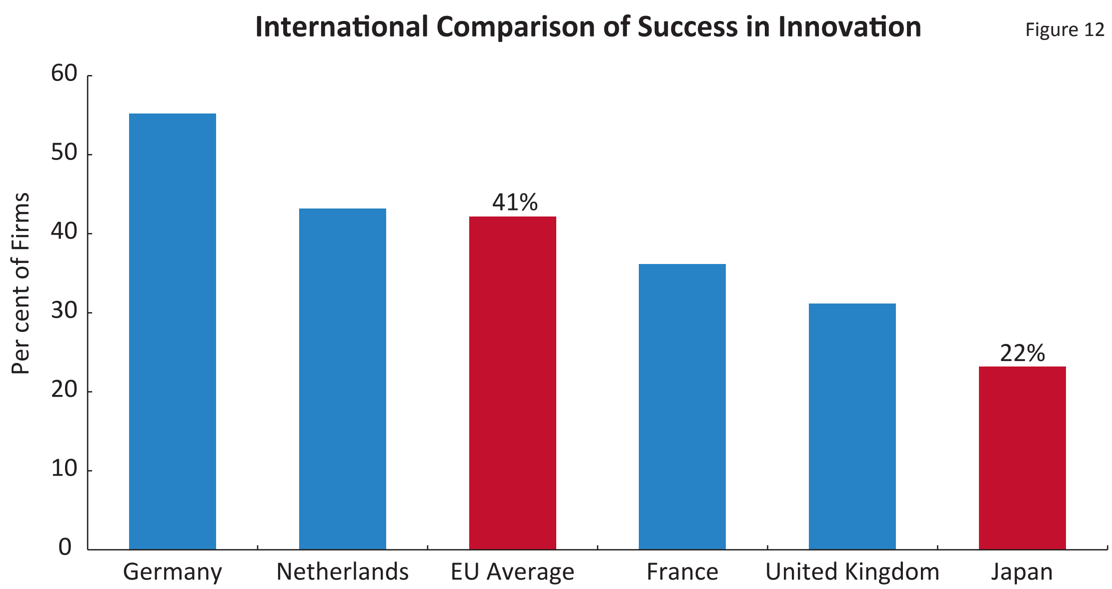
Source: *Upgrading Japan's Innovation System to Sustain Economic Growth,* Economics Department Working Paper No. 527 (p. 9), taken from OECD, OECD Science, Technology and Industry Scoreboard 2005.

at universities and other institutions by reducing administrative burdens on for university researchers.

In the fast-moving, global and knowledge-intensive economy of the twenty-first century, individual governments can't pick winners in new technologies and new business sectors. General subsidies or support policies are neither fiscally prudent nor economically effective. What will work—and has already worked in Japan—is entrepreneurship combined with policies that promote development, full utilization, and dispersion of new technologies.

To foster this entrepreneur-friendly environment, the ACCJ recommends

Figure 12



Source: *Upgading Japan's Innovation System to Sustain Economic Growth, Economics Department Working Paper No. 527* (p. 11), taken from National Institute of Science and Technology Policy, *National Innovation Survey 2003,* and Eurostat, *Innovation in Europe.*

the policies set out below. Our recommendations represent a starting point rather than a comprehensive guide. While the basic tasks at hand are clear, finding ways to achieve them will require relentless experimentation. In that effort, a well-publicized political commitment to supporting entrepreneurship and a spirit of aiming globally will be essential to success.

III. RECOMMENDATIONS

A. Leadership: Communicate How Vital Entrepreneurship Is to the Nation, and Celebrate Successes

The ACCJ recommends establishing an Office of Entrepreneurship in the Cabinet, reporting directly to the prime minister and headed by a senior political appointee. This office will establish and communicate, at the most senior levels, a clear national policy model for the promotion of entrepreneurship. The Office of Entrepreneurship should:

- Be placed above and independent of any individual ministry or agency. This would enable the office to coordinate among different ministries and help the Prime Minister become a spokesperson for change and advocate for entrepreneurship.
- Conduct analysis, hold regular hearings to solicit private-sector business and expert views on policy issues, and recommend government-wide policies to the Prime Minister to implement measures that will improve the business environment for new firms. Committees composed of industry participants and experts would advise the Office of Entrepreneurship, including both non-Japanese entrepreneurs based in Japan and Japanese entrepreneurs operating businesses overseas.
- Use innovation awards to draw positive attention to the role of entrepreneurs in bringing innovation to market. Specifically, the office could confer special awards on five entrepreneurs each year for their contributions to constructive change and growth in the Japanese economy.
- Be bold about celebrating thriving entrepreneurial businesses in government literature, official speeches and public relations, both domestically and internationally, to signal that Japan is an attractive place to start a business.

B. Create Sustainable Business Opportunities for Young Companies

The ACCJ recommends:

- Discontinuing policies that provide general or focused subsidies to existing SMEs, many of which may in fact be small, old and uncompetitive. Instead, implement government measures that help those small firms that are competitive acquire new customers or business, using “set-asides” or specific requirements to spend a set percent of each ministry’s budget on orders to small businesses. This will support SMEs that deserve it, based on arms-length market pricing and where there is actual demand for the product or service.
- Reducing regulatory barriers and other hurdles that hinder new market entrants and promote standardization that helps them, especially in growing non-manufacturing industries such as medical services, education, internet-related businesses, media and agriculture. (As an example, please see the chapter on the Internet Economy.)
- Revising the Bankruptcy Act, removing disincentives to would-be entrepreneurs by expanding the items exempt from seizure in the event of business failure. This will enable the person filing for bankruptcy to retain his or her residence, privately owned

vehicle, pension, and minimum living expenses for one year (3,960,000 yen). (The current law only exempts minimum household items, pension and minimum living expenses for three months in the amount of 990,000 yen from seizure.)

C. Secure Talented Human Resources for New Businesses

Train entrepreneurs and attract human resources, including foreign talent, and foster the mobility of skilled labor that new businesses need to succeed, in the following ways:

- Incorporate policies to improve the entrepreneurial environment as integral parts of national education policy. This effort should include measures to foster creative and critical thinking, communication skills, practical knowledge and the ability to function in cross-border environments, as well as high-level proficiency in foreign languages, particularly English. Further, require undergraduate and graduate engineering and technical studies majors to take courses on entrepreneurship and fundamental business knowledge.
- Encourage entrepreneurs from abroad to establish businesses in Japan by increasing ease of use and relaxing the criteria for "self-sponsorship" visas. At the same time, revise visa regulations to enable foreign graduates of Japanese universities to remain in Japan longer after graduation to search for a job, and to apply their years as students so as to more easily qualify for permanent resident status. (Please see the chapter on immigration policy.)
- As described in the chapter on labor mobility, implement measures to promote new hiring and transfers to other firms, while fortifying the safety net. As part of such labor policy reforms, create broadly acceptable employment guidelines that would enable employees of private firms, universities, research institutions and other organizations to take leave from their positions to establish or join a startup business while retaining the option to return to his or her original position (or a comparable position) within a period of three years.

D. Emphasize Private-Sector Financing and Encourage Market-Based Equity Financing of Startups and Small Businesses

The financing of existing small businesses and startups should be positioned as being neither a government responsibility nor social welfare. Instead, it should be presented as a rational, market-based investment activity that benefits society through the employment and innovative technologies that new firms create, and the tax revenues they will generate.

The ACCJ urges the Japanese government to change present policy and take the clear stance that investment in and financing of venture businesses, other new firms and small businesses is a for-profit business activity to be conducted by private-sector firms, pension funds, and other entities whose investment decisions are not directly controlled by the government.

Toward this end, the ACCJ recommends the following:

- That the Office of Entrepreneurship work with the Ministry of Economy, Trade and Industry (METI) and the Financial Services Agency (FSA) to standardize venture capital funding documentation in both English and Japanese, based on the advice of relevant experts, and publicize best practices and successful methods for venture financing and the growth of new businesses.

- That the Office of Entrepreneurship cooperate with METI, the FSA, the Ministry of Education, Culture, Sports, Science and Technology (MEXT) and other relevant parties to publicize standard best practices in the launching and financing of new businesses both domestically and abroad, such as the use of term sheets, and standard structures and their documentation. This will prepare Japanese entrepreneurs to carry out cross-border business transactions more easily and effectively.
- Enable private-sector partners in any deal involving any quasi-public, non-pension fund (such as the Innovation Network Corporation of Japan) that may invest in startup businesses to buy out the fund's interest in a transaction at attractive terms that ensure a suitable minimum rate or return to that fund (such as 8 percent), thereby using government participation to reduce risk to venture capital investors rather than to displace private investment.
- Permit the Government Pension Investment Fund to gradually increase its allocation of funds to third-party, private-sector fund managers and venture capital funds that specialize in startup investments from zero percent to three percent.
- Have the Office of Entrepreneurship take the position that a new firm's ability to deal with the rigors of the market represents an essential test of its attractiveness as an investment target. This includes recognizing that, statistically speaking, many ventures will fail, and that as a matter of public policy the resources tied up in failed ventures—including skilled personnel—should be allocated to more productive enterprises.
- As set out in the chapter on tax policy, enhance the "angel investor" tax system by increasing the maximum amount of investment that can be deducted from total income, and raising the maximum age of qualifying venture companies. In addition, allow losses from dispositions to offset any other type of income, and set up an alternative income tax credit system.

E. Make Better Use of Japan's Technology Base and Intellectual Property

The ACCJ recommends taking the following steps in this area:

- In consultation with intellectual property law practitioners, amend the Patent Act to permit the filing of a provisional application with the Patent Office using university or other research papers before filing a regular application. This will provide researchers a low-cost option to begin the patent application process, signal the intent of the inventor to commercialize an invention, and stimulate interest among possible licensees and business partners.
- More strictly enforce "march-in" rights under the Japan Bayh-Dole Law to force universities and companies to license underutilized technology created with government funding, and amend the law so that a certain portion of nonspecific funding is considered to be de-facto government funding of research.
- As proposed in the chapter on tax policy, permit Japanese LLCs (*godo gaisha*) to elect a pass-through taxation system, and permit their conversion into *kabushiki kaisha* on a tax-deferred basis. This will facilitate R&D collaboration, especially between corporations and universities, and the formation of new businesses based on such cooperation.
- To encourage faster technology spillovers and dispersion into new areas and smaller firms, create a

bilingual and searchable national database with user-generated uploads for underutilized technology that anyone can access.

- Have the Office of Entrepreneurship continue to publicize basic information regarding the creation, protection and management of intellectual property rights as a core element of business strategy for new firms and SMEs.

IV. CONCLUSION

Startup businesses and young, fast-growth firms have underpinned the vitality of Japan's economy in the past. The Fukao-Kwon and Eberhart-Gucwa reports suggest that new firms can also do so in the future. To thrive, Japan needs to generate a larger number of new startups that will compete with other companies to introduce disruptive new products and technologies and sell them globally.

With this end in mind, the ACCJ recommends that the government of Japan make the promotion of entrepreneurship and the rapid commercialization of new technologies a national priority. Japan's most senior national leaders need to convey the importance of these policy themes to the Japanese people, and carry out the changes needed to build a market-led environment that supports new businesses and fully utilizes Japan's prodigious technology base.

While many of the particular issues at stake may be complex in their details, the guiding principles we urge policymakers to follow are simple: *Promote what promotes entrepreneurship, and promote the creation of new technologies and their commercialization.*

Expand Inbound Foreign Direct Investment to Stimulate Growth and Create Jobs

I. EXECUTIVE OVERVIEW

The recent global financial crisis has worsened Japan's economic difficulties even as the country is busy dealing with the effects of a rapidly aging society and sluggish domestic investment and demand. The Fukao-Kwon Report points to a potent method of reinvigorating Japan's economy and creating jobs and growing GDP: boost inbound foreign direct investment (FDI). Professors Fukao and Kwon have shown that FDI brings new jobs, high productivity, and new business models.

Unfortunately, a host of other countries are far more attractive destinations to foreign investors than Japan. Japan's excessive regulation, high operating costs, high tax rates, low labor mobility, lack of opportunities for acquisitions by foreign companies, and the absence of concrete incentives for investment continue to push investors away. While the government has set a goal of a 5 percent FDI base of GDP by 2010, the current level is well short of that modest percentage, and significantly lags behind that of other Organisation for Economic Co-operation and Development (OECD) countries.

Many of the policies set forth in this white paper promise to boost FDI flows into Japan. Among them, a more vibrant mergers and acquisitions (M&A) market and a strong and transparent corporate governance regime are the most essential for increasing FDI in the near term. Tax and legal problems, however, are shackling M&A transactions in Japan. Other obstacles include the lack of independent directors on Japanese corporate boards, the proliferation of takeover defenses by Japanese corporations, and the recent resurgence of cross-shareholding arrangements aimed at bolstering those defenses. Some of these issues also cause portfolio investors to doubt the ability of Japanese managers to compete on a global playing field.

The ACCJ urges Japan to deploy integrated government policies that foster inbound FDI and increase public awareness of the benefits of FDI. The ACCJ also recommends taking legal, tax and corporate governance measures to facilitate M&A transactions and encourage domestic and foreign investors to invest long-term in Japan.

II. ISSUES AND ANALYSIS

FDI: A Key Driver of Sustained Economic Growth

Economists are well aware that FDI plays a vital role in enhancing and sustaining economic growth in all countries. The long-term benefits of FDI to Japan are both financial and nonfinancial. They include:

- Raising overall productivity by speeding the introduction of new management expertise and business models
- Accelerating the diffusion of new business know-how, products and technology
- Improving returns on capital
- Increasing investment flows
- Stimulating growth and employment

The Fukao-Kwon Report confirms the benefits of FDI in general, and shows that between 1996 and 2006 foreign-affiliated enterprises in Japan had the highest productivity among all company categories, and contributed more to the growth of domestic net employment than all other types of companies in Japan except newly-established firms.

The report also validates the previous in-depth study of FDI in Japan by Professors Fukao and Amano, which the ACCJ commissioned in 2003. Those findings, subsequently published as an award-winning book, demonstrated the following benefits of FDI:

- Productivity is high at foreign-affiliated enterprises, and generally improves at Japanese companies that they acquire in M&A transactions.
- FDI contributes to the accumulation of management resources in Japan.
- Foreign companies in Japan grow faster and create more new jobs than Japanese companies.
- FDI increases Japanese exports by combining foreign technology and management skills with Japanese technology.
- The benefits of FDI extend beyond major urban centers, with most of the facilities and over half of the employees of foreign-affiliated firms located outside Tokyo, Kanagawa and Osaka.

Compared with other forms of investment, such as portfolio investment, FDI is made with a longer view and is slower to withdraw in troubled economic times. So while all types of investment are generally good for an economy, direct investment offers extra benefits. As the Fukao-Kwon Report reveals, FDI created new employment at a faster rate during the “two lost decades” than domestic companies because it brought along with it new business models, know-how, products and management methods. Direct investment has boosted productivity and supplied valuable risk capital to the market, two things that are utterly essential to any feasible growth strategy for Japan.

Notably, analysis of the Fukao-Kwon Report also revealed that on a net basis very few of the new jobs created by foreign-held firms resulted directly from M&A transactions. Rather, almost all of the new jobs arose as a result of new foreign firms entering Japan’s markets, or the expansion of existing operations (some of which were first acquired by M&A and then expanded).

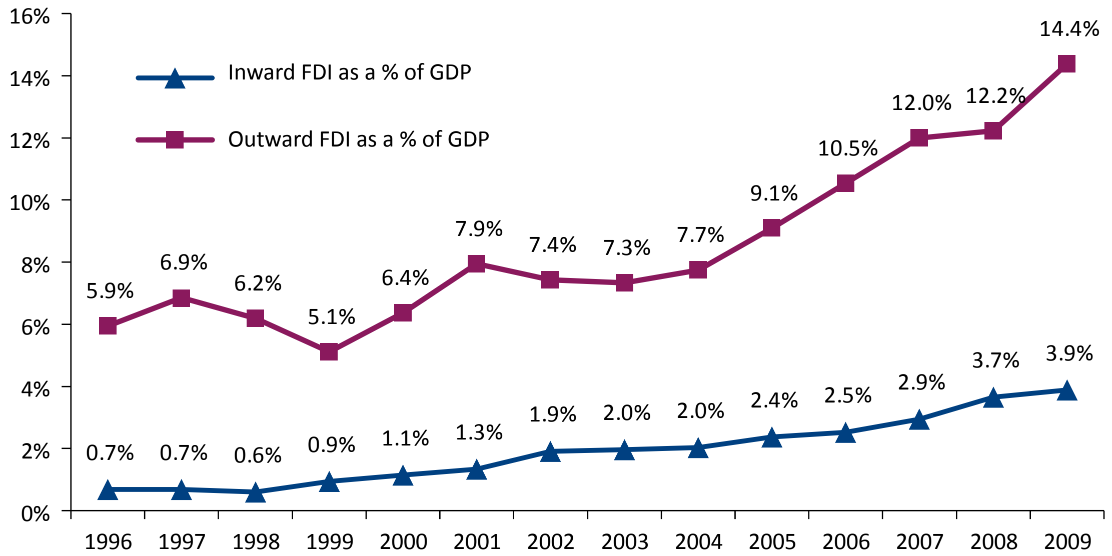
Moreover, because of the way the economic data are categorized, the aforementioned analysis did not include the significant contribution foreign entrepreneurs who live in Japan make to the nation’s economy. Such investments are not counted as FDI because they are being made by residents of Japan. The exact size of this group is hard to measure, but the composition of the ACCJ’s own membership suggests that it is not small, and that it is constantly growing as well. Regarding the potential for even greater activation of this group, please see the chapters on immigration, education and entrepreneurship policies.

Japan-Bound FDI Continues to Lag

In 2003, the Japanese government adopted a policy to double the nation’s cumulative base of FDI to 2.5 percent of GDP within five years. That target was nearly achieved. In May 2006, the government announced a new target of 5 percent, to be reached by 2010, and reaffirmed that commitment in early 2008.

FDI inflows, however, have dropped precipitously. Inbound FDI in Japan came to $11.8 billion in 2009, a fall of 52 percent compared to 2008. A collapse in M&A activity that pushed down equity capital inflows was the main cause of this sharp drop. During the first quarter of 2010, inbound FDI was just $535 million, a shocking 86 percent plunge from the same period in 2009. Japan appears

Cumulative FDI Base as a Percentage of GDP Figure 1



Sources: MOF (FDI data) and Cabinet Office (GDP data). End of year data.

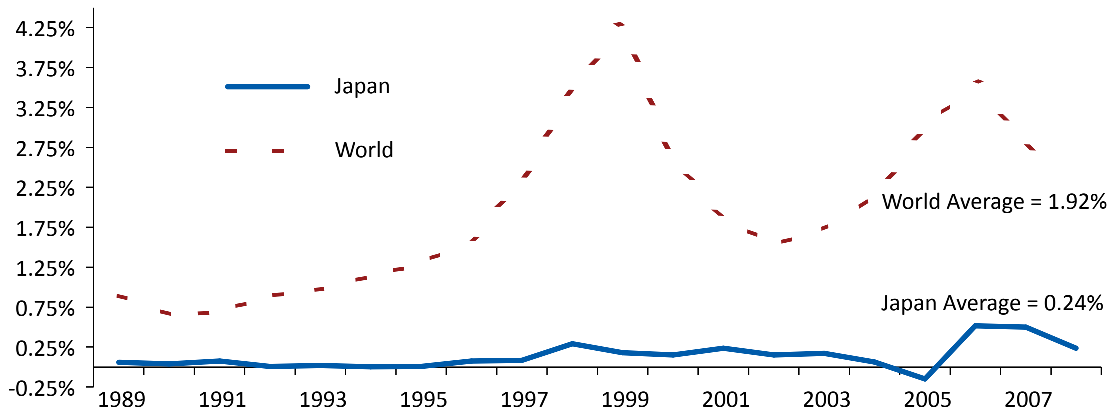
certain to miss its 5 percent target for 2010, a trend confirmed in the graph above (Figure 1).

The current low level of FDI lags far behind that of other OECD countries and is not enough to ensure Japan's sustained economic growth in today's harshly competitive global environment. Even 5 percent of GDP would be considerably less than that of Japan's competitors in the developed world.

Over the past two decades, global FDI flows have actually grown significantly, but Japan has failed to seize this opportunity as fully as other countries (see Figure 2 below).

At the end of 2008, only 2.2 percent of the nation's gross fixed capital formation came from FDI. That contrasts poorly with the 13 percent the European Union drew, the United Kingdom's 21.8 percent, 12.5 percent for the United States, and

Annual Inward FDI Flows as a Percentage of GDP Figure 2



Sources: UNCTAD and IMF.

6 percent in China, as calculated by the United Nations Conference on Trade and Development (UNCTAD).

As a result, Japan's economy benefits far less than those of its rivals from the advantages of FDI—productivity growth, innovation, management know-how and economic revitalization. This is a dangerous weakness when Japan is facing unprecedented macroeconomic and fiscal challenges, an aging and shrinking population, and the highest ratio of gross public debt to GDP among major OECD nations.

Japan's low level of inbound FDI is particularly troubling because its outbound FDI continues to rise as Japanese businesses put their funds into growth opportunities abroad. According to UNCTAD's World Investment Report 2009, Japan's outbound FDI flows jumped from 4.9 to 11.3 percent. Figure 3 shows that, in absolute numbers, annual outbound FDI hit 12 trillion yen at its peak in 2008, while inbound FDI flows reached just 1.8 trillion yen. Additional inbound FDI can help counterbalance outbound FDI flows and prevent a further "hollowing out" of the Japanese economy.

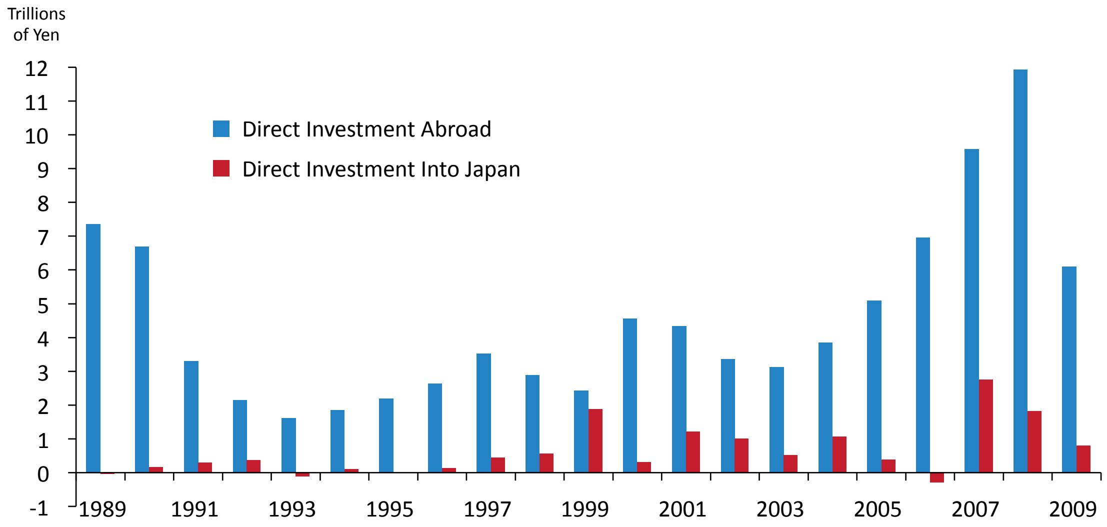
Japan is the developed nation that presently benefits the least from inbound FDI, and has the most to gain. The country urgently needs inbound investment to stimulate the economy and offset trends in demographics, productivity and domestic investment.

Japan's Market Appeal to Investors Remains Dangerously Low

Japan has the largest developed economy and the biggest and most sophisticated consumer and industrial markets in Asia. Yet many foreign investors do not consider it a desirable destination for direct investment. In fact, Japan wasn't even ranked on the list of the fifteen countries considered most attractive for FDI in UNCTAD's 2009 survey. (The leaders: China, the United States and India.) As Figure 3 reveals, even Japan's best corporations are coming to the same conclusion about the country's business environment and prospects.

Inbound and Outbound FDI (Japan Annual Flow Data)

Figure 3



Source: Ministry of Finance. Fiscal Year (4/1–3/31).

According to the UNCTAD survey, the factors considered most important to investors are market size, market growth, availability of less expensive labor, access to natural resources and business environment quality. Japan aims to be competitive on the basis of the first and the last factors, particularly the quality of its business environment. But excessive regulation, the slow pace of change, high costs, a lack of acquisition opportunities for foreign companies, and the absence of concrete incentives or regulatory regimes attractive to FDI make Japan far less appealing to foreign investors. (With regard to tax policy and the need to lower corporate tax rates and extend the net operating loss carry-forward period, please see the chapter on tax policy.)

These roadblocks, both real and perceived, are exacerbated by the lack of a government agency specifically charged with formulating FDI policy. Japan must demonstrate, with concrete measures, a higher level of commitment to attract FDI than it has so far.

Barriers to M&A Remain

M&A is the primary vehicle for inbound FDI in every developed nation. M&A transactions, and the expansion investment that often follows them, generate all of the same economic benefits that "greenfield" investments do—only faster. They also generate proceeds for the sellers, who use the funds to spend elsewhere in the economy.

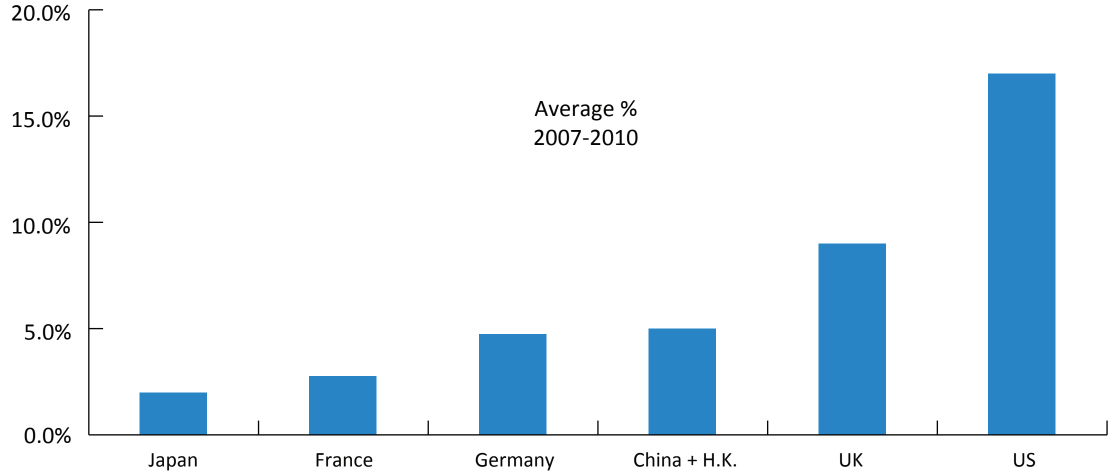
Among major economies, Japan benefits the least from these activities (Figure 4).

To be a magnet for inbound FDI on the scale needed to stimulate major economic growth and employment, Japan must become an active market for buying and selling control of Japanese companies. However, despite the potential benefits of increased FDI through M&A, barriers remain. Some examples:

Takeover defenses. Takeover defenses have proliferated in Japan in the wake of recent events involving activist funds. As of May 2010, 551 exchange-listed

Figure 4

Percent of Global Cross-Border M&A Sales* Volume



*Total net sales of the companies acquired in that region.
Source: UNCTAD.

companies had announced "poison pill" plans. Other firms have taken measures to the same end, such as increasing cross-shareholdings. Japanese law also effectively allows deployment of takeover defenses at almost any time.

However, there is still considerable confusion about the circumstances in which takeover defenses may be legally deployed in the interests of shareholders. The Ministry of Economy, Trade and Industry's (METI's) Corporate Value Study Group issued a report on this in June 2008, but most of the legal and practical problems remain. The boards of Japanese companies frequently form specialized "committees" in the context of takeovers. Because these committees lack any valid delegation of authority, fiduciary liability or basis in law, it is not clear that they function in a truly independent and value-maximizing manner.

The use of anti-takeover devices may be warranted in some situations. If defenses are employed to shield management and directors from accountability to shareholders, however, they perpetuate the international perception that Japan's corporate governance system lags behind that of other leading international financial centers, thereby impairing or even reducing FDI inflows.

Uncertainty regarding cash squeeze-outs. For reasons that include the difficulty of using stock considerations on a tax-deferred basis, almost all inbound acquisitions of Japanese corporations are for cash. In most circumstances, a cash purchaser will desire to acquire all of the target company's shares. That allows the buyer to manage the company without worrying about the company's short-term share price, minority shareholder rights or disclosure requirements under Japanese securities law. The Japanese government, recognizing the importance of allowing the purchaser of a public company to buy all of the company's shares, amended the Japanese Company Law in 2007 to permit cash mergers.

Unfortunately, a 2006 change to Japanese tax law treats cash mergers in an extremely unfavorable way, and has prevented widespread use of the new procedure. As in the United States and most other countries, the target company's shareholders are taxed on their capital gains. However, the target company itself is also taxed on the difference between the fair market value of the assets—as implied by the purchase price for all of the target company's shares—and their tax basis. Most public companies in Japan have assets with a low tax basis, and their revaluation results in an enormous gain taxable at an effective rate of up to 40 percent.

Enterprising Japanese lawyers have developed several ways of simulating a cash merger while apparently avoiding the tax on the target company's assets, such as the "callable share" (*zenbu shutoku joko-tsuki kabushiki*) method. However, such methods are unduly complex and confusing, and the Japanese tax authorities have provided no formal guidance to declare that these methods will bypass the asset tax. The complexity and uncertain tax treatment of these cash merger alternatives may deter potential investors, and increases transaction costs for all purchasers, domestic and foreign.

Modifying the Japanese tax rules to allow investors to use cash mergers to acquire 100 percent of a Japanese company without triggering tax on the company's assets would cut the transaction costs related to the complex "callable share" and other squeeze-out methods and encourage additional inbound FDI. However, the change would not reduce Japanese tax collections—since the revaluation tax is not being paid under the alternative squeeze-out methods—and would allow the 2007 amendments to the Company Law to use the cash merger mechanism as originally intended.

The difficulty of executing tax-deferred M&A transactions and corporate reorganizations. One of the biggest and most persistent barriers to FDI flows is the lack of tax-deferred treatment for a wide range of transaction structures for M&A and corporate reorganizations.

A tax deferral for cross-border forward triangular mergers was approved in May 2007, which at first glance appeared to be a positive development. In this scenario, a foreign parent company with a Japanese subsidiary acquires another Japanese company. The target company disappears, and the foreign parent issues stock to its shareholders in exchange for their shares in the target company.

However, the new rules require the foreign parent company to have a subsidiary in Japan with prior operations related to the target company's business unless the foreign parent company already holds a majority ownership stake in the target. The precise minimum requirements for this are unclear. Since the assurance of a tax deferral is essential to these transactions, this presents new entrants to the Japanese market with an unsavory dilemma: unless they first create an uneconomic business base in advance of the M&A transaction they use to enter the Japanese market, they cannot reduce a potentially huge tax risk to zero.

Faced with this unappealing choice and the tax risk, most foreign companies are unable to justify using forward triangular mergers to enter the Japanese market. The new rules therefore function as a barrier to market entry, favoring those companies with an existing base.

Moreover, a forward triangular merger is just one type of M&A transaction. Tax deferrals are still not available for virtually all other types of noncash cross-border M&A transactions. That includes reverse triangular mergers—which are not possible under Japanese corporate law—"stock-for-assets" exchanges, exchange offers and branch offices that foreign companies convert into Japanese corporations.

Making the above transactions legal and giving them tax-deferred treatment under reasonable qualifying conditions that prevent tax abuse would substantially reduce costs that pose a prohibitive obstacle to investment. In particular, the cost of paying tax even though the transaction has not yet generated any cash is a burden that ensures most of these transactions never occur. That denies Japan the tax revenues that successful transactions will generate through efficiency gains and taxable income.

Another factor that prevents efficiency-enhancing transactions is the inflexible nature of tax rules governing corporate reorganizations. This is especially true in the context of cross-border transactions. Japanese tax law needs to encourage transactions and make them more convenient. That will require expanding the present narrow focus that limits deferral to certain transactions defined in Japan's Company Law.

Significantly expanding the range of convenient tax-deferred alternatives for M&A, reorganization and branch office conversions in Japan would bring in more FDI by enabling transactions that wouldn't occur otherwise. It would also increase liquidity in the domestic M&A market, and make internal reorganizations at domestic Japanese companies more efficient. This would improve overall investment efficiency and the allocation of market capital, ultimately leading to greater tax revenues based on higher profitability and capital gains.

FDI Prerequisite: A Strong and Transparent Corporate Governance Regime

To invite FDI, ease transactions and assure investors that Japan's markets are fair and safe, Japan's corporate governance regime must be stronger and more transparent, adhering to internationally accepted principles such as those the OECD has laid out. Attracting international flows of capital will allow Japan to take advantage of the benefits of international investment and global capital markets and improve its competitive posture in the world economy.

The presence of outside directors is a prime indicator of an independent and objective board of directors that promotes strong and transparent corporate governance. According to the OECD, the board oversees corporate strategy and is also responsible for monitoring management's performance and "preventing conflicts of interest and balancing competing demands on the corporation." To help boards manage these competing responsibilities, internationally accepted principles of corporate governance emphasize the importance of ensuring that boards are able to "exercise objective and independent judgment," including through a "sufficient number" of independent board members.

Primarily as a result of the scarcity of independent directors on Japanese boards, in September 2009 Governance Metrics International ranked Japan 36th out of 39 nations for overall quality of corporate governance.

In 2010, the Tokyo Stock Exchange (TSE) began requiring companies it lists to have at least one independent board member in accordance with the TSE's definition. After the June 2010 round of shareholders meetings, however, close to 10 percent of listed companies still had not met that requirement. Moreover, only a quarter of the TSE's 2,299 listed companies had appointed independent outside directors, and more than 85 percent of those companies had only appointed one. The remaining 75 percent of TSE-listed firms fulfilled the requirement by appointing an "independent" statutory auditor. Statutory auditors, however, do not have the right to vote and therefore have limited influence on crucial board decisions.

These numbers are far from what global investors expect from Japan's top stock market. By contrast, most large Asian markets require exchange-listed firms to have more than one independent board director, and do not permit companies to use non-voting parties such as statutory auditors to meet that requirement.

Cross-shareholdings, which allow shareholders to exercise a degree of control much greater than the worth of their equity stakes justify, are also on the rise again in Japan. Nomura Securities Financial & Economic Research Center estimates that at the end of 2009, 11.7 percent of the shares of companies listed in Japan were held under crossholding arrangements. While this represents a 0.8 percent drop from 2008, the numbers have remained high for three consecutive years as more firms entered into cross-shareholding arrangements to bolster their takeover defenses.

Over the past two years, many of these investments were a primary cause of balance sheet deterioration and massive losses at Japanese banks and large companies. This is not surprising, because Ministry of Finance (MOF) statistics on all corporations show that a group consisting almost entirely of listed companies collectively held securities equal to 57 percent of their net assets at the end of 2008. In addition to weakening the financial system, this high level of security holdings saps vitally needed productivity from the economy because companies are investing their capital in non-core assets that do not manage themselves and which yield returns less than the corporation's cost of capital.

We applaud the amendments the Financial Services Agency (FSA) has made in 2010 to the disclosure rules applicable to listed companies in Japan requiring disclosure of certain cross-shareholdings. However, there is no guarantee that these new disclosure rules alone will reduce cross-shareholding among Japanese firms. Further reforms to governance structures and practices that enhance shareholder rights and transparency and make Japan a more attractive destination for FDI are needed. The ACCJ proposes the policies set out in the Recommendations section below.

Note: For a more complete discussion of corporate governance and shareholder rights issues, please see the ACCJ Viewpoints entitled "Improve Shareholder Voting Access and Disclosure to Enhance Corporate Governance and Boost the Credibility of Japan's Public Markets" and "Introduce a Legal Framework to Implement the Key Recommendations of the Corporate Value Study Group's June 2008 Report."

III. RECOMMENDATIONS

A. Leadership and Education to Encourage Inbound FDI

The ACCJ recommends the following measures to foster inbound FDI and raise public awareness of the benefits of FDI:

- Have the newly created National Strategy Bureau issue a Cabinet decision which formally affirms that the Japanese government remains committed to the policy of dramatically increasing foreign investment by implementing concrete goals and policies.
- Establish an FDI Policy Office within the National Strategy Bureau, headed by a political appointee and reporting directly to the prime minister independent of any particular ministry, to lead the formation of FDI strategy.
- Reconstitute the Japan Investment Council as an advisory council, comprised of foreign and domestic members with first-hand or research expertise in FDI to directly advise the FDI Policy Office on ways to increase the attractiveness of Japan as a global financial center and FDI destination.
- Conduct a robust campaign to educate the Japanese public about the need for FDI, including undertaking studies that show the benefits of FDI and publishing the results.

B. Institute Legal, Tax and Corporate Governance Measures to Encourage Inbound FDI

The ACCJ recommends the following measures to promote long-term investment by both domestic and foreign investors:

- Revise Japan's Company Law to require that independent directors comprise at least half of the board of any widely held or exchange-listed company in Japan. This should be according to a rigorous definition of independence as suggested by recent reports from METI's Corporate Governance Study Group and the Financial System Council's Study Group on the Internationalization of Japanese Financial and Capital Markets. Implementation of this requirement could be phased in over a period such as five years.
- Lengthen the carry-forward period for companies to use net operating losses for tax purposes from the current seven years to an unlimited period, with retroactive application allowed for several years.

Note: For a more complete discussion of topics related to the use of net operating losses for tax purposes and tax reform in general, please see the ACCJ Viewpoint entitled "Enhance Investment and Stimulate Economic Recovery Through Extension of the Net Operating Loss Carry-Forward Period," the chapter included in this report on tax policy, and the joint public statement made by Keidanren, the European Business Council, and the ACCJ.

- Reform the tax rules on corporate reorganizations on two fronts. First, by allowing flexible and convenient tax deferral for triangular mergers and other non-cash cross-border transactions. Second, by permitting the use of cash mergers to acquire all of a company's shares without triggering tax on the value of the company's assets, thus avoiding the complexity and uncertainty of the callable share squeeze-out method.

- Ensure that corporate anti-takeover strategies, including cross-shareholdings, do not impede the functioning of Japan's market for M&A transactions, in line with METI's Corporate Value Study Group June 2008 report.
- Fortify and better enforce laws relating to regulatory information disclosure and transparency by improving access to the public comment and shingikai processes, publishing "no-action letters" in redacted form to make regulations more predictable, and expanding the usable range of discovery methods for civil court proceedings.

IV. CONCLUSION

Japan is the developed nation that presently benefits the least, but has the most to gain, from increasing inflows of FDI. Inbound FDI is vital to sustaining economic growth in Japan because of the higher productivity, new business models and access to international channels such investments bring. Japan needs to pull in more FDI to secure higher employment and productivity that enhances GDP, especially in the face of sluggish domestic investment and demand and Japan's aging society.

To become more attractive to foreign investors, Japan has to reduce excessive regulation, high operating costs and high tax rates, increase labor mobility, give foreign companies better opportunities for acquiring Japanese firms, increase confidence in corporate governance practices and their transparency, and create concrete incentives and regulatory regimes. If those actions are not taken, the current level of FDI in Japan will continue to lag far behind that of other OECD countries.

The ACCJ therefore recommends that the government of Japan adopt leadership and educational measures to foster FDI and increase public awareness of FDI's many benefits. The ACCJ also urges Japan to adopt the legal, tax and corporate governance measures needed to facilitate M&A activity and promote long-term investment in Japan by both domestic and foreign investors.

Mobilize Education to Internationalize Japan, Reignite Its Youth, and Promote the Knowledge Economy

I. EXECUTIVE OVERVIEW

Japan's internationalization during the postwar period was primarily directed outward through trade in manufactured goods and driven by an immense base of technical knowledge that brought rapid productivity gains. The nation's educational system produced a highly literate and well-organized workforce that served the country well during this period of enormous growth in global commerce.

The world, however, has changed. Many products can be manufactured for less in the developing world, and in an internet-based world the production of services flows inexorably to the most dynamic environments. The acceleration of globalization after 1990 has made creativity, versatility and rapid adaptability essential to economic success.

These altered conditions demand better, more responsive educational institutions. Unfortunately, Japan's educational system has been far too slow to adapt, and continues to produce graduates ill-prepared to help Japan and Japanese companies maintain their lofty position in the world economy. Japan continues to be one of the least internationalized OECD countries, and has lost the ability to energize its youth—a factor crucial to the postwar boom. During the "lost two decades" analyzed in the Fukao-Kwon Report, many young Japanese people have lost their confidence and ambition.

At this critical juncture in Japan's transition to a mature knowledge-intensive economy, its educational system must do far more than screen high school students and teach specialized information and skills. These students need more critical thinking and cross-border communication abilities, along with portable, practical, universally applicable skill sets, more entrepreneurial creativity and confidence, and adaptable, resourceful, analytical mindsets. Moreover, these qualities all need to be imparted much sooner in the educational process.

Japan's growth will come from a workforce with more young people equally at home in a Japanese organization or a foreign one, who can serve as bridges between companies and between countries. The country needs more graduates who can become leaders in innovation and internationalization, and it needs to produce more of them than its own declining population can supply.

II. ISSUES AND ANALYSIS

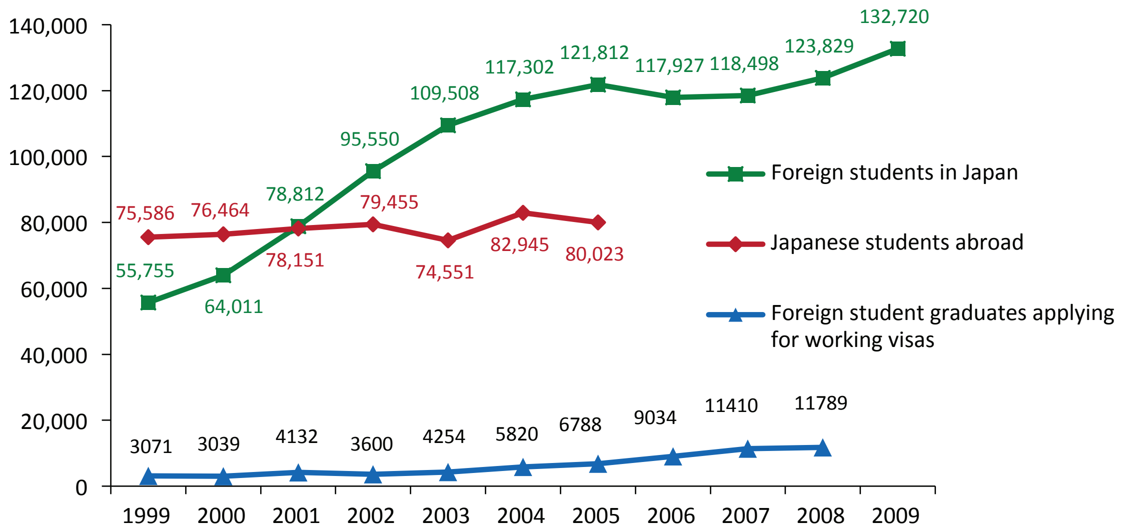
The 300,000 Plan and Globalizing Secondary Education

In August 1983, Japan was host to just 10,000 international students, which spurred then-Prime Minister Yasuhiro Nakasone to announce a plan to have 100,000 international students here by the start of the twenty-first century. As of the year 2000, however, Japan had only attracted around 65,000 foreign students. Subsequent changes to immigration law led to a wave of Chinese students, and by 2005 there were over 120,000 foreign students studying in Japan (see Figure 1 on the next page).

Despite this massive increase in the foreign student population, the percentage of post-secondary international students in Japan remained low compared to other leading OECD countries (see Figure 2). In January 2008, then-Prime Minister Yasuo Fukuda sought to remedy this, declaring a goal

Inflow and Outflow of Foreign Students

Figure 1



Source: MEXT.

of 300,000 international students by the year 2020. The Ministry of Education, Culture, Sports, Science and Technology (MEXT) followed up with detailed plans for achieving the goal, known as the "300,000 Plan."

While there is much to admire in the 300,000 Plan and related initiatives, the program faces major challenges as well as questions about its strategy. There are also many features of the country's education system that lie outside the

International Student Enrollments in Select OECD Countries

Figure 2

	U.S.A	U.K.	Germany	France	Australia	Japan
Students enrolled institutions of higher education **(1,000 persons)**	**10,797** (17,487) (includes part-time students) (2005)	**1,513** (2006)	**1,979** (2006)	**2,217** (2006)	**1,029** (2006)	**3,516** (2008)
Number of international students	**623,805** (2007)	**389,330** (2007)	**246,369** (2007)	**260,596** (2007)	**294,060** (2007)	**123,829** (2008)
Percentage of International students enrolled in institutions for higher education	**5.8%**	**25.7%**	**12.4%**	**11.7%**	**28.6%**	**3.5%**

Source: IIE (U.S.) "Open Doors," Higher Education Statistics Agency (U.K.), Federal Statistical Office (Germany), DAAD (Germany), Ministry of Education and Ministry of Foreign Affairs (France), Australian Education International (Australia), MEXT, and JASSO.

scope of the plan that Japan must address before its educational system can help accelerate Japan's slow economic "metabolism."

The 300,000 Plan: Challenges and Limitations

Competition from other education centers

When Prime Minister Nakasone announced his 1983 plan to attract 100,000 foreign students, fewer competitors were tapping the global pool of pupils interested in studying abroad. Many countries now understand the benefits of attracting foreign students, making the competitive environment more severe every year. For example, the European Union has ramped up its ERASMUS system for student exchanges among member countries. China is dramatically increasing its numbers of foreign students and offering them government scholarship support. Beijing announced plans in early 2010 to add another 10,000 foreign students over the next year. Singapore, with a population less than 4 percent of Japan's, has announced plans to enroll 150,000 foreign students by 2015, meaning foreign pupils would constitute 20 percent of all university students there. Korea is also aggressively seeking to expand foreign student enrollment.

The long-term stagnation of Japan's economy and growing interest in China and other countries are damaging the nation's ability to woo students. Beginning in 1998, Japan enjoyed five years of dramatic gains in international student numbers. From 2003 to 2008, however, enrollment remained stagnant (see Figure 1). The number of foreigners enrolled in Japanese-language programs in Japan fell as well.

A dearth of globally elite universities

For the 300,000 Plan to succeed in the face of greater overseas competition and declining interest in Japan and the Japanese language, colleges and universities here need to burnish their global reputations. This is a major challenge. While the ranking of global universities is highly subjective, perception is reality. Unfortunately, the perception is that Japan has fewer elite universities than its wealth and population warrant. The following list shows the handful of Japanese universities that three leading sources rank among the top 100 global institutions.

Japanese Universities in Global Top 100 Rankings Figure 3

QS Top Universities (2010)	Newsweek International (2006)	Times Higher Education (2010)
24 The University of Tokyo	16 The University of Tokyo	26 University of Tokyo
25 Kyoto University	29 Kyoto University	57 Kyoto University
49 Osaka University	57 Osaka University	
60 Tokyo Institute of Technology	68 Tohoku University	
91 Nagoya University	94 Nagoya University	

Sources: QS Quacquarelli Symonds (http://www.topuniversities.com); Newsweek (http://msnbc.msn.com/id/14321230/site/newsweek/); Times Higher Education (http://www.timeshighereducation.co.uk/world-university-rankings/2010-2011/top-200.html).

Top 20 (from Top 200) 2010 Asia University Rankings
QS Top Universities

Figure 4

Country	School Name	Rank 2009	Rank 2010
China (H.K.)	University of Hong Kong	1	1
China (H.K.)	Hong Kong University of Sci. & Tech.	4	2
Singapore	National University of Singapore	10	3
China (H.K.)	Chinese University of Hong Kong	2	4
Japan	University of Tokyo	**3**	**5**
Korea	Seoul National University	8	6
Japan	Osaka University	**6**	**7**
Japan	Kyoto University	**5**	**8**
Japan	Tohoku University	**13**	**9**
Japan	Nagoya University	**12**	**10**
Japan	Tokyo Institute of Technology	**9**	**11**
China	Peking University	10	12
Korea	Korea Advanced Institute of Sci. & Tech.	7	13
Korea	Pohang University of Sci. & Tech.	17	14
China (H.K.)	City University of Hong Kong	18	15
China	Tsinghua University	15	16
Japan	Kyushu University	**15**	**17**
Singapore	Nanyang Technological University	14	18
Korea	Yonsei University	25	19
Japan	University of Tsukuba	**19**	**20**

Source: QS Quacquarelli Symonds, http://www.topuniversities.com/university-rankings/asian-university-rankings/overall

Just as the rivalry among countries for international students is intensifying, so is the competition among universities. Another recent "perception is reality" ranking of Asian universities shows that several leading Japanese universities are dropping in status versus their regional competitors (Figure 4, with declines for Japanese universities indicated in red and ascensions in green).

MEXT has developed the "Global 30" initiative to counteract these trends. The program is meant to help internationalize designated elite universities in Japan, expanding their course offerings in English and opportunities to obtain a degree by studying primarily or exclusively in English. The Global 30 program has great potential, but it appears to lack political support and may

Source Countries for International Students in Japan (2007) Figure 5

Country	Number of Students	As Percentage of All Foreign Students in Japan
China	**71,277**	**60.2%**
Korea	**17,274**	**14.6%**
Taiwan	4,686	4.0%
Vietnam	2,582	2.2%
Others	22,679	19%
Total	**118,498**	

Source: MEXT materials

suffer budget cuts even before it can have any meaningful effect.

Regional but not global appeal

Despite substantially raising foreign enrollment since Prime Minister Nakasone announced his 100,000-student goal in 1983, studying in Japan has regional appeal but holds little global cachet. As shown in Figure 5, Japan draws 75 percent of its foreign students from only two countries—China and Korea—and very few from outside Asia.

The group of international students studying in Japan for a year or less is only slightly more diverse: in 2007, 45 percent were from China or Korea, and 15 percent were from the U.S. However, Japan does not even rank among the top ten most popular destinations for U.S. college students studying abroad: in 2008, Japan even trailed several other non-English speaking countries, including seventh-ranked Mexico, eighth-ranked Germany, and Costa Rica, which was tenth. Japan's ability to draw large numbers of students from China and Korea may prove beneficial to all three nations, but over-reliance on just two countries as sources of foreign students creates a risk for Japan. One reason is that Chinese and Korean students are beginning to look to their own rapidly improving universities. Another is that if problems arise between Japan and either country—witness the recent escalating tensions between Japan and China—they could adversely affect enrollment numbers.

Opportunities for students represent opportunities for Japan

MEXT and other governmental bodies, as well as universities in Japan, have tried hard to draw foreign students here. They have expanded student recruitment fairs and information, streamlined visa procedures, enhanced Japanese-language preparatory training, boosted financial assistance for foreign students, built affordable housing for them, and expanded opportunities to study in English. These efforts are commendable, but international students need more compelling reasons to choose Japan over other education destinations. The most persuasive one will be to show that studying in Japan leads to career opportunities here, including internships and post-graduation opportunities locally or with Japanese enterprises overseas.

As noted in the chapter on immigration and shown in Figure 1, few individuals studying in Japan remain after graduation to contribute to Japan's economy. This is a serious loss, because the college-age population in Japan is expected to fall 30 percent between 1995 and 2015. Bringing foreign students here as a supposed panacea for this demographic "time bomb" but then sending them home will derail the 300,000 Plan and deprive Japan of the benefits of contributions from foreigners who have adapted to living in Japan. Rather than viewing foreign students as a short-term solution for maintaining enrollments at Japanese universities, Japan should view them as long-term contributors to inward FDI and further economic development.

"Internationalizing" and going beyond the 300,000 Plan

If internationalizing education in Japan is to derive all the benefits that the cross-fertilization of peoples and ideas bring, Japan's policy initiatives should be far broader than the 300,000 Plan. They should also include efforts to attract international faculty and educational institutions. Japan's adoption of the "designated foreign university" system in 2005, for example, was a positive step. However, that one step took many years, tremendous effort, and overcoming major scepticism about the contributions foreign institutions could make to education in Japan.

Contrast this situation to efforts in other countries. In 1997, for example, Singapore announced its intention to recruit ten world-class universities to set up branches within a decade. The goal was met in half that time. Several oil-rich Middle Eastern countries have also aggressively recruited many U.S. and U.K. universities, convincing them to establish branches and collaborations with local schools. India and China—initially wary of foreign universities—now pursue them avidly. Japan should be doing the same, seeking out foreign educational institutions in Japan and foreign sponsors for Japanese universities.

The 300,000 Plan also lacks measures directed toward Japanese students. For example, there is a significant risk that many Japanese universities will split into separate institutions operating in parallel on one campus, with a Japanese program serving Japanese students and an English program serving foreign students. This is apparently already a reality at some schools. If this phenomenon occurs on a wide scale, the 300,000 Plan will be a failure even if it meets its numerical target. The plan will fall short of transforming post-secondary education, pull in less FDI, and fail to reinvigorate Japan's low economic metabolism.

The 300,000 Plan is by nature entirely "import"-oriented. To some extent, it makes sense for Japan to concentrate more resources on this rather than "exporting" students given that it is already among the world leaders in the number of its students who study abroad and a laggard in attracting foreign students. However, supporting Japanese students who want to study abroad by should not be neglected. Many of them will return to Japan and become valuable contributors to globalization in Japan in multiple levels of society.

Japan needs to pursue many other administrative, fiscal and deregulatory reforms to globalize education in Japan and the reputations of its leading universities. These are necessary to encourage and enable universities to better adapt to the global post-industrial economy.

Modernizing the Base: Primary and Secondary Education

This chapter focuses on post-secondary education. However, Japan's primary and secondary schools have also failed to adapt to the dramatic changes of the last two decades. The 300,000 Plan, Global 30 Plan and other efforts to enhance the global status and contributions of Japan's universities will only succeed if Japan also makes major changes in primary and secondary education.

A major problem is the placement exam-driven educational system, which focuses on rote memorization and the uncreative application of memorized information. That served Japan well from the 1950s to the 1980s when the "applied engineering" skills of incrementally improving foreign technology were in demand, but is wholly inadequate today. In the modern era, Japan's economy can only flourish as a center for creative innovation, new business formation, high-value services provision and leading-edge research. The education system has to do a much better job of stimulating creative thinking, teaching cross-border communication skills, and instilling entrepreneurial spirit and confidence.

It is instructive that the two countries with the greatest share of world's leading universities—the U.S. and the U.K.—have nothing comparable to Japan's "cram schools," which are practically mandatory here for high-achieving students. Too much effort in Japan goes into ingesting existing knowledge, and too little into motivating people to create new knowledge by developing creativity and analytical skills. The U.S. faces major challenges of its own in primary and secondary education, but its system still produces and attracts large numbers of the world's future leaders in entrepreneurship, the sciences and business. This is part of the answer to the frequently asked question, "Why is there no Japanese Google, Microsoft or Apple?"

The failure of secondary education is critical because educational reforms at the post-secondary level have increased the number of innovative, interdisciplinary forms of learning for first-year students in Japanese universities. These excellent initiatives will be futile if students are not prepared to take advantage of them because their education focused on test-taking skills rather than open communication in innovative, interdisciplinary seminars. Some private universities have recognized this, and more are using alternative forms of acceptance, such as admissions office entrance exams. National and public universities, however, lag far behind their private counterparts in this respect.

Another major challenge for Japan is the quality of its foreign-language education. MEXT's 2003 "Action Plan to Cultivate 'Japanese with English Abilities' " and related efforts to introduce English study earlier in education are positive developments, but neither the plans nor their execution have been sufficiently bold. As in other fields, English education in Japan is driven too much by testing, and produces graduates who may score well on grammar exams but who are not able to carry on a conversation in English or other foreign language.

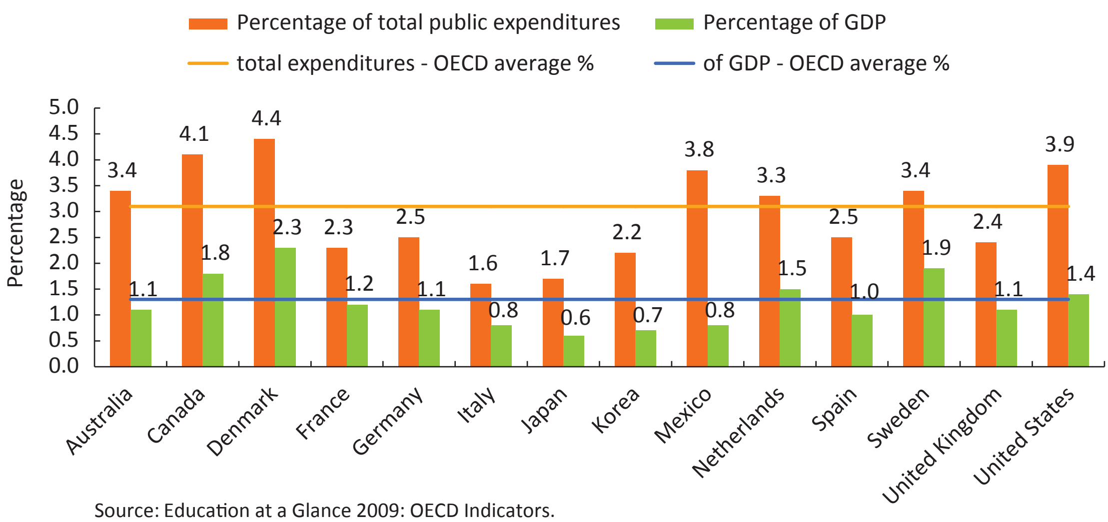
The top management of Western-based multinational companies and professional services firms regularly express frustration over the difficulty of recruiting strong, assertive English speakers in Japan, when at the same time their China offices are full of Chinese who are fluent in English and participate vigorously in company discussions. Even many executives at Japanese companies express frustration at the lack of English capabilities among their employees, and several have announced policies that require their employees to be fluent in English to be eligible for promotions.

It may be beneficial for MEXT itself to consider foreign-language study initiatives, since one impediment to foreign educational institutions developing or expanding their presence in Japan is that all meaningful interaction with MEXT must be done in Japanese. This is true of many other ministries as well, even when senior staff have studied abroad.

Education spending is also a challenge for Japan. As shown in Figure 6 below, Japan

Total Public Expenditures on Tertiary Education in 2006

Figure 6



Source: Education at a Glance 2009: OECD Indicators.

currently allocates a lower percentage of GDP to education than other leading OECD countries. In an era of budget cuts and other efforts to reduce Japan's extraordinary public debt, it is naturally a major challenge to increase spending in a given area. Japan would benefit greatly, however, from finding ways to spend more—and more wisely—on education.

III. RECOMMENDATIONS

The ACCJ recommends the following measures to enhance and globalize all levels of education in Japan. In particular, these actions will help Japan's universities contribute more to the Japanese economy and society and foster conditions that draw more FDI into Japan.

A. Internationalize Higher Education

If Japan is to boost its vitality as a knowledge-intensive economy, it must be able to compete globally for the best students, the best faculty, and research funding. These measures will help:

- Refine the business strategy and goals of the 300,000 Plan to ensure that it serves as far more than a stopgap strategy for replacing Japan's declining college-age population with foreign students as a way to shore up university finances. Changes to the plan should include efforts to better integrate foreign and domestic students and to enhance opportunities for international students to make continuing contributions to the Japanese economy after graduation.
- Enhance support for the Global 30 program and measures at other universities to develop their programs for international students and the globalization of Japanese students and faculty.
- Streamline visa applications for foreign students and provide them with affordable housing, financial assistance and access to educational loan programs. (Please see the chapter on immigration.)
- As detailed in the chapter on immigration, extend the post-graduate visa period for students who attend Japanese educational institutions and enable the time

they spent earning a degree here to count toward the requirements for a permanent resident visa.

- To make it easier for Japanese universities to attract highly qualified foreign professors, the latter must be hired under the same conditions as Japanese faculty and integrated into the university as equals. In particular, they must be treated as permanent, full-time employees in terms of contract provisions, working conditions, position description, faculty status and administrative responsibilities.
- Bolster the status of designated foreign universities by giving them the same benefits *gakko houjin* (the standard business form Japanese universities use) enjoy. Those benefits include exemption from most taxes, the right to sponsor student visas, eligibility of students for government loans or other financial aid, access to MEXT research grants, and the ability to participate in incentive programs such as the Global 30 Plan.
- Actively recruit foreign educational institutions to set up in Japan as designated foreign universities and develop joint ventures or other collaborations with Japanese universities. In addition, permit a range of structural alternatives for joint ventures to receive the benefits described in the preceding paragraph, and encourage foreign organizations to sponsor Japanese universities.
- Streamline procedures for transferring credits from non-Japanese universities to Japanese universities.
- Unify and clarify the system of accreditation and the accrediting bodies for all universities in Japan—national, public and private. Use this as a foundation for making significant strides in formulating academic degree and quality assurance standards more comparable and compatible with universities in China, Korea, Europe and North America.

B. Reform General Higher Education

- Move away from the current system of supplying private universities with massive government subsidies, which often constitute 10-15 percent of their operating budgets. Given the demographic changes occurring in Japan, some schools can and should close. Rather than supporting failing schools and subsidizing all private institutions, redirect government monies to scholarships and loans to students needing financial assistance. This will push schools to compete more vigorously for students and improve the efficiency of their operations. Similarly, permit increases in tuition rates at national and public universities (after increasing financial aid), and encourage schools to become more financially self-sufficient by developing ties with business, strengthening alumni organizations, donations from alumni, and other measures.
- Allow universities greater flexibility to develop innovative programs and forms of administration, and deregulate requirements on curricula and faculty-student and faculty-administration ratios. Maintain minimum standards that conform to accreditation norms in countries with leading education systems.
- Consider creating a national public service organization to employ and socialize young graduates, teach them leadership skills within organizations, and to serve as a possible means to facilitate student loan repayments. National public service could encompass a whole range of fields, such as disaster relief, aid to foreign countries, assisting the poor and elderly, participation in special

regional or national government programs, or by joining the Self-Defense Forces.

C. Modernize and Improve Primary and Secondary Education

- Implement measures throughout the education system to deemphasize placement exams that depend on "teach to the test" and "cram school" training. Develop cross-disciplinary, participatory education that fosters creativity and trains students to create new knowledge and learn critical thinking and communications skills relevant to working in a rapidly changing world.
- Begin education in English in kindergarten, set higher TOEFL standards during educational development, and expand opportunities for studying Mandarin Chinese and other languages. Emphasize interactive conversational skills more during foreign-language training. Shield the JET program from budget cuts, or ensure that any replacement program brings a steady flow of native English speakers to Japan to assist in English-language training.
- Close the gap with other OECD countries in the level of funding allocated for education.

IV. CONCLUSION

Japan's educational environment needs a serious overhaul at all levels if it is to produce students able to compete with their peers from other nations in the global economy. That includes giving them better practical and leadership skills, more flexible mindsets, and a more international outlook. Universities in Japan are also losing foreign students to competitors in the region because the welcome mat—in areas such as financial support and post-graduate educational opportunities—remains thin and uneven. Adopting the ACCJ's recommendations will help Japan regain economic strength and regional stature.

Revitalize Growth and Competitiveness with Tax Policies That Spur Productive Investment and Innovation

I. EXECUTIVE OVERVIEW

Nations only have three "drivers" to grow their GDP. They can make their workforce bigger, invest more capital, or use research, innovation and creativity to increase labor productivity and capital inputs. Economists generally recognize the massive potential benefits that R&D offers.

In Japan's case, these dynamics are critical considerations. Because of its fast-declining working-age population, Japan cannot depend on that driver to generate growth. The nation will have to achieve positive increases in investment or productivity in order to grow at all.

Moreover, as Professor Fukao has aptly pointed out, a lack of investment is not Japan's core problem. Rather, the issue is the relative lack of *productive* investment, exacerbated by Japan's chronically low "metabolism" when it comes to reallocating capital, labor and technology to higher-productivity uses. Japan needs policies that focus on pushing up productivity and accelerating the reallocation of these resources to the new investments, new entrants and new innovations that will contribute most to revitalizing its economy.

The Fukao-Kwon Report's analysis backs up these conclusions, showing that new entrants such as newly-formed businesses and businesses supported by inbound foreign direct investment (FDI) generated the vast majority of net jobs growth in Japan between 1996 and 2006. Moreover, foreign-held firms and young companies that were R&D-intensive or pursued "internationalized" strategies such as early exports had significantly higher rates of productivity, productivity growth and capital accumulation than other categories of company. Consequently they contributed more to growth in Japan than most other investment flows.

The tax reforms described in this chapter are intended to promote economic growth and higher employment in Japan in three ways. First, by encouraging more long-term risk-taking investments likely to be productive and profitable, from both domestic as well as foreign sources. Second, by promoting a much higher level of entrepreneurship and related investment in Japan. Third, by inspiring greater cooperation between the private sector and educational institutions to exploit intellectual property originally created through the research activities of universities.

With that in mind, the ACCJ encourages the government of Japan to reduce corporate tax rates, extend the net operating loss carry-forward and carry-back periods, and make compensation for corporate officers fully deductible. Similarly, we recommend permitting pass-through taxation for limited liability companies (LLCs) in Japan and improving tax benefits for "angel investors." The following sections outline our reasoning and specific recommendations.

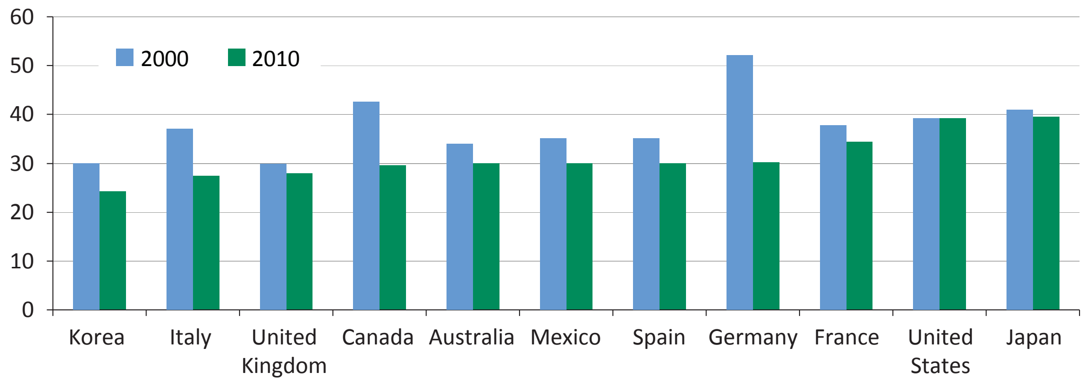
II. ISSUES AND ANALYSIS

The Problem with High Corporate Tax Rates

High corporate tax rates in Japan are hurting the country's international competitiveness and making it less attractive to new companies, foreign direct investors and high-productivity domestic investors. To spur growth and recover its competitiveness, Japan urgently needs to cut these tax rates to encourage more high-productivity

Corporate Income Tax Rates, 2000 vs. 2010 Figure 1

Top 11 OECD Countries by GDP



Source: *OECD Tax Database.* Corporate Income Tax Rate (percentage) refers to the basic combined central and sub-central (statutory) corporate income tax rate given by the adjusted central government rate plus the sub-central rate.

investment by foreign and Japanese companies, new market entrants and entrepreneurs. Lower corporate tax rates will also enhance domestic demand for new products and services by profitable companies, which will have increased after-tax resources.

New entrants will make many of these investments. Some will be new to Japan or startups with a creative new technology or product idea. Others will be smart Japanese companies using their technology and know-how in new areas or applications.

In short, many of them will be taking risks. They might consider the risk worthwhile, however, if they believe they have superior technology or know-how—or a superior business model—that can beat the competition. This is how a great deal of resource reallocation and productivity growth naturally occurs.

To encourage such entrepreneurial investment, it is necessary to improve the odds for risk-taking investors who create new businesses or expand their current activities. Risk-taking investors foster maximum economic growth and add jobs, both of which will help revitalize the Japanese economy.

The past decade has brought a clear global trend to reduce corporate tax rates. Unfortunately, Japan's corporate statutory tax rate ranks as the world's highest at approximately 41 percent. This compares unfavorably with tax rates of 27.5 percent for Korea, between 28 and 30 percent for the United Kingdom, Sweden and Australia, and between 33 and 34.5 percent for France, Canada, Belgium, Italy and New Zealand. Only the United States at 39.26 percent come close to Japan's rate.

Figure 1 above illustrates both the recent trend to reduce corporate tax rates and the significant difference between Japan's corporate tax rate and those of the other top ten OECD countries.

High corporate tax rates put both firms operating in Japan and the Japanese economy at a competitive disadvantage whenever global investment decisions are made. After-tax profits for Japanese companies stand at less than 60 percent. In contrast, Korean companies enjoy after-tax profits of around 72.5 percent, giving them more funds to reinvest in their businesses or return to shareholders.

As a result, Japanese businesses are less attractive in global capital markets, and their cost of capital rises. That discourages new job creation and investment in new or expanded business activities in Japan. High corporate tax rates therefore represent a clear disincentive for FDI in Japan when countries imposing lower corporate taxes offer more attractive alternatives.

According to a recent Dai-Ichi Life Research Institute study, lowering Japan's corporate tax rate by 10 percentage points could lift the nation's real gross domestic product by an estimated 5.9 trillion yen within a decade—equal to a 1.1 percent boost in economic growth. The resulting rise in on-hand liquidity at Japanese companies could also lift capital investment by 3 percent.

Dai-Ichi estimates that a lower tax rate could also entice more foreign companies to set up businesses in Japan, bringing an approximately 20 percent rise in investment from abroad. The report further predicts that larger investments will help create 200,000 new jobs.

If Japan does not take action now, the outbound transfer of Japanese companies is likely to accelerate, as will the recent tendency of multinational companies to bypass Japan when planning their Asia strategies. Japan may be left out of the global economic recovery, losing domestic employment and economic vitality.

Net Operating Losses: Carry-Forwards and Carry-Backs

Startup enterprises and "long-tail" capital-intensive projects typically require a massive investment. Japan currently allows net operating losses to be carried forward for only seven years, and permits no carry-back of these losses for businesses capitalized above 100 million yen.

Businesses such as startup firms that incur significant costs during the early stages of their existence, however, frequently require much longer than seven years to successfully commercialize their products. This occurs precisely because they invest substantially in research and development, facilities and equipment, marketing and promotion, and sales infrastructure to achieve long-term growth.

Very few companies would invest for more than seven years unless they are confident of making money later on. However, such costs cannot be deducted from any future profit that accrues after net operating loss carry-forwards expire. In Japan's case, that expiration date comes only seven years later. This means, in effect, that after that point companies will take a double hit for such early costs on a pre-tax basis, not only paying the costs themselves but also in the form of greater total taxes imposed on the future profits necessary to refund those costs.

The result? For every million yen of early costs incurred, a business will have to generate profits of 1.67 million yen to cover one million yen in early costs and 0.67 million yen in taxes. This onerous tax burden reduces the internal rate of return of investments intended to generate future profits.

Furthermore, where external factors such as the global economic downturn have triggered rapid deterioration in business performance and caused significant losses, the opportunity to deduct such losses is more likely to be lost when the net operating loss carry-forward period ends.

This problem arises for *any* business, not just startup companies. An extended net operating loss carry-forward period would also be an effective way to help companies in Japan retain and hire employees and invest in employee training from a long-term perspective, since it would allow them to recoup the costs at any time without an excessive tax burden. In this light, the Fukao-Kwon

Report's comments about the low level of off-the-job training in Japan compared to other developed nations are particularly relevant.

The United Kingdom, France, Germany, Singapore and Hong Kong allow indefinite carry-forwards, and the United States allows a twenty-year carry-forward. These countries have decided that it is simply good tax policy to have a long carry-forward period, for reasons like those described above. Japan's seven-year carry-forward policy is clearly inconsistent with the global standard other developed nations have set, and forces Japanese companies to compete with foreign firms subject to less onerous restrictions.

From the standpoint of international competitiveness, Japan is at a disadvantage as a market seeking investment. Foreign-based businesses considering major investments in this country are likely to see seven years as too short a time frame in which to recover investment costs, especially when they factor in startup costs, the economic environment, and the unpredictability of expected returns.

Japan's short carry-forward period has become a crucial issue in the current economic environment globally and within Japan, where continued slow economic growth is predicted. Slow growth conditions mean it will take longer for companies to garner the returns needed to pay back their investments and generate a profit on those investments. In many cases, they will conclude that other countries are more viable options from a risk-management perspective.

Extending the net operating loss carry-forward is therefore essential. However, that measure will only assist companies that make profits they can offset against the net operating losses carried forward. To provide assistance to companies with existing net operating losses, Japan also needs to extend the loss carry-back provisions.

Japan had a one-year net operating loss carry-back that applied in principle to any Japanese company, large or small, between 1950 and 1984. The provision was then suspended until 1988, made a brief comeback, and was dropped again in 1992. The one-year loss carry-back was reinstated in 2009 for enterprises with declared capital of 100 million yen or less, but not for those claiming capital in excess of 100 million yen.

This limitation on the carry-back rule should be eliminated. In fact, the current global economic downturn warrants an extension of the carry-back period to at least two years to allow any company to carry back losses and receive a refund of the corporate taxes it paid during prior years. This will provide an immediate boost to companies that suffered losses during the recent economic downturn.

The above measures will also enable companies to cope more effectively with variable profitability from year to year and avoid excessive short-term tax burdens. They will encourage companies to take risks by investing in and operating their businesses, with the knowledge that a spike in profits in one period—leading to a corporate tax liability for that period and followed by losses in future periods—can result in a refund of taxes paid on the profits enjoyed in the prior years.

The Benefits of Making All Executive Remuneration Deductible

The cost of compensating high-value corporate executives represents a considerable and ongoing expense for any business. Making the compensation of corporate officers fully deductible—including their bonuses—would reduce the excessive tax burden companies pay for their services.

Japan currently does not allow deductions for all executive remuneration. Significant restrictions are imposed on deductibility based upon whether the compensation is fixed and periodic and has been approved through corporate procedures. In particular, Japan generally denies a corporate income deduction on bonuses based upon corporate performance because such payments are considered to be a disguised distribution of profits.

The result is double taxation—taxes being imposed at both the company level and on the individual. This generates an unreasonably high cost of total compensation paid to executive officers in Japan, which includes not only the compensation paid but also the corporate taxes imposed on any amount not deductible at the company level.

Executive remuneration, including bonuses, is a necessary expense incurred during the course of business. The theory that certain compensation is a disguised distribution of profits is an outdated one that has no place in a modern economy. This is particularly true in the case of listed companies and other firms whose corporate governance and obligations to both shareholders and creditors have grown in recent years.

In this starkly competitive global environment, securing top-quality management is vitally important if a business is to successfully pursue corporate strategies. The current tax law imposes strict conditions for deducting officer remuneration but allows full deduction for employee salaries, resulting in unfair tax treatment.

This limitation on executive pay also has the harmful effect of making the remuneration structure rigid when it should be based on a company's particular circumstances. The remuneration structure becomes inflexible and unattractive to potential new managers. A company that designs a flexible compensation system risks incurring non-deductible expenses and a high tax burden, damaging its competitiveness.

The current restrictions on the deductibility of officer remuneration are particularly harmful to Japanese startups and foreign-based companies in Japan, which ordinarily require flexible compensation systems—including performance-based bonuses—to attract talented and experienced executives. Such businesses are at a disadvantage when they compete for talent against mid-size and large Japanese companies, which ordinarily have recruited their management staff over many years and offer them both monetary and non-monetary forms of compensation appropriate and expected in Japanese business culture.

To eliminate the double taxation of remuneration for personal services and reduce the cost of investment in businesses requiring high-value employee services, all director remuneration, including bonuses, should be made deductible.

Pass-Through Taxation for Limited Liability Companies

Double taxation at the corporate level and investor level imposes a heavy burden on the business profits of Japanese LLCs. Current Japanese corporate tax rules subject a company's profits to an effective national/local corporate income tax of approximately 40 percent. In principle, the recipients of the dividends are taxed again.

This double taxation of the same profits results in an excessively high overall tax burden—potentially as much as 65 to 70 percent—a strong disincentive to assume the entrepreneurial risks inherent in creating new businesses and exploiting new technologies. Entrepreneurs naturally will wonder why they should take risks just to lose up to 70 percent of the profits to taxes if they are successful.

The United States has addressed this problem effectively by allowing entrepreneurs to establish LLCs and have those LLCs treated as "pass-through" entities. Pass-through entities are taxed much like partnerships, with the profits of the partnership being taxed only once, when they are distributed among the partners in the venture.

The partnership form of business is a potential way to resolve the double-taxation issue. A variety of partnership options—including simple partnerships, silent partnerships, investment business limited liability partnerships, and limited liability business partnerships—already exist in Japan. So far, however, these partnerships have only been used for limited purposes. They include:

- Civil code (simple) partnerships and silent partnerships, which have often been used for narrowly defined investment projects. These include reasonably long-term investments in securities, real property, or other assets that are disposed of when the investment period ends.
- Investment business limited liability partnerships, which were first adopted for restricted purposes in 1998 and expanded in 2004. These partnerships are intended for specifically defined investment purposes—such as investments in securities, other investment partnership interests, and financing to facilitate venture capital investments—but not running an active business operation.
- Limited liability business partnerships, which were introduced in 2005 as a special measure civil code partnership to allow broader categories of business to use the partnership form. Limited liability business partnerships are still partnerships, however, and continue to encounter difficulties when dealing with third parties in matters of asset ownership, contractual relationships and reputation. In addition, these partnerships assume that all owners will have responsibility for operating the business.

As a result, Japan still has relatively little experience with the partnership form. Partnerships have not been used widely here as the basis of a functioning business that has to deal with customers, employees and third parties such as financial institutions and vendors.

Japanese entrepreneurs need a well-regarded entity they can use to deal with customers, employees and third parties but which does not result in double taxation of profits at the company level and the investor level. The *godo kaisha* form of company (GK), referred to as the Japanese LLC, is well suited to this purpose. Japanese LLCs should be permitted to select pass-through tax treatment, and investors should be allowed to fund the GK by contributing assets on a tax-deferred basis.

In addition, if and when the partners in a Japanese LLC consider making their entity a listed company, which requires becoming a *kabushiki kaisha* (KK), investors with financial interests in the LLC should be allowed to convert their interests into shares of KK stock on a tax-deferred basis.

Although Japan's experience with partnerships has been limited, many of the accounting and tax principles for partnership taxation have been developed over the years. These can be used for reference when designing the tax rules and reporting requirements to be applied to both LLCs that choose pass-through treatment and their investors.

The ACCJ believes that if Japan permits pass-through taxation for designated LLCs, the country can expect more new investment in business activities and greater economic activity and employment opportunities.

Enhanced Benefits Under the "Angel Investor" Tax System

The "angel investor" tax system was introduced in 2003 to encourage individuals to invest in venture companies, and was amended in 2008. The ACCJ believes that further measures should be taken to enhance and secure the intended tax benefits for angel investors and increase their incentive to provide such financial backing to startup companies.

At present, individual investors are permitted to deduct up to ten million yen (or 40 percent of their total income amount, whichever is less) for amounts invested in qualified venture companies. Alternatively, they may take their entire investment into account as a cost for the year in which they sell the venture company's shares. If losses occur, they may offset them against gains from the sale of shares and carry any excess losses forward for three years, and apply those losses against future gains from selling shares. If they take a deduction for their investment in the year of acquisition, that amount must be deducted from their basis (cost of investment) in the year of disposition to determine losses.

For the purposes of the deduction from income option, a "qualified venture company" is a small or medium firm under three years old. Depending upon its age, certain additional criteria apply. In the case of the deduction at time of sale option, the term refers to a small or medium company less than ten years old. Again, additional criteria are imposed.

The Impact on Educational Institution-Private Sector Partnerships Seeking to Develop and Commercialize Intellectual Property

As previously stated, economists generally believe that the potential benefits of R&D and innovation to Japan can be huge. This is particularly true for new, "disruptive" technologies and enhancements. Virtually all observers and experts agree that Japan's universities and companies possess a formidable base of technology that is underutilized.

Sangaku renkei, meaning "industry-university collaboration," is a popular buzzword in Japan. However, Japan's sangaku renkei successes have been few and far between considering its huge latent potential, and when compared to the countries that lead in this area, including the United States. There are no examples of a Japanese university producing a "Japanese Google" that brought the school $500 million in capital gains and launched a disruptive, paradigm-altering technology that created much growth, jobs and economic value.

The most significant reason for the lack of progress in this area has been a practical one: the absence of convenient and tax-efficient legal structures for pooling the financial, human and technology resources of private corporations and universities.

Allowing Japanese LLCs to use pass-through tax treatment and converted to KK status on a tax-deferred basis would change that scenario completely. Angel investors and corporations alike would immediately see much more potential upside and flexibility in investments, prompting them to buy in when they could not otherwise justify the risk. At the same time, would-be entrepreneurs at universities would see a much more feasible and tax-efficient path to a potential initial public offering after converting to a KK. Industry-university collaboration would become an exciting new beehive of economic and job-creation activity.

Although broadly applicable, the proposals described herein will be particularly effective in eliminating tax disincentives and offering tax incentives for investment in the development and commercialization of technology developed by educational institutions.

III. RECOMMENDATIONS

The ACCJ urges the government of Japan to pursue the following strategies as a way to improve the nation's business environment and economic status:

A. Reduce National Corporation Tax Rates

The ACCJ recommends cutting the national corporate tax rate from 30 to 20 percent. This will result in an overall national/local effective corporate tax rate of approximately 30 percent, which compares favorably to rates in other OECD countries.

B. Allow Unlimited Carry-Forward of Net Operating Losses and Permit Carry-Back for Two Years or More

The ACCJ recommends that Japan allow the unlimited carry-forward of net operating losses and also permit the carry-back of net operating losses for a period of at least two years, in light of the increasingly volatile economic environment.

C. Make the Remuneration of Corporate Officers Fully Deductible

The ACCJ recommends making compensation for all corporate directors and executive officers—including bonuses—deductible for corporate income tax purposes, without any requirement for onerous corporate approvals.

D. Allow Pass-Through Treatment for Japanese LLCs

The ACCJ recommends permitting Japanese LLCs (godo kaisha, or GKs) to elect a pass-through taxation system. Under this system, individuals or legal entities—including corporations and educational institutions—could contribute assets to the LLC on a tax-deferred basis.

Furthermore, the LLC's profits and losses would be allocated directly to those owning interests in it. This would ensure that the LLC's profits are taxed only at the level of the LLC owners, not under the national corporation tax law or local corporate tax laws.

The ACCJ also recommends allowing an LLC that has chosen pass-through treatment to be converted into a KK on a tax-deferred basis. The owners will be deemed to have contributed their interests in the LLC to the KK and received KK shares in return, with a carry-over basis in those KK shares reflecting their book value of the LLC interests at the time of the conversion.

The accounting and tax principles developed over the years for simple partnerships, silent partnerships, investment business limited liability partnerships, and limited liability business partnerships should be used for reference in designing the tax rules and reporting requirements to be applied to LLCs which elect pass-through treatment and their investors.

E. Permit Enhanced Benefits Under the Angel Investor Tax System

The ACCJ recommends amending the angel investor tax system to provide better, more certain benefits to investors, as follows:

First, increase the maximum amount of investment that can be deducted from the total income amount in the year of investment from 10 million to 20 million yen.

Second, increase the maximum age of qualifying venture companies from three years to ten years.

Third, offset losses incurred when venture company shares are sold against any other income, including salary, business income, and other income, not only capital gain income from the sale of shares.

Fourth, adopt an alternative income tax credit system for up to 50 percent of the amount invested.

IV. CONCLUSION

To boost economic vitality after two decades of stagnant growth, Japan needs to immediately focus its tax policies on measures that encourage productive investment and stimulate higher productivity. It is essential that tax policy promote the reallocation of resources to viable new investments, new entrants, and new innovations.

Building on the findings of the Fukao-Kwon Report, the tax reforms the ACCJ recommends are intended to promote economic growth and create more jobs in Japan. The Japanese government needs to encourage more long-term risk-taking investments that are likely to be productive and profitable, from both domestic as well as foreign sources. Japan also needs to foster a much higher level of entrepreneurship and related equity finance, particularly at the level of individual entrepreneurs and investors. Finally, it has to promote a greater degree of cooperation between the private sector and educational institutions to take advantage of intellectual property created through the research at universities.

Make Regulations and the Legal System More Transparent and Accessible to Promote Investment in Japan

I. EXECUTIVE OVERVIEW

A legal and regulatory environment that attracts foreign investors and encourages domestic investors and entrepreneurs to enter new markets is a key element in generating growth and jobs in Japan. Greater transparency, consistency and accessibility in the legal and regulatory environment will increase investment by enhancing the perception—based on reality—that the regulatory system is fair not only to incumbents but to all market participants. Similarly, a fair and dependable competition policy that protects competition rather than competitors is a critical factor affecting the investment decisions of new entrants and outsiders, and thus is also critical to the growth and health of a market economy.

To facilitate the adoption or refinement of policies that are friendly to foreign companies, the government of Japan should give foreign-invested firms a more active role in the policy formation process. In line with this, the ACCJ recommends modifying the public comment process to allow foreign companies to participate more effectively. We also recommend making the study groups and advisory councils that oversee the public comment process in certain industries—collectively known as *shingikai*—more transparent, uniform and open to both foreign enterprises and new market entrants. In addition, the ACCJ urges a more widespread adoption of "no-action letters" to improve clarity in areas of regulatory uncertainty, which will bolster industry and investor confidence. In the area of antimonopoly laws, we favor enhanced due process and procedural safeguards and more rigorous economic analysis during the adjudicatory process.

Finally, the ACCJ believes that the availability of better-integrated legal services will also make the legal and regulatory systems easier to navigate for new market entrants. We therefore encourage the elimination of cumbersome registration requirements for foreign legal professionals, as well as other practices and restrictions that hamper the profession-wide evolution of legal services, with the depth and sophistication that multinational companies expect.

II. ISSUES AND ANALYSIS

Due Process: Public Comment

The public comment process in Japan still has shortcomings. Meant to allow a well-informed and thorough debate of the underlying proposals and issues affecting laws, regulations, guidelines and agency recommendations, the process currently allows very little time for interested parties to provide input. Information on the proposed changes is also typically sparse. Rather than supplying the complete draft laws, regulations, guidelines and agency recommendations they have prepared, Japan's various ministries and agencies often provide only summaries.

Further refinement of the Administrative Procedure Law and Cabinet practices is necessary to ensure enhanced transparency in this process. For example, the ACCJ urges the Japanese government to make full drafts of the proposed changes rather than mere summaries available in a timely manner for public comment before such drafts are submitted to the Diet or ministry or agency for adoption. This will allow interested stakeholders to confirm whether their opinions are adequately reflected in the rule-making process, and to respond if they are not. Government agencies should also allow preliminary comments from foreign enterprises to be made in English—one of the primary languages used for international business and governmental affairs—to give foreign entities (in particular those who are new to Japan, or who do not have dedicated government relations staff) a voice in the deliberations while preparing a Japanese translation for submission.

The government of Japan should monitor and enforce compliance with the existing public comment process to ensure that all laws, regulations, guidelines and agency recommendations proposed are submitted for public comment. The government should also enforce a thirty-day waiting period after the public comment period expires and prior to the submission or release of a law, regulation, guideline or agency recommendation to give officials time to meaningfully consider the public comments received and reflect relevant concerns in the published measures.

Due Process: Shingikai

Leading foreign firms in Japan should be invited to serve as full members of the deliberation councils known as shingikai. To increase the usefulness and efficacy of the shingikai system, the ACCJ recommends the following:

Improved access

Administrative bodies should acknowledge foreign industry participants as crucial stakeholders, especially on issues pertinent to their interests and industries. Self-regulatory organizations should be required to allow all groups whom they regulate to fully participate in their proceedings. When their interests may be affected, startups and new entrants should be considered.

Clear and uniform standards

Administrative bodies should promote clear and uniform standards among different shingikai with respect to membership selection, disclosure of records, and acceptance of comments. This will provide the foreign business community with valuable guidance in ascertaining its role in the public comment process.

Greater transparency

Shingikai standards themselves must also be made more transparent as well. For example, shingikai should be more inclusive in their membership, more liberal in their release of records of internal discussions, and more receptive to public feedback. While shingikai sponsored by some governmental authorities have become much more inclusive, a greater opening up of shingikai membership to relevant parties (not merely to "neutral," academic, or passive domestic participants or advisors whose true opinions may hide behind their perceived reputations) will lead to a more integrated public comment process, and decision-making based on comprehensive input from all affected parties.

Furthermore, the administrative bodies should provide clear explanations for their findings and recommendations reached at the end of the public comment process. The explanations should reflect the majority view, the substantial minority positions, and any other dissenting opinions. A more meaningful release of information and exchange of opinions and debate will help both the foreign business community and domestic constituencies achieve greater awareness of future policy developments and contribute in useful ways to this important process.

Due Process: No-Action Letters

The no-action letter procedure should be available in all cases in which the provisions in question could determine the basis of an application's disposition, determine whether or not a license or approval is required, or influence a determination on whether an act or activity is permissible in light of the law or regulation in question. This should be the case even when noncompliance would not subject the business to penalties or sanctions. A viable no-action letter procedure is particularly important to non-incumbents and non-insiders.

There are a few ways to ensure that businesses use no-action letters more frequently and more effectively. First, the agency should inform companies making inquiries about the procedure, and encourage companies to use it. To make the procedure more convenient, each agency should make clear in its rules of implementation that responses to inquiries should be given as soon as possible, and in any case not later than a specified deadline—for example, thirty days after the date of the inquiry or additional submission of information by the applicant at the agency's request, whichever is later.

In addition, the no-action letter procedure should be used at more agencies and should cover more business practices. For example, it should be possible to apply for a no-action letter not just for a current or contemplated business practice, but also on a past practice about which some concern remains, particularly when the prior practice might be the basis for similar activities. Rapid changes and the introduction of new laws and regulations affecting a broad spectrum of business activities may render ongoing activities non-compliant or even have a retroactive effect. The business may need to confirm the permissibility of such activities (and thus the impact on a past investment or an ongoing line of business) in light of a new law or regulation.

It is also crucial that no-action letters fully disclose the basis for the agency's judgment, since other companies may look to previously published no-action letters for guidance on compliance with applicable laws and regulations. This will foster a compliance culture and good corporate citizenship.

Other Due Process Issues

The current system must do more to adhere to fundamental due process principles and transparency in investigations and give firms being investigated sufficient opportunity to prepare and present their defenses. For example, it is essential for the Japan Fair Trade Commission (JFTC) to bring its procedures into line with the standards of other leading competition agencies the JFTC often cooperates with before the Anti-Monopoly Act amendments are implemented. A competition policy that protects competition rather than competitors is critical to new entrants, those who are not insiders, and paradigm-shifting technologies and business models.

Right to counsel

The right to have legal counsel present during all aspects of an investigation—including and in particular during witness interviews—should be guaranteed. This is particularly important in light of the increased coordination and information sharing among competition authorities around the world, which in turn requires a party to be aware of the risks and differences in each jurisdiction. It is therefore essential for the target of an investigation and its employees who may be subject to interrogation to have ready access to counsel to ensure that defenses or privileges in other jurisdictions are not waived unknowingly.

Attorney-client privilege

The ACCJ believes that Japanese law should fully recognize attorney-client privilege as fundamental, but we recognize the difficulty in expeditiously implementing such a reform. Accordingly, we request as a limited reform that the JFTC and other administrative bodies at least recognize and respect the privileges and protections that exist in other jurisdictions whenever they are asserted during the course of a proceeding, particularly when a proceeding relating to similar facts and circumstances may be brought by another regulator. This limited measure would at a minimum help to ensure that parties do not waive their rights in other jurisdictions.

Specifically, the ACCJ recommends that parties be given the right to assert privileges and protections at the time of seizure, if it is possible to determine which documents are privileged, and upon review of documents the administrative body has seized or requested. As explained in greater detail below, it is critical that parties have access to documents seized by the administrative body. Parties could be required to assert the privilege based on written logs by attorneys certified in the jurisdiction in which the privilege applies. Ideally, the administrative body would not be allowed to review such documents.

At the very least, for purposes of avoiding waiver, parties should be allowed to designate documents or portions of documents as privileged or protected, and the administrative body should avoid disclosure of such documents to any third party, including other governmental agencies and courts.

Sharing of evidence against the accused

Access to an administrative body's allegations and evidence is fundamental to a fair defense opportunity. We recommend that the JFTC and other administrative bodies explicitly provide that a party has the right of access to the evidence against it prior to the issuance of an administrative order. Even when a party's own documents are seized during a dawn raid, there is no guarantee that a party can obtain copies of such documents.

The JFTC in particular retains discretion to refuse to allow copying, and in practice has done so. This is particularly unfair, since a party should at the very least be made aware of which of its documents the administrative body may be relying on. This practice is also extremely disruptive to ongoing business activities, and imposes a severe burden before liability has been adjudicated. The document inventory index provided by the JFTC is not sufficient to determine what specific documents were seized, or their contents, since the JFTC takes the originals. At the very least, the right to copies of documents seized by administrative bodies should be ensured.

Confidentiality

The current rules do not afford adequate protection of information provided to the JFTC and other administrative bodies during an investigation. The administrative body should be obliged to keep all information provided to the administrative body during an investigation confidential (except such facts that are required to be presented in a final order, as with the statement of objections in the European Union (EU)), and implement a similar policy to the EU and the U.S. with respect to information provided pursuant to a leniency application. Such provisions would be even more effective if the officials of the administrative bodies were subject to sanctions for breaching their confidentiality obligations. Strengthened confidentiality protections would also increase parties' (and the public's) confidence and trust in the agency.

Adequate notice and opportunity to present a defense

Presenting a proper defense requires adequate notice and time to prepare, prior to issuance of an administrative order. As the Supplementary Resolution states, the notice of tentative order should be explicit and sufficiently detailed to enable a business to consider and prepare its defense. While the rules provide that the JFTC must set a deadline to present views and submit evidence "that ensures an appropriate period" to prepare such materials, according to Articles 49(5) and 50(6) of the Anti-Monopoly Act, the time given is usually only two weeks. This time is too short to prepare an opinion and evidence, particularly because the notice of tentative order is often the first time the party under investigation is made aware of the facts and allegations against it. The ACCJ proposes that the period be fixed at not less than 45-60 working days.

Adequate protection for witness statements

A witness should not have to sign a witness statement until he or she has had adequate opportunity to review and correct it. Without an opportunity to have counsel present, there is intense pressure to sign the statement even though it may be an interpretive and selective summary by the JFTC. These situations are coercive and can result in statements that contain inaccurate, biased, manipulated or incomplete information. From a due process standpoint there should be no requirement for the witness to sign a statement, but instead to require the investigator drafting the statement to aver that it is a statement drafted by the administrative body and executed by investigator in good faith. A party should have access to any witness statements and other evidence against it in the possession of the administrative body. Access should be a voluntary and not automatic procedure, since a witness statement in the possession of the investigated party may be subject to discovery in U.S. litigation.

The need for proper economic analysis

The JFTC should employ experts in economic analysis and base its decisions on thorough economic analysis scrutiny. Parties should have an opportunity to submit economic analyses, expert reports and other evidence in support of their practices and positions. This is especially important in cases involving unilateral conduct, such as private monopolization and unfair trade practices, because there is a potential for the chilling effect of over-deterrence if careful economic analysis of the market and the conduct in question is not undertaken.

Enforcement of proper procedural safeguards

Parties should be provided an opportunity to contest procedures that do not conform to the administrative body's own rules or other due process norms. An objective third party or hearing officer should resolve any motions to object to administrative action, and such motions should be reviewable by a court. In addition, the JFTC and other administrative bodies should consider imposing sanctions against officials who do not follow the procedures prescribed in the rules.

Discovery

Current discovery laws and procedures in Japanese civil proceedings make it difficult to compel the production of a document without knowing its existence and details. The relevant laws and procedures should be modified to enhance the ability of parties to obtain necessary evidence without resorting to the courts.

Gaiben Administration

The Ministry of Justice (MOJ) seeks to develop a legal profession that provides legal services with the depth and sophistication that multinational companies and financial institutions expect. In contrast to this policy goal, the implementation of Japan's existing laws and regulations governing registration of foreign lawyers in Japan, or *gaiben,* has become cumbersome, arbitrary, time consuming and discriminatory in recent years, although the MOJ has lately taken welcome steps to streamline the process.

Accordingly, the ACCJ urges Nichibenren—the Japan Federation of Bar Associations—to implement the *Gaikokuho* Joint Enterprise Regulations and Employment Regulations in an efficient and nondiscriminatory manner. Such a welcoming approach toward foreign professionals would signal a similar attitude toward other types of investors. We also ask the MOJ to support amendments to laws and regulations that eliminate cumbersome requirements as well as the remaining rules and regulations that discriminate against gaiben. The availability of legal services that are better integrated both within Japan and across borders will make its legal and regulatory systems easier to navigate for new market entrants.

The ACCJ welcomes and applauds the MOJ's recent streamlining efforts, and believes it is essential to standardize and reduce the number of documents required for registration, and to shorten the registration process to a maximum of sixty days from the pre-screening stage to registration. Furthermore, we encourage the Nichibenren to eliminate the different standards and requirements applied to various types of law firms, unless those variances are fair and justifiable.

The ACCJ specifically recommends amending the regulations mentioned above to ensure that they are consistent with Japan's national treatment commitments under the General Agreement on Trade in Services. The government should both lift the longstanding restriction on law firms in Japan from opening branch offices other than by becoming a legal professional corporation (*bengoshi hojin*), and change the law to allow foreign law firms to register as bengoshi hojin.

We also recommend that gaiben, and gaiben and Japanese attorneys (*bengoshi*) operating jointly in Japan under the *gaikokuho kyodo jigyo* joint enterprise structure, be allowed to use a limited liability (LLC) structure. The government should also eliminate requirements affecting only gaiben, such as stipulating how they should relay advice received from lawyers outside Japan—including from other offices of the same law firm—to their clients in Japan. This would put the clients of gaiben and bengoshi on an equal footing with respect to third-country law.

The gaiben registration process can be arbitrary and cumbersome, in some cases taking over a year to move applications from the pre-screening stage to registration. The MOJ has recently taken steps to standardize the documents requested of applicants. That is a positive development, and we recommend that the MOJ and Nichibenren continue to streamline the procedure for becoming a gaiben.

Furthermore, the ACCJ believes that foreign lawyers should receive credit for work experience in Japan. Requiring a gaiben to have two years of post-qualification experience outside Japan is unjustifiably restrictive, and fails to recognize both the depth of experience that associates working in Japan receive under the supervision of gaiben and bengoshi and the growing number of foreign lawyers now devoting significant periods of their careers to serving clients in Japan.

Finally, the ACCJ strongly urges the Japanese government to have government agencies—such as the JFTC, the Financial Services Agency, the Ministry of Economy, Trade, and Industry, and Japan Post—assist in developing and expanding the legal profession by hiring legal professionals to handle issues for the government as they arise.

III. RECOMMENDATIONS

The ACCJ urges the Japanese government to use the following strategies to improve the business climate in Japan and boost the country's appeal as an investment destination for both Japanese and foreign investors:

- Enhance the transparency of the public comment process to ensure that final laws, regulations, guidelines and agency recommendations are based upon a well-informed and thorough debate of the underlying proposals and issues
- Create more uniformity and transparency in the procedures governing the establishment, composition and operation of the shingikai study groups and advisory councils that govern the process of public comment regarding rules and regulations specific to the various industries. This will afford a broader range of participants the opportunity to participate in the deliberation process and result in the creation of well-informed policies and legislation
- Expand the use and scope of no-action letters, which will enhance business confidence by clarifying the government's regulatory position in a variety of areas and bolster the ability of responsible companies to comply with the law
- Develop standards of due process in JFTC practices and procedures used to enforce the Anti-Monopoly Act and of other administrative bodies with investigatory and enforcement powers that are more consistent with international standards to enhance the fairness of the legal process and the uniformity of pro-competitive regulations internationally, thereby increasing investor and business confidence in Japan
- Improve the atmosphere of transparency and administrative efficiencies in the gaiben administration process to standardize the legal profession, encourage its expansion, and reduce costs and inefficiencies in the practice of law

IV. CONCLUSION

Many enterprises and professionals are eager to bring investment and new business models to Japan, but they are dissuaded from doing so by a domestic regulatory environment that is perceived to be difficult to navigate and overly biased in favor of domestic enterprises. Following the simple recommendations offered here would do much to increase the appeal of investing in Japan, improve investor confidence, and stimulate economic growth.

Promote "Open Convergence" and Take Maximum Advantage of the Internet Economy

I. EXECUTIVE OVERVIEW

Japan had over 99 million Internet users as of June 2010 according to statistics compiled by the International Telecommunications Union (ITU), as well as a robust infrastructure and networks, and a reputation for being a technological frontrunner. Yet the advent of the Internet Economy—meaning the conduct of economic activities through virtually borderless markets constructed online—has caught the country largely unprepared to deal with the issues posed by the digital "convergence" of voice, images and data that is transforming the telecommunications and broadcast industries in Asia and promises to redefine areas like education, healthcare and government services.

Staying at the frontier of all the possibilities the Internet economy offers is essential to Japan's future, and will enhance resource reallocation efficiency, the dissemination of information and technology, productivity growth and greater integration with the global economy. Yet the response of Japan's government and industry to the opportunities convergence opens up has been slow and uneven, and raises serious questions about Japan's potential to realize the full benefits of its huge physical investment in Internet-related infrastructure and technologies.

The ACCJ posits three possible convergence scenarios for Japan, but only one, the "open" convergence scenario, will enable Japan to make maximum use of new Internet technologies. The other two—"stalemated" and "closed" convergence—will slow and even reverse needed foreign investment and further erode Japan's position as a global leader in the information and communications technology (ICT) field.

But adopting an open convergence strategy will require determination and far-reaching changes by Japanese policymakers and industry. The key is for the government to adopt an explicit convergence policy that includes the removal of legal impediments to convergent business models, the introduction of a national ID as a basic infrastructure for convergent government services, and the introduction of a spectrum auction. Revising privacy laws, stronger promotion and protection of content online, greater harmonization with emerging international "cloud computing" standards and nondiscrimination between domestic and offshore data center services providers are also essential initiatives.More fundamentally, government and industry must recognize that entrepreneurs, foreign-capitalized companies and other new entrants are essential participants in the process and keys to the future competitiveness of Japan in the ICT sector.

II. ISSUES AND ANALYSIS

How the Internet Affects Japan's Economy

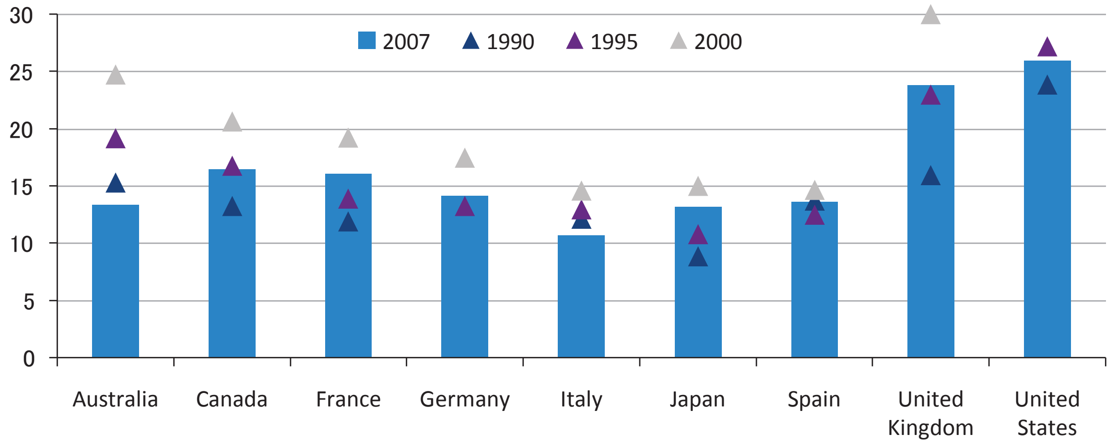
The global scale and networked characteristics of the Internet have transformed the world's economy by bringing together national economies and expanding the operations of businesses and the reach of consumers in unprecedented ways. Technological change is occurring at a pace faster than society has ever experienced.

The Internet Economy will affect nearly every aspect of Japan's economy, and a global Internet Economy will emerge regardless of Japanese government policy. Japan has an opportunity to be a leader in

Figure 1

ICT Investment in Non-Residential Gross Fixed Capital Formation

Percentage Share at Current Prices



Source: OECD Productivity Database, 2010; 1990 data unavailable for Germany.

this realm, however, so any government growth strategy or industry business strategy has to factor in ways to use and maximize access to the Internet.

Being in the forefront of Internet Economy developments is essential to Japan's economic future for a couple of reasons. First, the Internet Economy is perhaps the most visible manifestation of what "new growth theory" economists like Professor Paul Romer of Stanford have called the information or knowledge-based economy, as distinguished from the traditional physical economy. A very special, productivity-enhancing feature of many Internet-based businesses is that they can enjoy endless and higher proportionate increases in output for given increases in input, rather than the diminishing returns that ultimately affect physical goods. This is because they are not limited by the scarcity of physical inputs.

Second, doing business online can radically lower costs and shorten the time required for transactions and the sharing of information and technology. These practical factors are essential to hastening the pace of economic growth. In the language of new growth theory, faster knowledge dispersion leads to growth because the process of "deepening human capital" has increasing returns to scale. And as the Fukao-Kwon Report explains, the GDP and productivity growth in the Japanese economy has been held back for many years by chronically low "metabolism," characterized by slow reallocation of resources and labor.

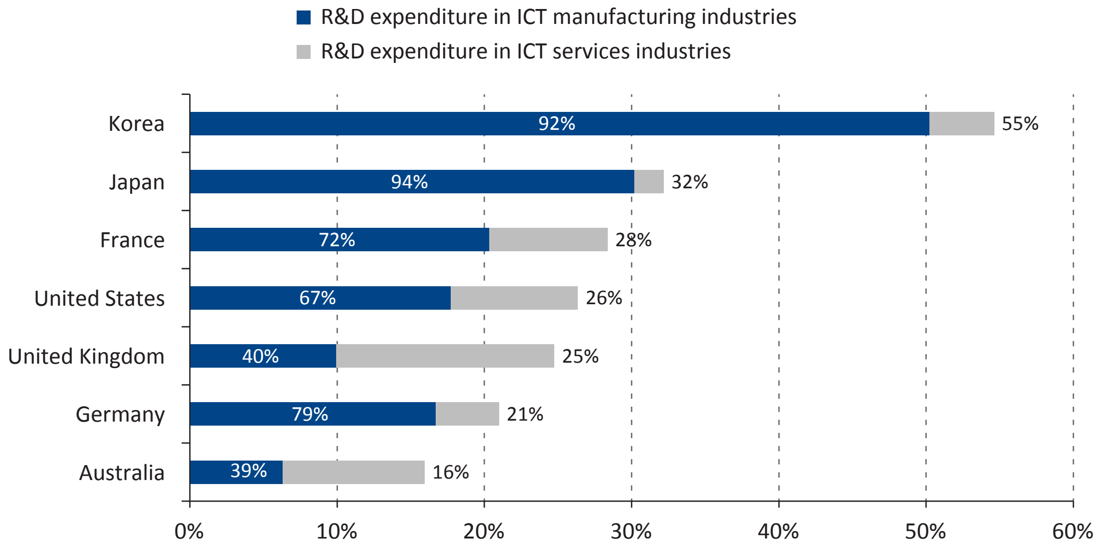
The speed and cost advantages of the Internet are starting to improve productivity and efficiency in many areas in Japan, but with the right policies this process could move much faster. Because of these advantages, the information, communications and telecommunications (ICT) sector and related services are now major contributors to GDP growth in every developed country. This is true in Japan as well, but the country lags behind other developed nations in the proportion of capital formation that ICT investment supplies, as shown in Figure 1.

Japan has generally ranked high against global benchmarks for progress in the Internet Economy when the focus is on

R&D Expenditure in Selected ICT Industries, 2005

% of Business Enterprise Sector R&D Expenditure (far right %)

Figure 2



Source: OECD, ANBERD database, March 2005.

infrastructure. However, it is actually behind in the overall utilization of that infrastructure. The reasons for this disconnect often relate to government structure and industry practices, and involve support for local standards at the expense of globally harmonized business models. They are also related to Japan's failure to promote technological harmonization and innovation that enables the value-added, converging layers of services, applications and content where Internet growth has been most explosive.

As shown in Figure 2, only 6 percent of Japan's total ICT-related R&D expenditure relates to ICT services, whereas the other 94 percent is concentrated in the ICT manufacturing industries.

Japan's infrastructure and networks are particularly robust, both in speed and capacity, but the nation is significantly behind many OECD economies—including Korea—in areas like secure Internet services and e-commerce, government online services and consumer software spending.

Moreover, Japan is clearly not a major player in the higher-value and rapidly growing areas of platforms, services, applications and content that sit on top of the infrastructure base. These areas are dominated by a relatively new group of companies with entrepreneurial origins and foreign roots, such as Microsoft, Apple, Google, Amazon and others. Applications built for game-changing devices such as the Apple iPhone are providing users in Japan and elsewhere with new ways to communicate, learn, transact business, and even interact with government.

Innovative apps are also transforming sectors such as healthcare, education, social services and transportation. They are driving major new business models as well, making online commerce a real competitor to brick-and-mortar stores and transforming the advertising world and the content business that depends on it for revenues.

The Promise of Convergence

Convergence has effects and consequences beyond issues associated with telecommunications and broadcasting network services that much of the current debate revolves around. In communications technology terminology, convergence principally refers to different types of traffic—voice, data, and content—going through the same set of pipes. Digital technology made this possible. In the internet world that emerged, everything becomes bits of data transported using internet protocol.

Economic, social and political structures can influence and even slow the pace of convergence. For example, national regulators and policymakers are responsible for the legal aspects of convergence related to the telecoms and broadcast sectors. Yet convergence is also a global trend driven by technological advances, economic opportunity and borderless social interaction. If convergence is to be a constructive rather than a disruptive force, its impact has to be addressed and accommodated by policymakers in advance.

The reason is that convergence involves a lot more than bringing together networks, data and content. The internet is all about unbundling, and all across the media landscape the impact has been to shake up the close relationship—and value chain or business model—linking content creators, advertisers and broadcast networks. And with this unbundling comes industry fragmentation and new forms of competition and services.

Japan is one the few markets in which mobile TV has seriously taken off, and it is also far ahead of most of the world in mobile payments. In retail, too, convergence is apparent: with its ATM, online event ticket terminals and computerized merchandise-tracking system, the local convenience store is already very high-tech.

The "Galapagos Syndrome" Could Repeat Itself

The potential for innovation spreading from Japan out to the Asian region and beyond is boundless. Yet few such market opportunities have materialized. Japan once led the world in consumer electronics wizardry, but public policy choices have handicapped the ability of Japanese firms to exploit global markets. The grip NTT exerts in the infrastructure and network layers here raises questions about wider global interoperability and competitiveness downstream by Japanese companies.

The "Galapagos syndrome"—referring to products and services that evolve in isolation from the rest of the world—has plagued Japan's development of mobile telephony. That self-referential pattern could be repeated with the Internet Economy, but on a larger scale and with more deleterious effects on the nation's economic future.

The reasons for this are straightforward. First, the Internet Economy is above all a global phenomenon. Success for Japan will depend on how seamlessly Japanese businesses and consumers interact with it. That will require significantly more global harmonization and flexibility than has been demonstrated so far.

Second, national approaches to networks that favor a few dominant infrastructure players and local business models limit global participation. They also undercut Japan's ability to take advantage of network effects on a global scale. Finally, there is a need for more innovation and a fresh, user-focused approach to development in the value-added layers of services, applications and content, which in turn will depend heavily on the incentives and capital available to entrepreneurs.

Regulatory Flexibility and Entrepreneurs Are Essential

In the global marketplace, major multinational corporations compete with each other across national borders and, equally significantly, with venture capital-funded startups. Some of these new companies have grown exponentially in only a few years to become the next set of multinational giants.

Outside of Japan, many of the Internet Economy's current stars were recent startups launched with a handful of employees, including:

- Amazon.com, an early Internet entry launched in 1995, has gone from being an online bookseller to a virtual marketplace for an extraordinarily wide range of retail products.
- eBay, also founded in 1995, created the online auction paradigm, letting small businesses and even individuals do business across the globe.
- Craigslist, which has transformed classified ads in the U.S. to an online marketplace, and has spread overseas.
- Skype, established in 2003, demonstrated that voice over Internet protocol (VoIP) could not only succeed but also become a major alternative to traditional telecom services.

More recently, new companies such as Facebook and Twitter are attracting large participatory audiences, creating the potential for substantial worldwide revenues.

From these examples, it is easy to see that Japan has a major opportunity for economic growth if it encourages new entrants to the Internet Economy. That source is not being fully tapped as yet. While there are successful new Internet-related companies in Japan such as DeNA, Rakuten and mixi, few of them have brought truly game-changing new technologies or business models to the market.

In contrast, the foreign companies listed above have challenged incumbent industry leaders and even the very existence of traditional business models. They succeeded because they arose in environments that let entrepreneurship flourish and are free of unnecessary regulatory constraints. Success in the Internet Economy demands change and flexibility, especially regulatory flexibility. In some cases, government regulation and regulatory structures will have to realign as industries take new shapes. Japan needs to foster competition and give innovation free rein.

Institutional Limitations Hold Back Constructive Change

Growth in the Internet Economy in Japan appears to be slowing as this global phenomenon runs into local institutional limitations in three specific areas. One is the regulatory and institutional segregation between the telecoms and broadcast sectors. Another comes in the form of barriers limiting broader economic uptake across the health, education, transportation and other sectors of the economy. The third is the recently curtailed international expansion of Japan's high-tech sector and the prevailing cultural "uniqueness" of the domestic market. Taken together, these factors are postponing if not stalemating convergence, an area where Japan should be a model rather than a follower.

At this stage it is unclear how the above trends will play out. While a number of international trends—such as the spread of "over the top" (OTT) video delivery—are fairly well developed in Japan. Others are far less mature. Japan is still a world leader in network and device development, recent innovations by the likes of Apple, Google, Facebook, Twitter and YouTube notwithstanding. A decade ago, DoCoMo's decision to marry the device to the operating system (iMode) on an open media platform represented the world's first successful mobile Internet story, and moved the Japanese away from their PCs and onto their mobiles a good five to eight years before the rest of the world. The Koizumi government's commitment to universal broadband access in the early 2000s gave the country the world's best ICT infrastructure long before the trends of broadband ubiquity and cloud computing.

Yet in some respects Japan's earlier technological leadership may have left the country in a technological cul-de-sac. Local handset manufacturers develop almost solely for the domestic market and broadband ubiquity has stagnated, constrained by high-usage prices for fiber-optic service that has slowed the development of a consumer base large enough to sustain the services the network has made possible. A telling statistic is that while today fiber to the home (FTTH) reaches around 93 percent of Japan's population, only a third have elected to purchase the service. The reason is that NTT, having built the network, is reluctant to engage in the kind of price-cutting competition that would drive new utilization.

Without some intervention—either the emergence of entrepreneur-driven new business models or far greater foreign participation in the market—it appears there will be increasingly little co-development of the above trends. Established local players like NTT will maximize earlier technological advances but grow increasingly isolated from global trends while existing companies and interests remain protected.

Japan needs a new and more "open" scenario that sustains growth and improves its global competitiveness. That will require a challenging and interrelated set of changes in the telecoms and broadcast sectors, spurred by government policies that promote competition and entrepreneurial new business models. It will also require greater openness to foreign participation in Japan's market, and more externally focused business strategies by domestic Japanese companies.

At this juncture there appear to be three possible convergence scenarios for Japan. The first, stalemated convergence, probably best describes the current situation here. Regulatory barriers are

Three Convergence Scenarios for Japan

Stalemated Convergence	Closed Convergence	Open Convergence
Existing players stifle reform and block new entrants while revenues sharply decline	Limited reform seeks to manage rather than promote the convergence process	Regulatory barriers to converged services are removed; competition draws new entrants
Japanese business and consumers move offshore for "cloud" computing needs	The focus is on protecting domestic markets and competing aggressively abroad	The new framework encourages new partnerships domestically and more expansion regionally
Infrastructure utilization remains low; new value-added services are not introduced	New business solutions are slow to emerge domestically; dependence on outside innovation grows	New convergent services in telecoms and broadcasting open doors to new services elsewhere
Outside players bridge the gap between domestic and international "cloud" market	Foreign firms disinvest as growth stagnates, and regulatory impediments slow uptake	Japan emerges as a regional hub; domestic and foreign firms collaborate on "cloud" services

obstacles to greater cross-service offerings between telecoms and broadcast services providers, and these in turn slow the uptake of convergence in other key sectors of the government and private economy.

The use of the word *stalemated* here does not imply that convergence can be delayed for long. The advent of convergence will likely be very disruptive for Japan's economy as Japanese businesses and consumers look offshore for services not available domestically. That trend is already well under way in the entertainment field as consumers access content—sometimes illegally—through YouTube and other online services because they can't get it from local broadcasters and other traditional distribution channels in Japan.

This trend will probably be replicated in other areas like online commerce and financial services where OTT providers will develop workarounds to supply services to Japan from offshore. Under this scenario, there will be (as in other economies) large growth opportunities in the area of convergent services, but offshore entities will be the beneficiaries of that growth.

The second scenario, closed convergence, appears to be the direction that Japanese policymakers and industry leaders favor as a way to preserve the local market and spur Japanese exports. This is reflected in the wording and tone of recent pronouncements from government advisory groups that focus on increasing the global competitiveness of Japanese firms by promoting greater domestic research and development in the ICT field and creating new Japan-based standards.

These groups and reports do recognize the need to address convergence and its consequences for Japan. Yet the emphasis appears to be on managing the process internally while promoting the activities of "local champions" abroad, since the latter are thought to be best positioned to mediate between Japan and the rapidly converging external environment in Asia and elsewhere. Little weight is given to the roles of local entrepreneurs and foreign investment in creating fresh business models and bringing new technology to Japan as a way of promoting growth.

Much of the growth envisioned in this scenario will be externally determined, with the domestic economy continuing to lag because of limited uptake of convergent business solutions and technologies within Japan. This will reinforce the growing trend for foreign ICT firms to bypass Japan as they distribute their investment dollars in Asia and slow the release of innovative products here to focus on other, more dynamic markets.

The third scenario—open convergence—offers the most desirable outcome, but it will require determination and focus by typically conservative Japanese policymakers and industry leaders. The government needs to formulate an explicit convergence policy. This policy should begin with telecommunications and broadcasting but push into other areas where new information and communication technologies can serve as fresh ways of delivering public services, education and healthcare.

The role of entrepreneurs and foreign investment in this effort not only has to be recognized but promoted through various incentives. Promoting greater labor mobility would also unleash the tremendous amount of engineering and technical talent locked up in Japanese industry and universities and lead to greater collaboration with a range of global partners. (Please see the separate chapters on these topics.)

Collaboration, not competition, should be Japan's goal, because openness is the key to growth in a convergent world.

III. RECOMMENDATIONS

The ACCJ recommends ten priority policy actions that the Japanese government should consider as it thinks through how to better utilize the internet in promoting growth and benefit from the possibilities that global convergence presents. Government and industry circles are already debating many of these issues. The intent here is to affirm our support for the changes they represent, and to highlight their importance as part of a coherent ICT growth strategy.

A. Full Deregulation and Convergence of Telecommunications and Broadcasting

The failure to pass a number of modest revisions to the existing Broadcast Law in the 2010 regular Diet session is indicative of the slow pace of reform. The government needs to take steps to fully privatize and restructure NTT and allow telecommunications providers and broadcasters to promote convergent platforms that deliver a variety of properly licensed content in every market.

B. The Kasumigaseki Cloud and Creating a National ID

Discussion on this sensitive subject has continued for too long, and current discussions to postpone any introduction until 2015 are delaying this essential change. Agreement on a framework for a national ID is crucial to the introduction of a comprehensive platform for government services, or "Kasumigaseki cloud," that will promote greater consolidation and coordination of government services. The ACCJ sees these two initiatives as key elements in a coherent convergence policy.

C. Establish a National Communications Commission in Japan

The ACCJ's *Internet White Paper,* published in 2009, called for transparency and consistency in the regulation of the internet Economy. While we know that rules are necessary, we strongly believe that the government should use a light hand in dealing with the Internet. We are therefore urging Japan to separate policy promotion and regulatory functions within the various ministries and agencies. We also recommend consolidating these regulatory functions in a single independent regulatory body akin to the United Kingdom's Office of Communications.

D. Name a National CTO and Start Government ICT Procurement Reform

The recent budget-cutting process left many believing that government investments in ICT are often both expensive and ineffective. This view has some merit, and a key reason has been the lack of professional ICT leadership within the government able to set and implement a comprehensive ICT strategy. The Japanese government should follow the example of the United States and name a chief technology officer (CTO) and give this official the staff and resources needed to draw up and carry out a long-term ICT strategy and procurement plan. In parallel with this process, the government should also introduce multi-year budgeting for ICT projects and permit the funding of prototypes to spur competition and identify "failure points" early in the process.

E. Open Up Spectrum Allocation to Competition

Spectrum is the fuel of the information economy, and its efficient use is a key to growth and innovation. We are calling on the Japanese government to follow the example of other advanced nations and begin a spectrum auction in Japan so that spectrum can be properly valued and new market entrants can compete for and win spectrum, allowing them to introduce new technologies and business solutions. The current nontransparent "beauty contest" is a significant obstacle to Japan's ability to manage and reap the benefits of convergence.

F. Privacy: Focus on Sharing Data, Not Just Protecting It

Japan is a latecomer among advanced countries to online privacy issues and policy. The current law was fully implemented in 2005, nearly twenty years after European countries instituted similar legislation. Not surprisingly, enforcement of the law has been uneven and often done in ways that have "protected" data to a degree that made sharing it impossible. Convergence implies appropriate sharing of data as a major driver of new business models. We urge the Japanese government to reexamine both the provisions and application of current privacy law and recommend the consolidation of privacy policy in a new independent commission headed by a privacy commissioner.

G. Get Content Online and Distributed

While the ACCJ does not support the weakening of copyright protections, we also believe that some revisions to the Copyright Law—such as the recently adopted exemption to allow caching of search data—are in fact useful and necessary to encourage continued innovation on the Internet. Updating the antiquated ISP liability law and other revisions would be similarly beneficial. Overall, we support a balanced approach and believe that a market environment that allows new business models to be tested, along with firm respect for copyright protection, will encourage the growth of the industry. While we understand the concern that the current vertical integration of the broadcast industry may constrain the distribution of content via the Internet, we believe the Japan Fair Trade Commission should address this issue rather than the Cultural Affairs Agency.

H. Standards: Open Collaboration, Not Closed Competition

Many in Japanese government and industry think Japan should be more proactive about standardizing its technology internationally. Many also believe that the best protection from outside competition is to develop domestic standards that raise the cost of doing business here for foreign entrants. The ACCJ supports efforts to standardize the country's technology, but believes that the focus should be on the benefits to be gained from promoting harmonization of Japanese standards with international standards. The goal should not be simply to gain a competitive advantage but rather to enable Japanese companies to collaborate better with foreign partners and make the Japanese market more open to foreign business models and technologies, not less.

I. Data Services Without Borders

Convergence and cloud computing go hand-in-hand, and depend on the free flow of data across national boundaries. GATT and bilateral trade arrangements have sparked growth by reducing or eliminating tariffs and other barriers to the free flow of goods and services. Along with trading partners such as Korea and Singapore, Japan's government has been exploring how to deal with the difficult privacy, security and data sovereignty issues associated with the use and provisioning of "cloud services." The ACCJ strongly supports these efforts and recommends making this a key topic for the U.S.–Japan dialogue on the Internet Economy. We also urge Japan's government to subscribe to the principle of nondiscrimination between data services provided from data centers outside Japan and those inside Japan.

J. Education and Immigration Reform—A New Generation of ICT Workers

To realize the full potential of the Internet Economy and manage the impact of convergence, Japan needs a new generation of skilled ICT professionals both knowledgeable about the technology and comfortable with working across borders in a convergent and interconnected world. Whether Japan's education system is up to this task is an open question. The PC-to-student ratio is still just 1 to 7—among the lowest in the OECD—and measures to introduce a digital curriculum are still years off. (Please see the chapter on education policy.)

Moreover, the aging of Japan's population is removing engineers from the workforce faster than they can be replaced.

Concurrent with steps to improve ICT education here, the ACCJ believes that Japan should also consider providing more flexible visa options for ICT professionals from Asia and elsewhere to bring their skills and experience to Japan under both short- and longer-term arrangements. (Please see the chapter on immigration policy.)

IV. CONCLUSION

The emergence of the Internet Economy is occurring rapidly and producing an explosion of growth globally, particularly in Asia, transforming these economies domestically and helping them leverage more growth through expansion into export markets. The process is not linear, however, and the benefits will not be evenly distributed. Current ICT market leaders like Japan may face the greatest test, particularly if they lack the flexibility and political will to both manage and lead the process. Economic policy must be based on consumer preferences as well as the needs of industry. Utilization, not infrastructure, will drive resource allocation and investment decisions.

Convergence is a fundamental part of globalization that will dovetail not just economies but entire cultures, making it an opportunity and a tool for regional integration. Convergence is already creating a borderless "world" economy where partnerships between domestic and foreign firms and outside capital and business solutions are the norm, not the exception. Yet despite the border-free nature of convergence, national governments have a key part to play. The recently launched U.S.–Japan Internet Economy dialogue offers an opportunity for both the United States and Japan to define the challenges and seize the opportunities afforded by the ongoing process of convergence to restructure our economies and societies in ways that promote growth and continued technological innovation within and beyond this region.

Improve Labor Mobility to Enable Japan to Better Compete in the Global Economy

I. EXECUTIVE OVERVIEW

Nations, economies and companies compete based on how fast they can mobilize and reallocate resources—including the human kind—for the greatest productivity and growth.

The Fukao-Kwon Report concludes that for many years the Japanese economy has been held back by declining labor productivity and its chronically low "metabolism," characterized by slow reallocation of resources and labor. The report suggests that imperfections and a lack of flexibility in the labor markets may be holding back economic growth.

The report also concludes that new entrants to the economy, such as startup businesses and companies backed by foreign direct investment (FDI), have generated the vast majority of net job growth in Japan between 1996 and 2006, a trend that is likely to continue as Japan's economy evolves and adapts.

New market entrants obviously need to hire employees. Since they lack the resources and track record established Japanese companies have, however, it is hard for them to attract employees straight out of college and groom them and build their loyalty, as larger Japanese firms do. Moreover, new market entrants usually need to hire employees with prior work experience and defined skills. In Japan's stability-conscious society, though, enticing employed individuals to leave their less productive yet established employer is a tough sell.

Conversely, businesses in decline have to be able to restructure and dismiss staff in a transparent and fair process that minimizes disputes if they are to survive. In Japan, however, employees tend to cling to jobs even in unproductive or dysfunctional firms, making it difficult for new market entrants to hire them away.

This unfortunate phenomenon exists for two reasons. One is that Japanese laws concerning employee termination are complex and overly vague. The other is that the public safety net is too flimsy and porous for employees to consider leaving employers to retool and retrain themselves for more productive and fulfilling jobs elsewhere.

The ACCJ believes that the Japanese government has to address these issues and make labor mobility and improvement of the safety net national priorities. By equipping its citizenry to compete fully in the global and knowledge-intensive job market of the twenty-first century, Japan can help secure their futures and boost its own economic growth.

II. ISSUES AND ANALYSIS

Overregulation of Dismissals Contributes to Poor Labor Mobility

In their 2009 paper *Labor Immobility in Japan: Its Causes and Consequences,* Professor Kenn Ariga and Dr. Ryosuke Okazawa of Kyoto University estimated that dismissal costs totaled about 0.2 percent of Japan's GDP, a significant figure given the low number of terminations that occur in Japan. While such costs cannot be calculated with precision, high hiring and firing costs often cause foreign businesses and Japanese businesses alike to divert investment from Japan to jurisdictions with more predictable and transparent employment regulation systems.

Managers hiring new staff in Japan face a patchwork quilt of employment contracting options, vague regulations, and frequent and unpredictable shifts in administrative interpretations. The changes in procedures and documentation—along with the time and resources needed to stay abreast of them—are far too costly for both employees and employers. Furthermore, it is hard to mitigate employment law compliance risks because violations of many provisions impose criminal penalties as well as administrative sanctions, including publishing the names of violating firms.

As the Fukao-Kwon Report indicates, a large part of Japan's future growth potential is tied to stimulating more investment by emerging companies and FDI, which have been generating net job growth in recent years. Given Japan's excellent technology base, much of this investment could and should be in high-risk, more innovative sectors.

However, research by experts such as Professor Eric Bartelsman of the University of Amsterdam reveals that those high-risk, innovative sectors are smaller and less productive in countries with strict employment protection legislation. ("Barriers to Exit, Experimentation and Comparative Advantage," by Eric Bartelsman, Enrico Perotti, and Stefano Scarpetta, June 13, 2008.)

Professor Bartelsman and his colleagues suggest, for example, that high-tech companies tend to avoid jurisdictions with large potential exit costs for companies that fail. Strict employment protection pushes companies to follow conservative strategies that minimize the enterprise's risk of failure but impede the economy's overall vitality.

Simplifying and streamlining employment law and regulations would result in more investment, growth, jobs and positive outcomes for all parties. However, the laws and regulations that govern employee dismissal in Japan lack clarity on when firing someone is appropriate. This creates confusion and encourages disputes between employers and employees. Article 16 of the Labor Contract Law states: "A dismissal shall, where the dismissal lacks objectively reasonable grounds and is not considered to be appropriate in general societal terms, be treated as a misuse of that right and invalid." What "objectively reasonable grounds" and "appropriate in general societal terms" mean is unfortunately wide open to interpretation.

The Ministry of Health, Labor and Welfare (MHLW) has also failed to provide clear and user-friendly guidelines on when these criteria are fulfilled and termination is valid. The Tokyo Labor Bureau did issue guidance on this point to employers under its jurisdiction in a publication called "Completely Master the Labor Standards Law: Termination Edition." These guidelines, however, do not include objective criteria that tell an employer when it may terminate an employee. Instead, the bureau's guidelines state that termination is valid when the employee "has significantly bad performance," "is unable to return to work for a long time," and "is significantly uncooperative"—again, all variables that are subjective and open to debate. In practice, it is very difficult for an employer to justify a termination based on bureau guidelines.

This lack of lucid guidance and the unpredictability of outcomes sows the seeds of legal disputes that cost both employee and employer money, mental anguish and lost time when the employee could be working productively and happily at a new job, or being retrained for a different position.

Furthermore, the only solution that the Labor Contract Law provides when an employee is terminated without sufficient justification is an essentially unworkable one: reinstatement. After a long, drawn-out court battle, it is unrealistic and unreasonable to expect that a relationship of trust can be reestablished. Even if the employee wins the legal dispute, the issue is not really settled, since the parties must then negotiate a severance payment in return for "voluntary" resignation.

Since the severance payment is subject to negotiation, the amount given may differ significantly from employee to employee. This creates an unfair imbalance among terminated employees as well as between those who are terminated and challenge their dismissals and those who leave voluntarily.

In sum, the current rules on dismissals in Japan have created a situation in which the only legal remedy is one that neither the employee nor the employer want, and which can produce extreme unfairness in outcomes.

The statistics in Figure 1 below clearly reveal that this confusing situation is leading to more and more disputes requiring third-party intervention.

In contrast, European countries such as Germany known for strong employment protection handle the problem of dismissals much more rationally. German law requires the employer to justify the dismissal with a clear reason, but also provides a convenient path to dispute resolution outside the court system by setting well-known guidelines for severance pay. Although Germany has no statute or government regulation that mandates specific monetary compensation or severance payment, many years ago its courts established case precedents that generally require an employer to pay one month's salary per year of employment when terminating an employee without cause. This bright-line rule creates fairness among German employees and employers and cuts down on the number of labor disputes.

The Problems of Being Overprotective During Probationary Periods

Japanese employment law is unclear about the rights of employers during trial or probationary periods (*shiyo kikan*) longer than two weeks. Article 21 of the Labor Standards Law states that employees can be terminated within two weeks of the start of employment without thirty days' prior notice or a payment of an equivalent average salary in lieu of notice. However, a new employee's competency cannot be verified within such a short period.

To ensure that the employee can perform as agreed, the employment contracts many companies use put new hires on contractual "probation" for a set period when the employment relationship begins. Although the courts have been more willing to allow terminations when employees are still on probation, the inability of an employer to terminate a probationary employee at will makes some firms very reluctant to hire new employees and encourages the use of dispatched workers.

All Japan Labor Tribunal Statistics*

Petitions for Confirmation of Status as Employee

Figure 1

2006	2007	2008	2009
418	719	1022	1701

*Statistics obtained from a report by the Supreme Court Secretariat as tallied on April 12, 2010.
(Note: The 2006 figure was calculated from April to December of that year.)

In contrast, the laws regarding probationary periods are often much clearer and more pragmatic even in countries known for their protective employment rules. In Germany, for instance, employment relationships can be terminated at will within the first six months. And in New Zealand, which recently stipulated a three-month “termination at will” probationary period, a survey found that 40 percent of those who hired staff actually did so because of the introduction of the new flexible rules (source: *New Zealand Herald,* July 21, 2010). If Japan adopts such clear and practical rules, the ACCJ believes that employers and employees here would be able to reset the labor-employer relationship, causing fewer disputes and boosting both labor mobility and worker productivity at the same time.

The Practice of *Naitei* Restricts Labor Mobility

The practice of *naitei*—in which employers make students an unenforceable quasi-job offer up to a year before graduation—is immobilizing labor and hurting the competitive strength of the small and foreign-funded companies that are contributing so much to Japan’s economic growth.

As we have seen during the recent economic crisis, many students with naitei offers who were confident of their prospects saw those offers vanish suddenly, throwing their short-term futures into doubt. The false sense of security a naitei offers is dangerous for Japan’s economy because it reinforces hopes of “lifetime employment” at a time when many companies in the country can no longer make good on that implicit offer.

On the other hand, legitimate naitei offers represent a substantial future financial commitment—something that many small and medium enterprises (SMEs) and foreign companies have difficulty matching. The practice allows large Japanese employers to unfairly reserve the best and brightest for themselves at no immediate cost. We believe Japan’s labor laws should either explicitly prohibit these offers or strictly interpret them as binding employment contracts.

Restricting Dispatched Workers Perpetuates Poor Labor Mobility

Recent economic developments related to certain large Japanese manufacturing companies have led to a great deal of negative publicity about the worker dispatch system. This has in turn resulted in political pressure to severely restrict the use of dispatched workers. However, there has been little serious analysis of the negative effects such restrictions would have on Japan’s labor market and the overall economy.

Japan’s regulatory regime for temporary employment reflects policy objectives that include fostering regular long-term employment, preventing intermediaries from benefiting improperly from the labor of dispatched workers, and protecting worker rights and welfare. However, for reasons historical and otherwise, this regime has evolved into an impenetrable maze of rules and requirements that apply to different types of worker tasks depending upon whether they fit into one of twenty-six arbitrary categories of skilled labor covered in the Dispatch Law.

For example, a company that retains a dispatched office automation operator—one of those twenty-six skilled worker types—must ensure that the dispatched worker spends no more than 10 percent of his or her time on activities unrelated to office automation operation, which would expose the employee to dispatch term restrictions. Furthermore, a recent MHLW opinion states that if a dispatched office automation operator serves tea to a visitor or sorts the mail, the worker is classified as an unskilled worker whose dispatch period must not exceed three years even if these unskilled duties take up less than 10 percent of the employee's work hours. The MHLW also reportedly requires dispatched office automation operators to be engaged in "thinking" to qualify for treatment as workers having special skills under the Dispatch Law.

In addition, the rules that apply to providers and users of dispatched workers are subject to interpretation by labor regulators. Their interpretations, in turn, are vulnerable to sudden policy changes and ministerial reevaluation, which can have a devastating impact on the ability of dispatched workers *even if they want to continue their employment.* These complex rules have become a self-perpetuating set of bureaucratic imperatives without any real connection to the underlying principles of the regulatory regime described above, and do not generate any corresponding gains in regular employment.

All of this distracts from the fact that these temporary assignments constitute a foot in the door for many workers. Dispatch jobs provide opportunities to switch to permanent employment with companies that use such workers. At the very least, dispatched workers develop skills and experience that they can potentially leverage into a permanent job. Japan's restrictions on dispatch are negatively affecting the livelihood and career development of workers by creating a compliance burden for companies. These factors constrict rather than stimulate new employment in Japan.

Japan's Poor Social Safety Net Prevents Mobility

Professor Ariga and Dr. Okazawa note in *Labor Immobility in Japan: Its Causes and Consequences* that over the past twenty-five years non-regular employees have increased from about 15 percent to close to 35 percent of the total workforce.

Despite that rise, overall labor mobility has not increased because many trained employees are holding fast to their present jobs and are unwilling to consider other positions. This tendency to "cling" is not surprising in a country where unemployment benefits are extended for a shorter time and are significantly lower than those in countries like Germany, the Netherlands, Switzerland and France.

The current Japanese system caps unemployment benefits at 7,685 yen per day, or 230,550 yen per month. In contrast, the following European countries offer far higher benefits, as shown in Figure 2.

Even at current exchange rates, unemployment benefits in these countries are substantially better than those in Japan. Moreover, they are not defined as a percentage of the last income earned or tied too closely to the number of hours a person has worked in his or her prior job. They are also usually adjusted according to other factors, such as age.

Like Japan, the German system allows for "work sharing" (*kurzarbeit*) when external economic factors force companies to temporarily reduce working hours and pay but keep the employees on the payroll with partial reimbursement from the government. However, a crucial difference is that German employers and employees decide on such work-sharing arrangements together rather than relying on the government to dictate them, a format which injects additional risk into the equation. The German system also allows for equal treatment between partial and full unemployment benefits by ensuring 60 percent of the employee's forgone net wages—and 67 percent for those with children—and leaves the decision-making in the hands of the private sector.

Like the nation's social security system, the unemployment insurance system in Japan has multiple categories with different benefit levels. In addition to being inequitable, the program is inefficient and too expensive. It also

Maximum Monthly Unemployment Benefit Figure 2

	(converted to yen)	(in local currency)
Japan	¥230,550	¥230,550
Germany (w/o children)	¥362,250	€ 3,150
Germany (w/children)	¥404,455	€ 3,517
Switzerland (w/o children)	¥592,700	Fr. 8,400
Switzerland (w/children)	¥617,400	Fr. 7,350
The Netherlands	¥332,005	€ 2,887

Source: "Social Security Programs Throughout the World – 2008 edition" Europe/Asia, International Social Security Association. Note: Japan monthly benefits calculated at 7,685 yen /day x 30 days.
Exchange rates used: 1 Euro = 115 yen; 1 SFr = 84 yen

creates an inherently unfair situation, since the country's safety net denies people who have never worked as regular full-time employees the time needed to seek training and upgrade their skills in anticipation of obtaining better jobs if they are laid off. Older workers are also unwilling to pursue a new job because age discrimination may prevent them from finding another position if their new company fails.

For many individuals with potential, these factors lead to frustration, a sense of helplessness, and a never-ending cycle of dissatisfying and minimally productive temporary positions. Even worse, this is occurring during the age of IT and the Internet Economy, when the need for specialized knowledge and training are increasing exponentially.

Expand Childcare Facilities Now

The relative lack of convenient subsidized childcare facilities in Japan and labor-contracting flexibility has made it hard for women to rejoin the workforce after having children, and also hinders their productivity after they do return.

Certain cities in Europe, such as Geneva, have been pondering the issue of preschool in early childhood as a critical element of society for decades. Since the 1980s, for example, Geneva has set up dedicated bodies such as the Commission on Early Childhood to ensure not only monetary support but also expertise to help co-manage independent childcare institutions. In addition to providing financial plans, technologies and educational techniques, the city is helping to manage staff working conditions at childcare facilities. We believe that Japan should adopt a similar comprehensive approach to childcare.

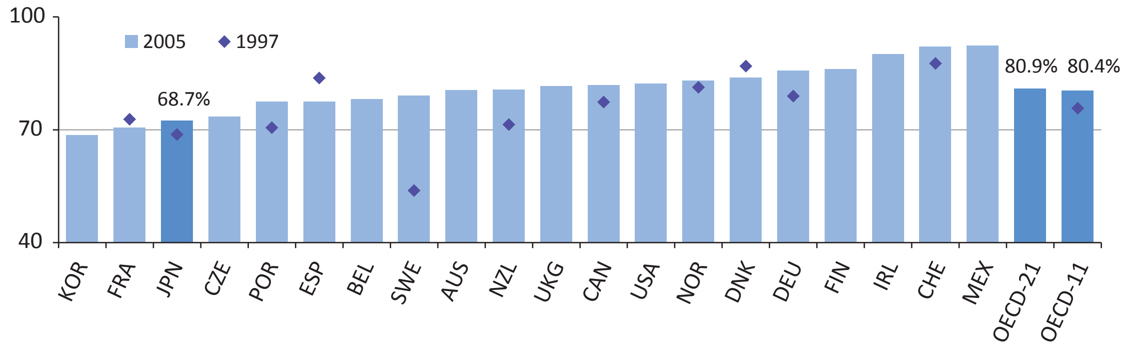
Overprotection of Employment Does Not Lead to Job Satisfaction

Despite sharp reductions in working hours and various attempts to protect employment in Japan, statistics show that Japanese employees score far lower on work satisfaction than almost every other country within the OECD (Figure 3, next page).

The ACCJ believes that a satisfied employee tends to be a productive one, and that the proposals below will increase both job satisfaction and productivity.

Figure 3

Percentage of Employees Completely, Very or Fairly Satisfied with Their Jobs, 1997 vs. 2005



Source: OECD, Society at a Glance, 2009.

III. RECOMMENDATIONS

A. Allow Greater Flexibility, Clarity and Predictability in Employment Contracts and Dismissals

To reduce unemployment, lower the number of disputes involving wrongful termination, and generally improve the vitality of the Japanese economy, we recommend that the government of Japan and the MHLW review current laws and regulations to allow for greater employment contracting flexibility, clarity and predictability at the end of the employment relationship.

Specifically, the ACCJ urges the Japanese government and the MHLW to:

- Issue written guidelines that interpret Article 16 of the Labor Contract Law and create a bright-line rule that clearly specifies when an employer may legally terminate an employee
- For dismissals without sufficient justification, introduce a well-defined monetary compensation system in lieu of reinstatement to provide more practical and efficient options to both employees and employers in disputed dismissal cases
- Ensure that any regulatory changes related to labor law reform are made in a fully transparent manner. This includes giving the private sector fair and meaningful opportunities to help identify problem areas, assist in shaping the proposed changes, openly comment on them, and exchange views with officials and government advisors.

B. Reduce Employee Protections During Probationary Periods

To persuade employers to hire more workers, the ACCJ urges the Japanese government and the MHLW to promulgate the regulatory changes and written guidelines needed to sanction the legality of agreements between employers and employees that state the employer may dismiss the employee at will during a trial period that may extend up to six months after hiring.

C. Prohibit or Strictly Enforce Naitei under Japanese Law

To ensure a level playing field for employers and protect the interests of job applicants, the ACCJ recommends that the government and the MHLW abolish the naitei system, or ensure that naitei offers are legally interpreted as binding employment contracts.

D. Relax the Constraints on Dispatching Workers

To convince employers to hire more employees, increase labor mobility, and give more young workers a chance to get into companies that may become their future regular employers, the ACCJ urges the Japanese government and the MHLW to:

- Significantly simplify the twenty-six types of work to which no restrictions on the term of dispatch apply, or simplify the rules by mandating a maximum continuous dispatch period of six years
- Review all the restrictions and the interpretation of those restrictions placed on the various duties of dispatched workers. This review should be performed according to the advice of a panel of experts that includes human resource directors from foreign capital companies and SMEs.
- Redesign legislation and guidelines concerning the dispatch of workers to minimize frequent and arbitrary changes to interpretation and implementation by regulators
- Exempt SMEs from dispatched worker restrictions
- Legislate preferential tax treatment for companies that directly hire workers dispatched to them
- Legislate preferential tax treatment for firms that provide training programs for dispatched workers.

E. Fortify the Safety Net

To provide fair and adequate safety net coverage for the citizens of Japan, the ACCJ urges government and the MHLW to:

- Revise the maximum cap on unemployment benefits to a level that is commensurate with compensation in Germany and other major European countries
- Lengthen the maximum period of benefits to 18 months and implement effective safeguards against abuses
- Create a single national unemployment insurance benefits system that is available to all wage-earners, regardless of contract type (part-time, full-time or fixed-term), does not differentiate between industrial sectors, and provides benefits for a sufficient length of time to allow retraining
- Legislate unemployment benefits so that they relate to the historical wage level of the worker (for example, 60 percent for people without children, 67 percent for those with children), but provide a minimum floor for benefits
- Require all wage-earners and their employers, regardless of contract type (part-time, full-time or fixed-term), to contribute unemployment insurance premiums, and provide strict penalties for not contributing
- Replace the current “work sharing” system with a German-style “short work” system in which the decision to implement temporary work sharing is determined by the employers and employees together, not by the government
- Increase both the availability of convenient childcare and the flexibility of labor contracting to make it easier for women to rejoin the workforce after having children

IV. CONCLUSION

The ACCJ urges the Japanese government to make movement within Japan’s labor pool more fluid and provide a more robust social safety net using the methods outlined above. Doing so will empower

Enhance Labor Mobility

Japanese citizens to better compete in the global and knowledge-intensive economy of the twenty-first century and enjoy their full potential as productive employees, while boosting the country’s economic growth.

Modify Japan’s Immigration Policies to Stimulate Investment and Growth

I. EXECUTIVE OVERVIEW

Japan is overlooking a largely untapped source of economic growth and vitality that the country sorely needs: potential immigrants, particularly foreign students, entrepreneurs and investors.

The 2010 Fukao-Kwon Report concludes that small young, newly-established firms and foreign investors, most of which were new market entrants, generated the greatest net job growth in Japan between 1996 and 2006. That occurred in spite of the harsh realities of Japan’s shrinking population and workforce, which are both key drivers that will affect expected future GDP growth.

In the case of immigration in particular, new market entrants bring Japan the sort of fresh thinking, creative business models, resourcefulness and hungry, competitive attitudes that have contributed so much to other advanced nations. Germany’s workforce, for example, is 8.5 percent foreign-born. In the United States, 15.6 percent of the workforce is foreign-born. These large immigrant constituencies are powerful contributors to economic growth.

Japan, however, provides a stark contrast. According to the Ministry of Justice—which oversees immigration issues and policies—immigrants comprise roughly 753,000 of Japan’s local workforce. That translates into a mere 1.1 percent of the working population.

Japan-educated foreign students, potential foreign investors and talented foreign professionals with the flexibility and skills to work cross-border represent an enormous opportunity. Japan needs to factor the immense value that young, highly skilled foreign employees offer into its economic growth strategy. Doing so would have an “inward globalization” effect that would increase Japan’s overall global competitiveness while also growing its tax base and economy.

The receptive policies and incentives in place in many other developed countries have led many enterprising immigrants to establish new businesses and invest their money in their country of residence. The inward globalization benefits Japan can enjoy will arise from having a more diverse, often bilingual workforce as well as from the entrepreneurial investments immigrants typically make.

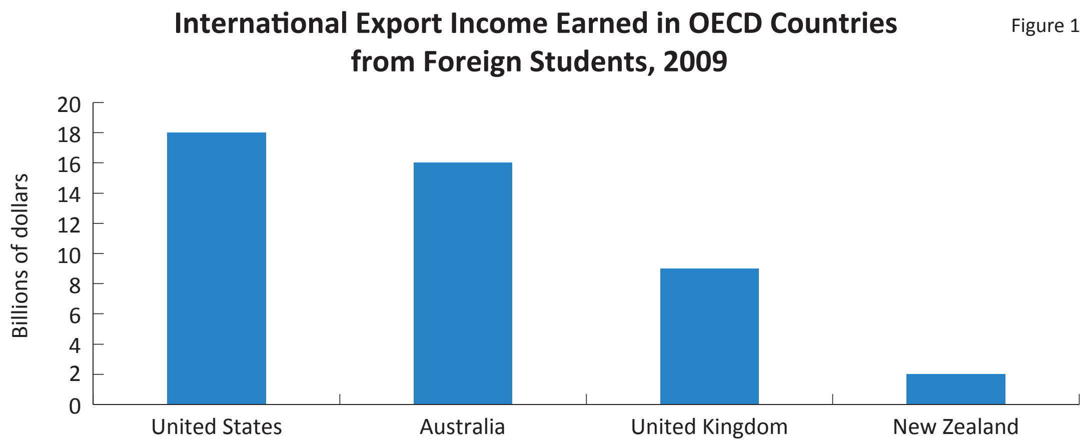
Unfortunately, Japan’s current immigration rules and requirements fall well short of encouraging long-term immigration and attracting foreign direct investment (FDI). The negative perceptions they have produced persist among both visiting and resident foreigners.

Including a focused and effective immigration policy as an integral part of its economic strategy can improve Japan’s dismal results in this regard. Such an immigration policy would feature clear reporting guidelines, goal-setting, cross-ministerial coordination via the Cabinet Office and “user feedback.” More educated immigrants would be eager to remain in Japan, establish businesses and work for Japanese companies, contributing to the country’s economic growth and global competitiveness.

II. ISSUES AND ANALYSIS

FDI, Immigration and Economic Growth Are Related

As outlined in the chapter on foreign direct investment, postwar Japan has



Source: Fostering Global Engagement Through International Education, The Economic Impact of International Students from a Cross National perspective (pp. 21-30), taken from NAFSA: Association of International Educators (2009).

struggled to increase inward FDI for decades. The 2008 global recession made pulling in new sources of FDI an even harder proposition. However, as Professors Fukao and Kwon have shown in their analysis, attracting more FDI is essential to reinvigorating Japan's stagnant economy and growth.

Immigration is directly related to FDI, new businesses and job creation and economic growth. FDI often rises when more immigrants enter a country because they tend to bring assets, create their own businesses, pay taxes and—in the case of Japan and others—supplement a depleted workforce while providing bilingual staff for newly entering firms.

As Professors Fukao and Kwon point out, the declining numbers of the working-age population here have been a primary cause of Japan's stagnant GDP growth. The present 1.1 percent penetration of immigrants into Japan's workforce highlights the urgent need for changes to the current immigration system.

Immigration policies in other OECD countries for students, investors and professionals have improved economic growth, job creation and foreign direct investment.

Another Essential Element—Education Policy

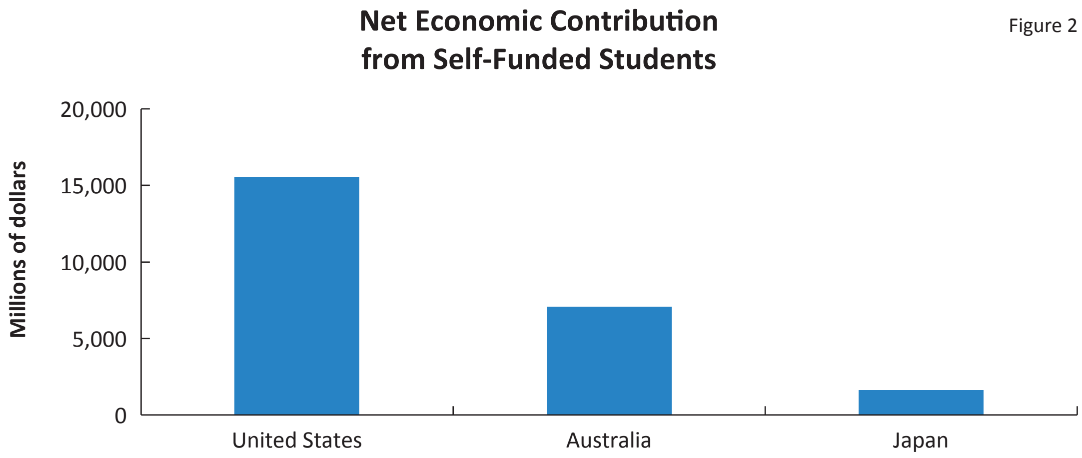
Because immigrants often settle down in a foreign country to pursue higher education there, in most developed nations the most salient benefit to the economy first comes in the form of increased education revenues.

For instance, the Institute of International Education reports that the U.S. economy obtained roughly $17.6 billion in export income from a recent spike in foreign student enrollment at American institutions of higher learning in 2008, while Australia gained $15.5 billion and the U.K. earned $8.5 billion (Figure 1).

According to Japan's Ministry of Education, Culture, Sports, Science and Technology, 91.5 percent of foreign students in Japan are privately funded, so there is significant potential for economic growth simply from a greater influx of foreign students (Figure 2).

The second salient benefit of immigration typically appears when foreign students remain in the host country and build their careers there. At present, however, the number of foreign graduates who apply for Japanese working visas is a fraction

Figure 2



Source: Fostering Global Engagement Through International Education, The Economic Impact of International Students from a Cross Cultural Perspective (pg. 39), taken from NAFSA: Association of International Educators (2009).

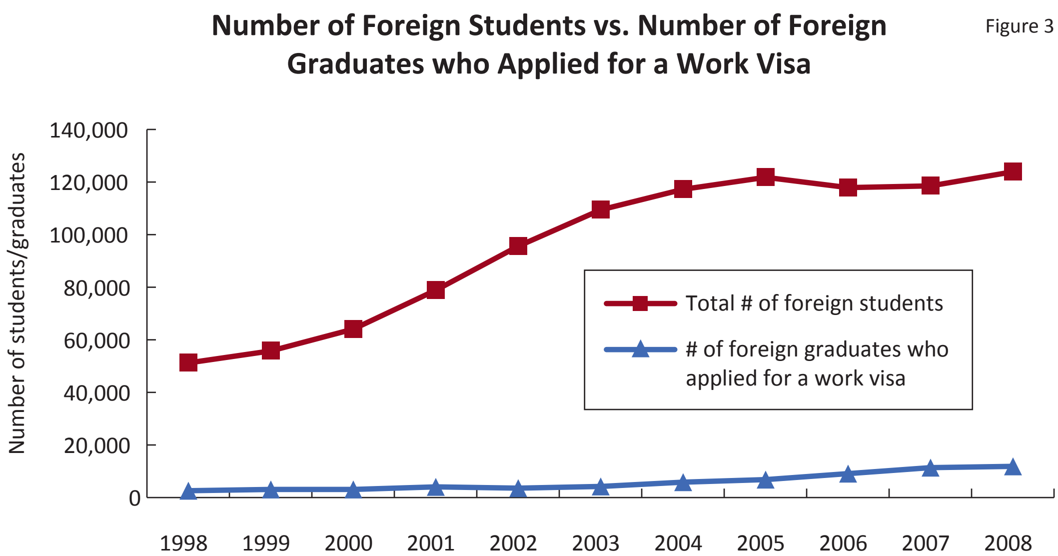
of the masses of foreign students in Japan (Figure 3). The urgent need for policy reforms to address this massive opportunity gap is clear.

Fundamental Problems with Current Immigration and Visa Policies

The primary issue with Japan's current immigration policies is that foreign graduates of Japanese universities do not benefit the Japanese economy in the longer term. Japan's foreign student population has been steadily increasing since the early 2000s, but less than 10 percent of these students end up seeking Japanese working visas (see Figure 3).The rest leave the country after graduation to work, invest or establish businesses elsewhere.

In 2008, for example, only about 11,800 foreign students out of the 123,800 studying in Japan applied for a Japanese working visa. These foreigners that Japan is training in its language and ways of

Figure 3



life and business are leaving to benefit another country's economy after they graduate.

In terms of economic growth, this low proportion of "stayers" represents a substantial lost opportunity. By further easing rules regarding working visas and extending the period of student visas, the Japanese government would actively encourage an economically promising segment of foreign students to remain and work in Japan on a long-term basis.

The second-biggest issue is that Japan's huge and sophisticated economy is not attracting its full share of individual investors. Anecdotal evidence and the real-life experiences of ACCJ members show that Japan does indeed attract a wide variety of foreigners who start up successful businesses here based on fresh ideas. There would be more such entrepreneurs if the system were geared to seamlessly promote their entry.

It is important to recognize that the tiny 1.1 percent proportion of immigrants in Japan's declining workforce is not just the result of particular immigration rules and regulations. The policies themselves are also inconsistent. The Japanese government should integrate public relations and greater cross-ministerial coordination into its immigration policies. Working together, the various arms of the government need to send clear and consistent messages that attract and retain high-quality students and immigrants and promote the workforce diversification, development and internationalization of human resources capital that Japan urgently requires.

Japan's new, clear immigration policy will require specific changes to create internal consistency and alignment with other pro-investment and pro-growth policies, such as those promoting general entrepreneurial investment. These policies must actively encourage visitors to stay longer in Japan and consider engaging themselves as entrepreneurs and direct investors as they integrate into Japanese society, thereby contributing to economic growth locally and globally.

Likewise, this updated immigration policy will require coordination with overall education policy, including policies to enhance labor mobility and a relaxation of rules for such things as short-term work visas for skilled employees who are employees of multinationals or hired under contract. (Please see the other chapters on education policy and labor mobility for more detail on these issues.)

Japan Needs to Ride This Virtuous Cycle

Immigration policies refined with a view to stimulating economic growth will also promote inward globalization of the sort that Professors Fukao and Kwon, and other experts, have pointed out is essential for Japan to increase productivity, FDI, and new entrants to Japan's market. The Fukao-Kwon Report shows that over the past fifteen years, these factors have started to work together to create a virtuous cycle. However, the still-low cumulative base of FDI—and the low penetration rate of immigrants into Japan's workforce—indicate that these assets are significantly underutilized in the growth game and could be harnessed to a much greater degree to turn the gears of growth faster.

As Professor Fukao calculated in 2003, if Japan were to raise its stock of inward FDI from 1.1 percent of GDP to the U.S. level of 12.4 percent, capital investment by foreign-affiliated firms would lead to a 1.5 percent increase in capital stock—an 18.8 trillion yen impact—and that GDP would expand by 1.5 percent, or 7.5 trillion yen. Moreover, if foreign-affiliated firms raised their share of total employment from the current 1.3 percent to the U.S. level of 8.6 percent, they would support some 4.6 million jobs.

In the seven years since Professor Fukao wrote that analysis, however, the base of cumulative inward FDI has only increased to 3.89 percent of GDP. Yet according to the most recent Fukao-Kwon Report, even this modest increase has already had a major positive impact on economic activity, productivity and net job growth.

Based on this analysis, the ACCJ's policy recommendations will focus on the following groups of individuals:

- Foreign investors and entrepreneurs who intend to underwrite or operate a business in Japan
- Foreign graduates of Japanese universities who demonstrate Japanese-language proficiency

III. RECOMMENDATIONS

The ACCJ recommends the following changes to streamline and simplify Japan's current immigration infrastructure:

A. Offer Flexible Visa and Immigration Options to Foreign Students with a Japanese Education and Business-Level Fluency

- *Grant a visa extension option of a year and a half* to foreign graduates of Japanese universities who have business-level Japanese ability. The current grace period is six months, and can be renewed once for an additional six months. One year is often not enough time for these fledgling jobseekers to procure meaningful employment in Japan. It is also important to ensure that they can qualify for other employment visas after this extended period.
- *Drop the current ten-year residency requirement* for permanent resident status to five years. Furthermore, help qualified foreign students obtain permanent residency on an expedited basis by letting the four years they spend at a Japanese university count toward the five-year requirement, to be supplemented by one year of work experience in Japan after graduation. Present policy requires foreign students to work in Japan for a minimum of five years after graduation before their Japanese university years can be counted toward the present requirement of ten years.

  Reducing the ten-year minimum will provide a significant incentive for Japan-educated foreign students to remain here and either obtain jobs at Japanese firms or establish startup businesses. The resulting flow of talent into the workforce will benefit Japan's long-term economic growth, jumpstart its global business competitiveness and increase labor productivity and competitiveness. In the long term, permanent residence will ensure that foreign students are able to take advantage of their cross-cultural professional capabilities and work in either their home countries, Japan, or both.

B. Offer Incentives to Draw More Individual Foreign Investors and Entrepreneurs to Japan

- *Develop more flexible and attractive self-sponsorship visa options* for foreign investors and entrepreneurs who possess the minimum five million yen in business startup capital and demonstrate sufficient intent to conduct business in Japan, regardless of their visa status.

  Currently, there is no specific status of residence stipulated in the immigration code as a "self-sponsor visa." However, the immigration code does provide a "self-sponsorship" residence status for "Engineers" and "Specialists in Humanities/ International Services" as exceptions for foreigners who are not employed by a company. To be eligible for self-sponsorship, applicants must present multiple contracts from companies certifying that the minimum required level of income stipulated by their residence status will be met, and also provide proof that they have paid Japanese taxes for the previous twelve-month period. Regional immigration authorities evaluate these applications on a case-by-case basis.

To show that Japan is open to convenient business formation by foreign entrepreneurs, these self-sponsorship rules and restrictions need to be relaxed and standardized.

- *Create provisional visa options* that facilitate the smooth and timely conversion of visa status from "tourist" to "business/investor" for foreigners who show the means and intent to invest in or create businesses in Japan.

  The current procedure requires such individuals to return to their home countries (or another country outside Japan with a Japanese embassy) to renew their tourist visas. We recommend eliminating this costly bureaucratic requirement and similar burdensome procedures, and granting visiting investors and entrepreneurs a special provisional visa while they are planning to launch a venture in Japan, raising the required capital and finalizing their business plans.

  Qualifying for the coveted business/investor visa currently requires startup capital of five million yen and office space. If actively raising money and contracting for office property are considered non-tourist activities, prospective immigrant investors are caught in a double bind. First, they cannot realistically prepare to apply for the business/investor visa without courting the risk of being seen as committing a visa violation. Second, it may not be possible to secure office space without a non-tourist visa.

IV. CONCLUSION

To maximize the potential for FDI inflows and economic growth, the Japanese government needs to review and revise any and all obstructive and burdensome stipulations that complicate visa applications for foreign students and entrepreneurial foreign investors. Japan's current immigration policy regarding foreign investors is structurally sound and does not require broad, sweeping changes. However, the current system does not make it easy for foreigners who have graduated from Japanese universities gain entry into Japanese society.

Pursuing these measures will add new strength to Japan's workforce, and the investments these new members of society make will accelerate the global exchange of novel ideas and business practices Japan needs to enrich its stagnant economy. Japan will also gain the multicultural entrepreneurial human capital it needs to compete in today's global arena.

The ACCJ therefore urges the government of Japan to improve its immigration procedures and integrate immigration policy with its economic growth strategy. This should include establishing a favorable environment that helps qualified bilingual foreigners apply for the visas they need to work in Japan, and future foreign investors and entrepreneurs to conduct business here. This will also require close cross-ministerial coordination of policies, and for Japan to send clear and consistent messages to show that, for qualified applicants, immigrating to Japan is a viable and attractive option. Collecting "user feedback" also has an important role.

The thoughtful repositioning of current Japanese immigration policy outlined above will encourage foreign observers to once again look upon Japan as a flourishing center of investment and business opportunity.