ECONOMIC OUTLOOK

by Richard Katz

Growth versus equality debate

You're both wrong!

Here we go again. As a result of today's political turmoil, Japan is once again going through a sterile debate that pits growth against equality.

Many of the LDP leaders are reading—misreading, in our view—the July elections as a repudiation of the reforms of Junichiro Koizumi by the LDP's traditional rural constituencies. They argue that the party can only win back support by shoring up equality and security, and that it can only do the latter via the traditional growth-destroying tools of public works, protection of inefficient economic sectors and the like. In other words, to gain equality, Japan must give up growth.

On the other hand, there are the Japanese reformers who, in the Koizumi tradition, can only see reform in its Thatcherite version. To gain growth, Japan must sacrifice equality and security.

If the debate remains locked into this mode, additional reforms will be hard to come by. Besides, the fundamental premise the debate is misguided. A look at the experience of other countries shows that equality and growth can be friends, not alternatives.

Among 12 OECD countries, countries with greater income equality enjoyed slightly faster growth in GDP per worker during 1995-2005 (see chart). In fact, research is divided on how much, if any, trade-off there is between growth and equality.

Japan's problem is not that it has too much equality and security. Japan's problem is that the way it achieved that equality and security destroyed growth. It simply needs to change how it achieves those objectives. With the right kind of reform, Japan could gain a lot more efficiency and growth without giving up as much equality and security as under the choices now being presented to voters.

Three economic models

When it comes to income equality among rich countries, we can see can see three models:

* *Swedish model*: Income distribution produced by the market (wages, income of self-employed, and returns to capital) is unequal, but government redistribution (taxes and transfer payments) do a lot to make income distribution more equal.

* *US model:* (particularly post-Reagan): Income distribution produced by the market is unequal and government redistribution only modifies this a little.

* *Japan model:* (pre-1990 or 1995): Income distribution apparently produced by the market is more equal than elsewhere; hence the government does little directly to redistribute income.

First, let's look at the distribution of income produced by the market in 1995 (see top panel in the table on pg. 11). Japan had, by far, the highest share for the poorest 30% and the lowest share for the richest 30%. The US and Sweden look surprisingly similar.

Now, let's look at the final disposable income after including taxes and transfer payments (middle panel of the table). Sweden, along with Denmark, had the highest share of disposable income going to the poor and lowest share to the richest 30%. Japan was close to the 12-country average. The US had the lowest share going to the poor and tied with Italy for the most going to the rich.

Finally, let's look at the impact of government in redistributing income (bottom panel). Denmark and Sweden, along with Belgium, did the most to shift income from rich to poor. Japan, by far, did the least. The US was second to Japan in doing so little.

A Nordic mirror

Interestingly enough, when it comes to income distribution, two Nordic countries, Norway and Denmark, have a lot in common with the "Japan model."

Out of 15 OECD countries ranked in the mid-1980s by Gini co-efficient (a different measure of income equality); Norway and Denmark topped the ranks with the most equal market-determined distribution of income. Japan came in fourth. As a result, like Japan, Denmark and Norway saw little need to do that much via taxes and government transfer payments to further equalize income. Denmark ranked 13th and Norway ranked 11th in government measures to equalize income. Japan was 15th. Nonetheless, because market-determined income distribution had started off so equally, Denmark came in 2nd and Norway 3rd in the final post-government distribution of disposable income. Japan didn't do as well: it was 9th.

Unlike Japan, both countries found a way to make the market-income more equal without sacrificing growth. During 1993-2004, Denmark's per capita grew 2.1% a year, about the average for Europe. Norway grew 2.7% a year per capita, 0.5% faster than

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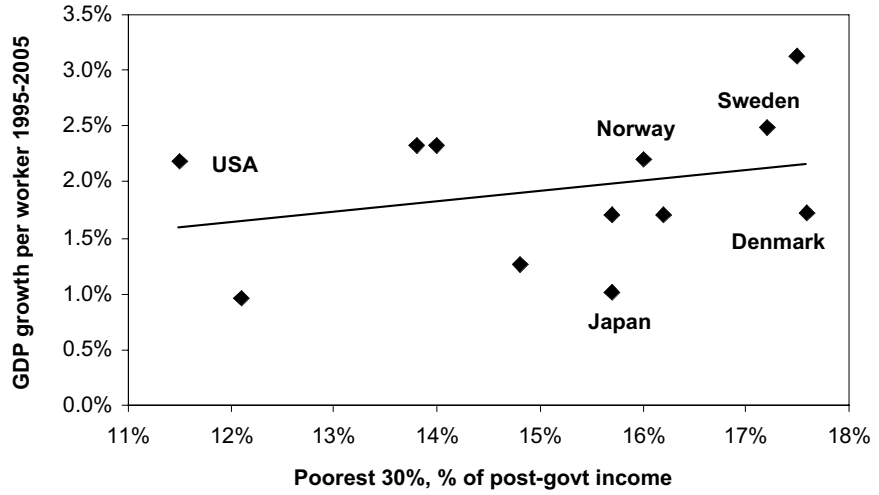
Growth and equality are not enemies



Source: OECD and Penn World Tables
Note: "% of post-govt income" means the share of income held by the poorest 30% after considering taxes and government spending

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the European average and 0.3% faster than the US. Out of 20 OECD countries, Norway stood second to the US in per capita GDP in 2004, at 96% of the US level. Denmark was fifth at 79%.

In 2004, Norway's unemployment rate stood at only 4.4% and Denmark's at 5.2% (way down from 10% in 1993). To cure Eurosclerotic rates of unemployment, Denmark introduced a "flex-security" package of active measures to help workers move from job to job.

Naturally, the Scandinavian countries have had their share of problems, including banking crises in the early 1990s. Sweden was hit particularly hard. As a result, the Scandinavian countries have had to adjust various growth-hindering parts of their system, while keeping intact the basic goal of achieving both growth and equality.

Sweden appears to have done well in making needed reforms. After growing only 0.9% per capita a year in the decade ending in 1996, its per capita growth nearly tripled to 2.8% in the ten years ending in 2006. Labor productivity in the private sector doubled from 1.9% a year in 1981-91 to 2.9% in 1992-2001 to 4% in 2002-06.

Humpy Dumpty is dead

Japan's people have been accustomed to a society in which income equality appears to have been produced by the market. Now, due to a number of forces, that market-income equality is eroding. Yet, the government is still doing little to counteract the trend. On the contrary, under constraints of the budget deficit, it wants to cut spending that spreads wealth. In the name of alleged incentives and increasing the competitiveness of Japanese firms in the global market, it wants to lower taxes on rich people and companies. Shifting from the income tax to the consumption tax also undermines redistribution.

What Japan's reformers and resistors both overlook is that market-produced income equality can be done either in ways that are harmonious with growth or in ways that destroy growth.

Progessive taxes, aid to education and social mobility, a good minimum wage, good pay for overtime, good regulations regarding part-timers and temps, heavy unionization, active measures to workers move from job to job, can all help produce greater equality of income. Moreover, these measures do this without much, if any, trade-off between equality and growth. In fact, some of these measures actually help growth.

On the other hand, when Japan preserves inefficient industries and firms in the name of job security, this undermines growth. The Bank of Japan found that a large part of the income of the inefficient service sector was really a covert redistribution from the manufacturing sector.

In the end, Japan's economy-distorting form of redistribution destroyed itself by causing the "lost decade." There is no going back. Since then, cuts in public works, deflation, increased imports and other trends have weakened the covert mechanisms of income redistribution. Yet, as these elements disappeared, they were not replaced by more positive overt measures. At the beginning of 2007, the minimum wage in Japan was only 28% of the average wage, far lower than France's 47% and lower even than the US level of 34%, a level that Congress is raising to around 45% over the next two years.

To gain support, the opposition Democratic Party of Japan (DPJ) has supported both pro-growth and anti-growth forms of redistribution. It wants to raisie the minimum wage to 1,000 yen from the current 673 yen and boost overtime pay 50% above regular hourly wages from the current 25% level. The DPJ has also proposed more regressive measures, like price supports for rice even more generous than LDP's plans.

Japan has a history of absorbing the best practices of other countries. It needs to do so again. The Scandinavian experience may be particularly relevant. Even though some of the Nordic practices spring from a social democratic tradition, many of them are more in tune with Japan's communal spirit than the "rugged individualism" of post-Reagan America or Thatcher's Britain.

Market distribution of national income

	Poorest 30%	Richest 30%
Japan	13.7%	51.2%
Norway	8.8%	54.2%
Sweden	8.0%	57.0%
Denmark	7.8%	54.6%
US	7.6%	59.6%
Average of 12 OECD countries	8.1%	57.6%

Distribution after taxes and government spending

	Poorest 30%	Richest 30%
Denmark	17.6%	44.2%
Sweden	17.2%	44.9%
Norway	16.0%	46.8%
Japan	15.7%	47.8%
US	11.5%	53.5%
Average of 12 OECD countries	15.2%	48.5%

Impact of government taxes and spending

	Poorest 30%	Richest 30%
Denmark	9.8%	-10.4%
Sweden	9.2%	-12.1%
Norway	7.2%	- 7.4%
US	3.9%	- 6.1%
Japan	2.0%	- 3.4%
Average of 12 OECD countries	7.1%	- 9.1%

Source: OECD, data from 1995
Note: The top two panels show the share of personal income by the poorest and richest 30% of the population; the bottom panel shows the change in the share of income caused by taxes and government spending.