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JAPAN AS LOCATION OF FOREIGN DIRECT INVESTMENT (FDI) – BARRIERS AND RECOMMENDATIONS

Abstract: The third largest economy have been losing its position in global economic system because of years of neglect that had generated administrative, cost and cultural barriers for trade and investment flows. Far from potential of Japanese economy FDI inflows indicate the necessity of reform in order to increase competitiveness of the economy. Recommendations include improvements of M&As, FDI regulations, sectoral strategies, reduction of business costs, increase of system transparency, revitalisation using foreign capital. In particular, investors expect reduction of tax rate and labour costs. In this context, foundations of government strategy should be more ambitious.

Key words: Japan, Foreign Direct Investment, mergers & acquisitions.

1. Introduction

Japan, the third largest economy – after United States and European Union, accounts for 11% of global GDP and 6% of world trade, respectively. Export-oriented, Japanese economy's ratio of exports to GDP fluctuates between 10 and 15%, meanwhile imports' share in domestic demand reached the modest level of 6%. Mostly characteristic is strengthening position of East Asian emerging economies within global trade of goods, which results in rapid expansion of bilateral agreements between Asian tigers of two generations (like Singapore and South Korea) and well developed countries from Asia-Pacific region, especially United States and Japan. One of indirect negative consequences of deepening complexity of regional rules of trade is low Japanese FDI performance, far from potential and expectations. The phenomenon analyzed below should be associated especially with structural barriers, rather than protectionist dimension of trade policy, however, some aspects of corporate governance should be also taken into account and considered.

2. Barriers to FDI inflows in Japan

Calculations presented in UNCTAD *World Investment Report 2008* confirmed the lowest position of Japan in terms of FDI performance of OECD member states

(Figure 1). The stock of FDI in Japan was only 2% of GDP (according to data from 2007), compared to 14% in United States and almost 38% in Canada.

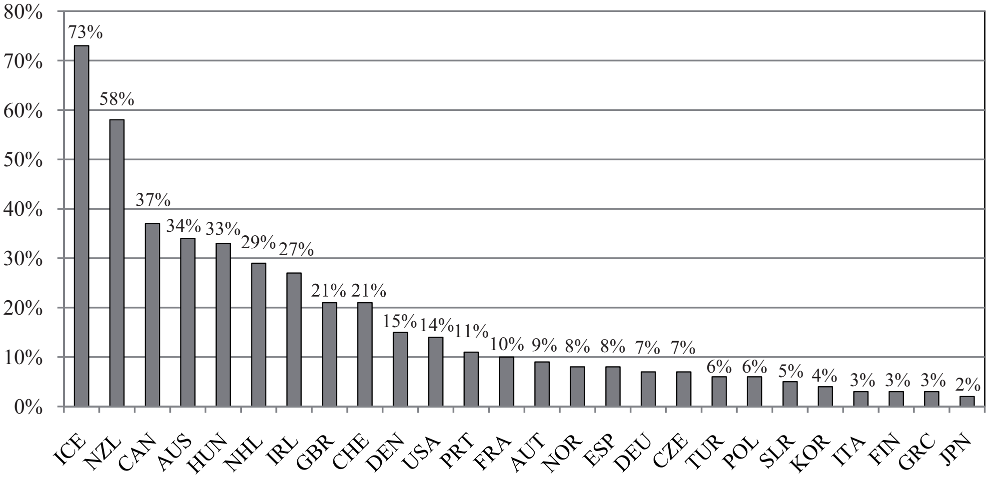

Figure 1. FDI/GDP ratio for OECD member states

Source: *World Investment Report 2008*, www.oecd.org/dataoecd/26/56/33717459.xls UNCTAD, New York and Geneva 2008.

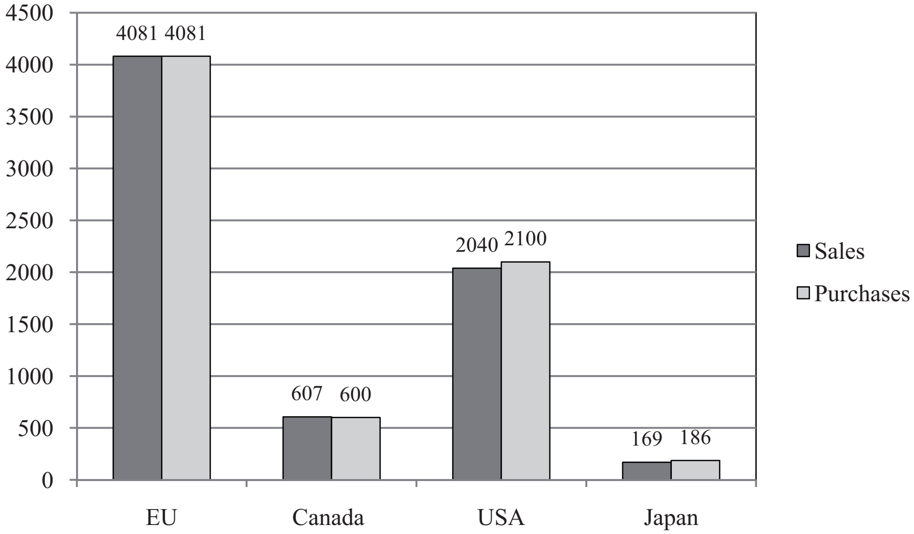

Figure 2. International M&As deals in 2007

Source: *World Investment Report 2008.*

FDI/GDP ratio for Japan remains lower than that for other well developed countries like Germany, France, United States or Great Britain (7, 10, 14, 21%, respectively), at the same time represents similar level to other Asian member state of OECD – South Korea. Considerable divergence between the potential of Japanese economy and the scale of FDI inflows indicates some failures and inefficiency of business environment and structure, which affects foreign investors' operations undertaken within national economy. Very characteristic was relatively low number of mergers & acquisitions (M&As) deals in Japan when compared to other OECD member states (Figure 2).

Only 169 sales of domestic Japanese companies to foreign buyers, versus186 purchases of foreign companies by domestic buyers in the same period suggest serious structural problems of national economy. Dynamics of M&As transactions might be perceived as a kind of side effect of restructuring processes.

Project implemented by the Japanese Ministry of Economy, Trade and Industry is connected with the identification of main obstacles for foreign investors – precisely, 209 senior executives of US, European and Asian companies were interviewed (Figure 3).

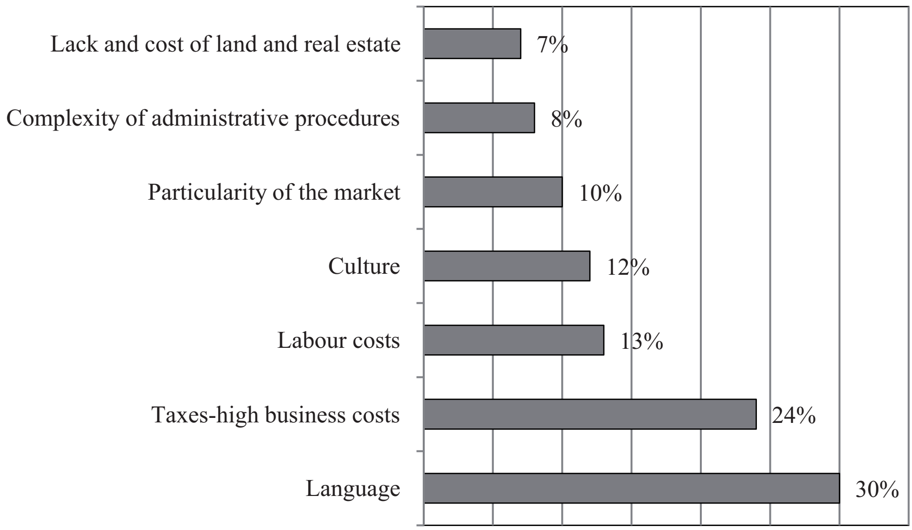

Figure 3. Main obstacles to investing in Japan

Source: Ernst and Young and JETRO, *Japan's Attractiveness Survey 2008*, JETRO, Japan 2008.

Within the most serious barriers, which were underlined regarding the Japanese market, language- and cost-related criteria were mentioned. Language was cited by investors as the main obstacle (30%), followed by taxes and labour costs (24 and 13%, respectively). Many obstacles, in fact specific for Japanese market, seem to be hard to overcome in the short and medium term. Closed character of economy, Keiretsu-affiliated companies and orientation on personal buyer–supplier relationship are deeply rooted in Japanese culture, generating exceptional challenges for foreign investors.

Obstacles mentioned above may differ across sectors (Table 1). For instance, over half of investors from the information and telecommunication sector (ITC) faced language barrier, while representatives of chemical, pharmaceutical, medical equipment manufacturing-life science sector, wholesale and business-to-business services complain of the language difficulties much more rarely (17 and 205, respectively).

Table 1. Main obstacles to investing in Japan by sector (in %)

Obstacle	Total	ITC	Business services	Life science	Automotive	Electronics
Language	30	52	20	17	36	26
Taxes-high business costs	24	14	20	26	41	17
Labour costs	13	10	9	11	9	24
Culture	12	14	11	17	14	4
Particularity of the market	10	10	11	13	5	11
Complexity of administrative procedures	8	8	11	13	5	4
Lack and cost of land and real estate	7	6	11	–	9	7

Source: Ernst and Young and JETRO, *Japan's Attractiveness Survey 2008*.

It should be stressed that 41% of investors from automotive sector experienced relatively high business costs in Japan, while almost one fourth of respondents from electronics sector complained of labour costs. Complexity of administrative procedures, related to approval of licences, legal regulations and standards, and inspections of products may suggest low competitiveness of Japanese market and inefficiency of regulatory reform process (Table 2).

Main categories that should be considered as anti-competitive in Japan were regulations of telecommunication and energy sector, strongly conditioned by political circumstances, especially within institutional frameworks (6.0 respectively). Far from western counterparts scores' were also Japanese indicators for regulations of network sector and accountability of regulations of telecommunication sector (5.1 respectively).

Table 2. The regulatory reform and competition in Japan

Item	Japan	EU	USA	Canada
Competition law and policy indicator	2.8	1.3	1.4	1.8
Antitrust framework	2.0	1.3	1.4	1.7
Network sector regulation	5.3	–	1.6	2.2
Scope of law and enforcement	2.4	1.3	1.4	1.6
Legal framework and rules	2.6	1.8	2.9	2.8
Exemptions	1.0	1.0	3.4	2.7
Merger regimes	1.3	1.7	0.3	0.0
Enforcement	3.4	0.8	0.3	1.5
Independence of competition authorities	0.5	1.4	1.5	1.8
Institutional design	1.0	1.7	3.0	3.5
Accountability	0.0	1.2	0.0	0.0
Independence of sector regulations, telecommunication	6.0	1.9	0.7	2.0
Institutional design	6.0	1.2	0.0	1.5
Accountability	5.1	0.9	0.0	2.4
Powers	6.0	3.6	2.0	2.0
Independence of sector regulations, energy	6.0	2.1	0.9	1.5
Institutional design	6.0	1.2	0.0	0.0
Accountability	–	1.0	0.0	2.4
Powers	–	4.0	2.7	2.0
Network access	3.5	2.1	2.4	2.3
Entry restrictions	1.8	1.6	1.7	1.1
Vertical integration	6.0	2.8	3.5	4.0

Note: Individual policies are scored against a benchmark of generally – agreed best practices in the area of competition enhancing policies. Low (high) scores are indicative of a high (low) level of competition. Scores lie between 0 and 6. “Network Access” focuses on regulations affecting market access and vertical separation of network sectors.

Source: *Competition Law and Policy Indicators for the OECD Countries*, Working Paper 568, OECD, 2007.

3. Government initiatives to stimulate FDI inflows

Several projects to attract Japan as localization of FDI have been implemented by the government since 2003, among them "Program for the Promotion of Foreign Direct Investment in Japan", formulated by the Japan Investment Council (JIC), which established a strategic plan to improve the evaluation of foreign investors. The main goal was to double the FDI stock over the period 2001-2006. Apparently, the principle was achieved – the FDI stock increased from 6.6 trillion yens in 2001 to 12.8 trillion yens in 2006 (Figure 4).

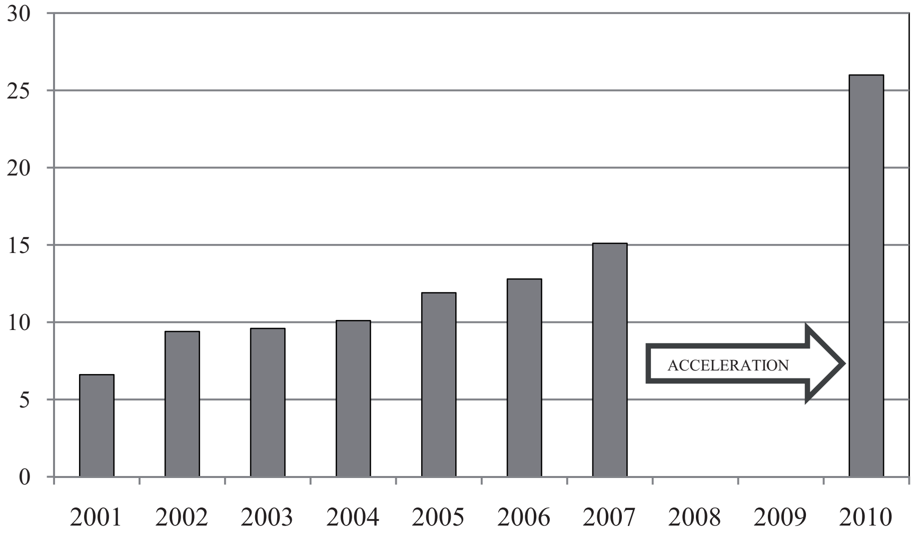

Figure 4. The Japanese government' FDI target (trillions of yens)

Source: *United States – Japan Investment Initiative 2008 Report*, US Japan Economic Partnership for Growth, 2008; http://www.mac.doc.gov/japan-korea/sector-specific/Investment%20Initiative%202008%20Report.pdf.

In 2006 government formulated another goal – increase of FDI Stock by 2010 to the level of 55 of GDP, which requires an acceleration of the growth rate in FDI inflows. Taking into account FDI/GDP ratio of 4% for South Korea in 2007 (Figure 1), Japanese goal appears to be quite modest. Optimistic symptom of slight improvement was observed in 2007 – annual increase of 2.3 trillion yens, the biggest in 5 years.

In 2006 JIC announced the "Program for Acceleration of Foreign Direct Investments in Japan" including government's perspective 2010. Two years later, the Expert Committee on FDI Promotion was created in order to project and implement innovative instruments of stimulating FDI inflows, setting out the views of foreign investors interested in entering and expanding their activities in the Japanese market. Results of discussions were included in the document "Five Recommendations toward the Drastic Expansion of Foreign Direct Investment in Japan". The five recommendations included:

1. Enhancement of the system for the facilitation of M&A
- corporate M&A activities in Japan (boost the predictability of the M&A process),
- sorting out and clarifying takeover rules without delay,
- promotion of studies for the facilitation of cross-border M&A,
- elimination of allergy towards M&As by foreign companies.

2. Comprehensive studies on FDI regulations
- clarification of the scope and grounds of cases where FDI regulations are necessary as exceptions to the principle of non-discrimination between domestic and foreign investors),
- Japan's open investment policy should be shown to the rest of the world.

3. Establishment of priority strategies by sector
- bringing the world's most advanced medicines to Japan,
- selection of sectors and formulation of action programs (in particular medical devices and pharmaceutical products).

4. Reduction of business costs and improvement of system transparency
- reduction of the corporate tax rate,
- improvement of the "no-action letter" system and written reply procedures for taxes,
- evaluation of regulations and administrative burden survey,
- revision of hearing procedures, etc., under the Antimonopoly Act,
- promotion of utilisation of private-sector dynamism in public service by government.

5. Regional revitalisation by foreign capital
- strategic attraction of foreign capital in wide-area economic zones ("local to local"),
- activities to attract foreign capital centred on former private-sector personnel,
- building on living environments suitable for foreigners,
- facilitating continuation of business of small and medium-sized companies through foreign capital M&As,
- strengthening of appeal that FDI in Japan is welcome.[1]

Expert Committee's priorities should be confront with foreign investors' expectations (Table 3).

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[1] *Five Recommendations Toward the Drastic Expansion of Foreign Direct Investment in Japan*, Expert Committee on FDI Promotion, 2008, http://www.investjapan.go.jp/fdip/files/en_recommendations_20080519.pdf.

Table 3. Investors' expectations as to Japanese government policy (in %)

Item	Total	ITC	Business services	Life science	Automotive	Electronics
Reduce taxation	45	50	44	39	50	43
Reduce language barriers	40	42	33	35	45	46
Reduce labour costs	38	42	33	39	32	43
Make labour regulation more flexible	29	48	24	26	18	26
Implement simpler, more flexible administrative procedures	25	24	20	17	32	33
Improve the country's image abroad	17	16	16	17	23	11
Improve quality of life	15	20	16	15	9	13
Improve the education system	11	8	22	9	5	11
Improve transport and communication infrastructure	8	6	13	11	5	4
Improve innovation and R&D	7	12	7	7	5	4

Source: *Japan's Attractiveness Survey 2008*.

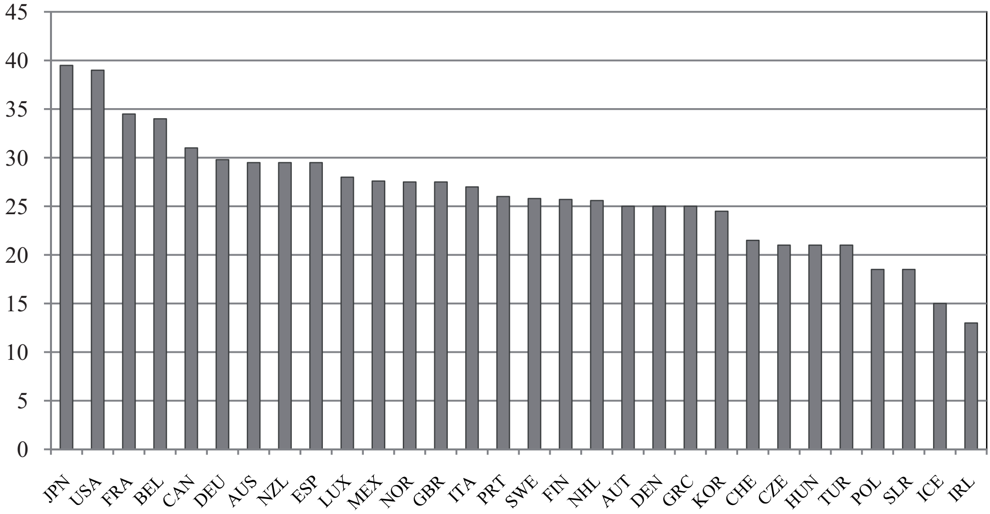

Figure 5. Combined corporate income tax rate

Source: *World Investment Report 2008*; S.A. Hodge, US States Lead the World in High Corporate, *Taxes Fiscal Fact* 2008, Vol. 119.

In general, almost a half of respondents expect reduction of taxes, next – reduction of language barriers and labour costs (45, 40 and 38% respectively), mostly within ITC and electronics sector. Infrastructural issues, the same as aspects of innovativeness, were of marginal significance. Some legal improvements to increase flexibility of labour market regulations were expected especially by representatives of ITC sector (48%). One fourth of foreign investors suggested more flexibility of administrative procedures (particularly in the automotive industry and manufacturing of electronics, electrical instruments and high-tech equipment).

Taxation issues, so often emphasized by respondents, arose mainly due to the fact that Japan actually has the highest combined corporate tax rate among the OECD countries (Figure 5).

However, the importance of taxations issues and its influence seems to be indirect – OECD member states, like Poland, Republic of Slovakia, South Korea or Greece, with tax rate under 25% (Japan – almost 40%), do not experience relatively high FDI performance (FDI/GDP ratio of 6, 5, 4, 3%, respectively). Obviously, the impact of attractive taxation conditions is strongly correlated with other factors, like legal and institutional framework, labour costs and infrastructure.

4. Conclusions

Japan, challenged by various economic difficulties, like deflation and low growth dynamics, but also by strengthening position of regional emerging economies, had to redefine its role and policy. Traditionally formulated economic structures, character of business relations and political implications within strategic sectors affect the size and directions of trade flows, which determine also FDI inflows because of their mutual complementarity. Liberalization of trade might stimulate FDI inflows, easing barriers to investment should encourage trade.[2] Long-term consequences, especially effectiveness of initiatives and programmes implemented by Japanese government in context of attracting FDI inflows, cannot be evaluated still, but, taking into consideration quite modest principles, further actions will be required.

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JAPONIA JAKO LOKALIZACJA BEZPOŚREDNICH INWESTYCJI ZAGRANICZNYCH – BARIERY I REKOMENDACJE

Streszczenie: Trzecia co do wielkości gospodarka świata traci pozycję w globalnym systemie ekonomicznym za sprawą wieloletnich zaniedbań generujących bariery administracyjne, kosztowe, a także kulturowe dla przepływów towarowych i inwestycyjnych. Daleki od potencjału gospodarki japońskiej napływ BIZ wskazuje na konieczność reform dla podniesienia konkurencyjności gospodarki. Rekomenduje się w szczególności usprawnienie procesów przejęć i fuzji, regulacji dotyczących BIZ, strategii sektorowych, redukcję kosztów biznesowych, zwiększenie transparentności systemu, rewitalizację na bazie kapitału zagranicznego. Inwestorzy oczekują w szczególności redukcji stopy podatkowej oraz kosztów pracy. W tym kontekście założenia strategii administracji rządowej powinny być bardziej ambitne.