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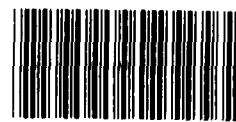
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STATEMENT OF

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BEFORE THE  
SENATE COMMITTEE ON FINANCE



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SUBCOMMITTEE ON ECONOMIC GROWTH, EMPLOYMENT  
AND REVENUE SHARING

ON

JAPANESE INDUSTRIAL POLICY

Mr. Chairman and Members of the Subcommittee:

We are pleased to be with you today to discuss our reports, "Industrial Policy: Japan's Flexible Approach" (GAO/ID-82-32) and "Industrial Policy: Case Studies in the Japanese Experience" (GAO/ID-83-11). Our work focused on (1) exploring the contribution of macroeconomic policy to industrial growth, (2) determining those policies which support growing industries, and (3) determining those which assist declining industries.

We examined Japan's past and present experiences with industrial policy and reviewed the goals and tools of Japan's industrial policy to assess how and why they have changed over the postwar period. In addition, we discussed how macroeconomic

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monetary and fiscal policies have helped to achieve the goals of industrial policy.

From World War II through the early 1970s, the widely accepted consensus in Japan strongly supported government efforts to reconstruct the economy by rebuilding the nation's basic industries and by working to catch up with the technology of the United States and Western Europe. This was accomplished by using such tools as

- strict foreign exchange controls,
- commercial policies which gave incentives to exports and restricted imports, and
- controls over foreign investment and the acquisition of technology.

Monetary and fiscal policies reinforced the effectiveness of these tools in a number of ways, but primarily by

- keeping interest rates low, thereby lowering the cost of investment and generating demand for loanable funds that exceeded supply;
- placing strict controls over domestic capital markets, which effectively prevented these markets from becoming a major source of free market capital;
- administering a tax system which favored savings and investment; and
- channeling government-controlled resources into productive investment.

In the early postwar years, policy goals were primarily oriented toward rebuilding specific basic industries and an industrial infrastructure. By the mid-1960s, Japan had largely achieved its postwar development goals and began placing growing

emphasis on technology and social development issues. Following the economic turbulence of the mid-1970s, Japan has focused on adjusting to stable growth, supporting resource conservation and environmental improvements, while continuing to support the development of new technology.

With these changes in the goals of industrial policy, tools to implement these goals also changed. Such changes are attributed to numerous factors, including

- the financial success of Japanese firms which left them less dependent on debt financing;
- the relaxation of domestic regulation of financial markets, which opened new avenues of financing to firms;
- international pressure and obligations of Japan, such as those under the International Monetary Fund and the General Agreement of Tariffs and Trade;
- increasing budget deficits, which placed constraints on the government's ability to finance industrial development; and
- a rising class of structurally depressed industries.

Government influence over key industrial sectors began to weaken as a result of these factors.

#### INDUSTRIAL POLICY TOWARD GROWTH INDUSTRIES

To illustrate our discussion on the mechanics of industrial policy in growth industries, we studied computers, aircraft, and robotics. Segments of each of these industries meet criteria enumerated in the government's overall economic goals, that is,

they embody high value added or contribute to productivity or quality improvements in the Japanese economy or society as a whole. Industrial policy for these industries is implemented within a framework of temporary laws which promote electronics and machinery industries. These laws have allowed the Ministry of International Trade and Industry (MITI) to permit certain activities under exemptions from Japan's anti-monopoly law. A loosely constructed framework composed of numerous government and industry groups provides coordination for policy development and implementation.

A significant aspect of Japan's industrial policy toward emerging industries lies in government support for the development of leading-edge technologies as well as support for the diffusion of advanced technology throughout the economy. The industries receiving support, therefore, are important not only in and of themselves but also for improving the performance and productivity of the economy as a whole. Direct subsidies to joint industry-government research and development projects and tax credits for research and development help to provide the resources to develop new technology. Recognizing that the contribution of new technology depends on how quickly and widely it spreads throughout the economy, the Japanese Government has also used preferential tax treatment, credit, and government supported leasing companies to encourage the diffusion of new technology.

INDUSTRIAL POLICY TOWARD  
DECLINING INDUSTRIES

Rising labor costs, sluggish world demand, lower priced products from Southeast Asia, increased raw materials costs, and foreign market import restrictions have all contributed to severe economic disruptions for some Japanese industries. The government has attempted to assist these declining industries to adjust to new circumstances through numerous mechanisms. The government also assists workers in these industries through a number of unemployment and reemployment programs.

Government assistance toward declining industries has several basic objectives:

- to help industries adjust to short-term or cyclical disruptions;
- to help industries which need significant restructuring to regain their competitiveness; and
- to help industry segments which have lost comparative advantage move into more competitive, higher value-added production.

The parameters of government involvement in the adjustment process are outlined in the Specific Industries Structural Improvement Temporary Measures Law enacted in July 1983 and in its predecessor, the Structurally Depressed Industries Law, enacted in 1978. The earlier law outlined general criteria under which industries could apply for designation as depressed and basic elements of stabilization plans to reduce industry capacity. "Depressed" in the context of this legislation can apply to an industry suffering from either a cyclical fall in demand

or secular decline. The 1983 law is geared toward basic industries, primarily refiners and processors of intermediate products, hard hit by energy price increases, sluggish demand in the economy, and the rise of developing country competitors.

Under the 1978 law, 14 sectors were designated as structurally depressed, including shipbuilding, the synthetic fiber segment of the textile industry, aluminum refining, and urea, among others. Basic materials industries which can be considered for designation as depressed under provisions of the 1983 law can be divided into four general categories.

1. Those in secular decline due to rising raw material and energy costs.
2. Those experiencing reduced demand due to energy conservation.
3. Those needing on-going product development to respond to competition from newly industrializing countries, And,
4. Those in cyclical downturns because of depressed business conditions.

A number of industries or industry segments have been designated for assistance under this new law, including aluminum smelting, petrochemicals, chemical fertilizers (urea, ammonium, and phosphoric acid), electric furnace steel, synthetic textile fibers, ferroalloys (ferrosilicon), paper and paperboard, and polyvinyl chloride, among others. The shipbuilding industry, included in the 1978 law, is not covered by the 1983 law.

Under provisions of both laws, stabilization plans are developed through negotiations between the government, industry and labor. These plans may include commitments on the part of industry to scrap certain equipment, close down production facilities, install new, more modern equipment, and so on. The plans also include proposals for reductions in work force, employee transfers, early retirement, retraining and outplacement programs. The nature and form of government assistance is also outlined in the stabilization plans. Formulating consensus on the appropriate adjustment mechanisms through this negotiating process has become increasingly difficult.

The emphasis of government assistance is on helping small and medium-sized enterprises to adjust on the premise that large firms have sufficient internal resources to reduce capacity and diversify and greater flexibility in shifting workers. The government also has measures available under other laws to assist small and medium-sized firms, depressed regions, and displaced workers.

#### SPECIFIC TOOLS OF GOVERNMENT ASSISTANCE

Tools of government assistance are essentially the same under both the 1978 and 1983 laws. The primary tools available to the government are anti-trust waivers, financial assistance through government loans and loan guarantees, and tax incen-

tives. Import restrictions are not prohibited, however, the laws state that trade protection to maintain or preserve uncompetitiveness should be avoided. In addition to these tools, the government has implemented a number of employment assistance programs to aid unemployed workers.

#### Anti-trust waivers

The use of cartels is a primary tool available to the government in helping industry adjust. The depressed industries laws grant a specific waiver from Japan's anti-monopoly law for the creation of anti-recession cartels for the purpose of reducing industry output. Cartels are also used to reduce production capacity in response to long run secular decline.

For the most part, anti-recession cartels are used to address short-term price and production disruptions. MITI may authorize the creation of a cartel to reduce industry output in response to any number of competitive factors which may be injuring an industry. The key feature of these cartels is that they are approved only for specified time periods, and for output reduction.

MITI can also authorize other forms of joint activities, with the concurrence of Japan's Fair Trade Commission (JFTC). In many industries designated under the 1983 depressed industries law, (e.g.-ethylene, urea, phosphoric acid, etc.) MITI is proposing that firms engage in joint production,



marketing, sales, and investment activities. MITI proposes joint activities of this nature with the aim of restructuring and revitalizing the industry concerned. Such cartel activities, developed in the context of industry stabilization plans, are permitted for limited and clearly specified time periods. However, these activities can result in permanent changes in the structure of these industries.

#### Financial assistance

Financial assistance in the form of loan guarantees and preferential financing has been used by the government to assist structural adjustment. Under provisions of the Structurally Depressed Industries Law, the government established the Depressed Industries Credit Fund. The primary contribution to this fund (80 percent) came from the Japan Development Bank, with the remainder coming from private financial institutions. Loan guarantees have been provided from this fund to the shipbuilding and aluminum industries. By far the largest proportion of this fund, roughly 62 percent, was designated for shipbuilders. Additionally, a Shipbuilding Stabilization Association, created to oversee capacity cutbacks, purchased nine shipyards with loans from the Japan Development Bank and commercial banks and with capital raised from the government and private sector. In the case of the textile industry, the government has provided low-interest loans to encourage equipment modernization and in one instance paid outright for equipment to be scrapped.

### Tax incentives

Tax incentives are also available to assist in the adjustment process. For the textile mills, tax incentives were provided to encourage equipment modernization. Although not under the auspices of the depressed industries laws, Japan also provides tax incentives to industries to locate or relocate in depressed areas to help ameliorate the effects of industrial decline.

### Trade protection

It has been the stated policy of the Japanese Government to avoid the use of trade restrictions in the formulation and implementation of restructuring and revitalization plans for depressed industries. This precept is specified in both the 1978 and 1983 depressed industries laws. MITI believes that by not implementing restrictive trade measures, it is able to constantly "remind" the industry that adjustment is necessary and thereby gain quicker industry acceptance of stabilization plans.

However, MITI has not always followed through with this principle. For the aluminum refining industry, designated under both the 1978 and 1983 laws, MITI imposed a combined tariff and quota system for the importation of alumina. It is also our understanding that although no formal trade restrictions were imposed on the import of chemical fertilizers, MITI has attempted to restrict such imports through administrative guidance.

Japan defends its depressed industries law as representing a positive adjustment policy in accord with Organization for Economic Cooperation and Development standards which state that aid to declining industries should be limited in time and be directed at eliminating uncompetitive operations, and retaining only those parts of an industry which can be viable over the long term.

Stabilization plans: conflict or cooperation

Inherent in the process of developing stabilization or adjustment plans is a great deal of conflict. In virtually all industries where some sort of restructuring has been necessary, the process has been marked by significant conflict between government and industry, firms within the industry, and in fact, between government agencies. Despite a generally constructive working relationship between these groups, consensus-formation has been difficult.

There was severe conflict in the shipbuilding industry, for example, between government and industry concerning the extent of capacity reductions and among large, small and medium-sized firms concerning which would bear the most significant costs associated with these reductions. Similar conflicts existed in the aluminum industry and delayed the conclusion of a plan for several years. Moreover, JFTC and MITI have at numerous times disagreed on the activities which would be permitted in cartels

formed under the law. Finally, political and social constraints have caused the government to take actions it thought economically unwise, such as assisting a shipbuilder which had relatively little hope of regaining its competitive position.

### Employment policies

Labor adjustments in Japan have been relatively smooth in large multiproduct firms, while small and medium-sized companies have experienced a more protracted and often acrimonious process. Our review of the shipbuilding industry, which is comprised of small, medium, and large firms, reflects this pattern. Patterns of adjustment in large firms are characterized by (1) heavy reliance on inter- and intra-firm transfers, (2) labor reductions through attrition, (3) cost reductions through cuts in working hours, bonuses, and wages, and (4) diversification of business activities. Because of their ability to transfer workers, large firms also make widespread use of retraining. In smaller firms, adjustment measures are more likely to include lay-offs of part-time employees, solicited early retirements and outright dismissals.

The government has created a series of measures, designed to assist unemployed workers and to smooth structural adjustments, which concentrate on employment stabilization and retraining. The unemployment insurance system, financed by employer and employee contributions, contains an employment

adjustment subsidy which has been used since 1975 as a short-term measure to maintain employment in depressed industries. Firms certified as eligible by the Ministry of Labor receive reimbursement for one-half to two-thirds of a worker's wage. Receipt of these funds is contingent on preparation and implementation of detailed adjustment plans. Local employment offices receive and approve the plans.

In conjunction with the passage of the Structurally Depressed Industries Law, two employment measures were enacted, one for unemployed workers in depressed industries and one for workers in depressed areas. These measures, together with a third one aimed at small and medium-sized firms, provide various unemployment benefits, subsidies, assistance for retraining and job searches, and provisions for employment in public works programs for eligible workers. Since the late 1970s, public employment policies have placed increasing importance on providing employment opportunities for older workers.

Under the above provisions, between 1975 and 1979 a total of \$730.7 million was allocated by the government to 1.3 million displaced workers and roughly 700,000 establishments. Government assistance appears to have been relatively more important in smaller firms, while the potential for shifting labor within the firm and extensive cooperation between labor and management in agreeing to formal adjustment plans have been significant in larger firms.

## OBSERVATIONS

In the decade since the first oil crisis, Japan has experienced industrial problems, slower economic growth, and increased exposure to international trade and competition. In an era of slower overall growth, adjustment to decline in specific industries is difficult to achieve, creating severe economic and political pressures on the government.

The Japanese Government has developed a coordinated approach to problems of adjustment of declining industries. The focus of government assistance has been on small and medium sized firms, because large firms typically are expected to adjust more readily on their own. However, attempts are made to include all firms in an industry in negotiating an adjustment plan. Within the framework of the structurally depressed industries laws, industry and labor agree to stabilization and/or restructuring plans in return for government assistance in the adjustment process. The significance of such programs lies in industry and labor recognizing the need to restructure and being willing to do so, as evidenced by acceptance of stabilization plans. By attempting to avoid the use of import restrictions the government forces industries to recognize the need for positive adjustment. The information provided in the context of this process makes possible better analysis of the causes and effects of the problems faced by a particular industry and helps determine the most effective mechanism for

adjustment--scrapping, mothballing, and/or modernization programs. The Japanese process, therefore, is one in which responsibility for industrial restructuring and employment adjustment is shared by industry and labor, with the government providing the incentive and funds where necessary.

The adjustment process in Japan is not always a smooth or easy one as evidenced by the difficulties encountered in formulating consensus concerning the development and implementation of stabilization plans. Moreover, political considerations can hamper or override what would otherwise be economically rational decisions on the part of the government.

The ultimate success of the Japanese Government's adjustment programs will lie in its ability to closely coordinate adjustment to decline with incentives to encourage shifts of resources into more competitive, promising activities. Tax incentives to encourage new industries to locate in depressed regions and programs of the Japan Development Bank to develop infrastructure and provide funding to attract industries to these areas are all steps in this direction. In a slower growth environment, recognizing that emerging industries can ease adjustment problems of declining industries and coordinating programs to assist resource shifts from declining to emerging industries are key elements of Japan's positive adjustment policy.