

## ESRI Policy Forum

# Some Unique Aspects of the Japanese Economy: Obstacles/Potentials to Expand Inward FDI in Japan?

Kozo Kiyota  
Keio University

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2 Labor market conditions

3 Tax and debt

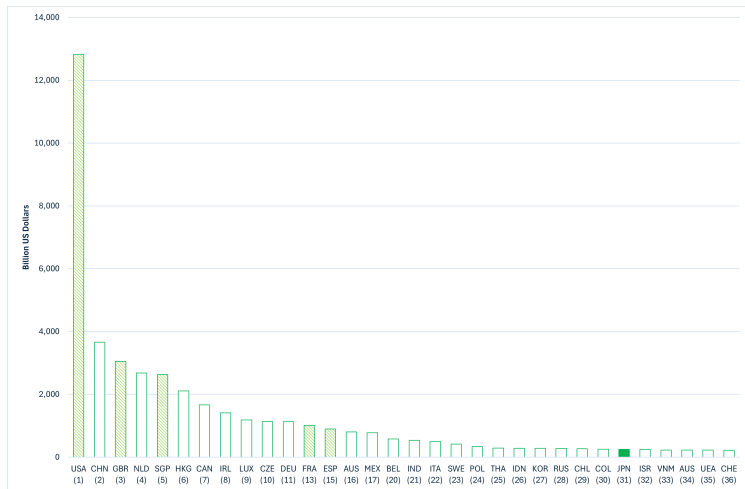
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# Inward FDI stock

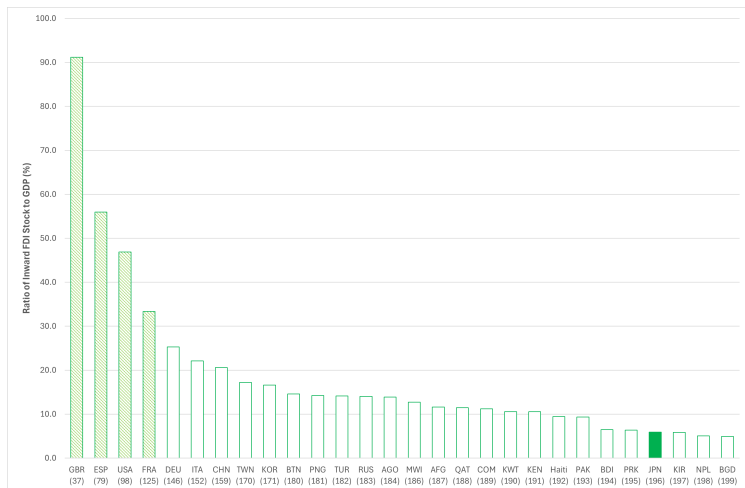


Note: The horizontal axis indicates countries (represented by their ISO alpha-3 country codes). Figures in parenthesis indicate the rank. Figures in the UNCTAD are based on the directional principle.

Source: UNCTAD (2023) World Investment Report.

- In 2023, inward foreign direct investment (FDI) stock in Japan was about 247 billion US dollars, which was ranked 31st of 199 countries

# Ratio of inward FDI stock to GDP



Note: The horizontal axis indicates countries (represented by their ISO alpha-3 country codes). Figures in parenthesis indicate the rank. Singapore was ranked 5th (561% of GDP). Figures in the UNCTAD are based on the directional principle.

Source: UNCTAD (2023) World Investment Report.

- If I account for the country size, inward FDI in Japan is extremely low
- The ratio of inward FDI stock to GDP was 5.7%, which was ranked 196th of 199 countries (the lowest among OECD countries)

# Background

- The figure implies that Japan is one of the least attractive and/or the most protected countries for foreign firms
- While a bigger ratio is not necessarily better for welfare, the rank 196th of 199 countries looks extremely low for developed countries
- Japanese government is trying to attract FDI in Japan

# Background

- In this speech, I highlight some unique aspects of Japanese economy that could be obstacles/potentials to expand inward FDI in Japan:
  - ① Labor market conditions
  - ② Tax and debt
  - ③ Language
  - ④ Technology
- The purpose of this speech is to motivate the discussion
- Due to the data availability, let me mainly focus on OECD countries in 2019 (before the COVID-19 pandemic)

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# Labor market flexibility and employment protection

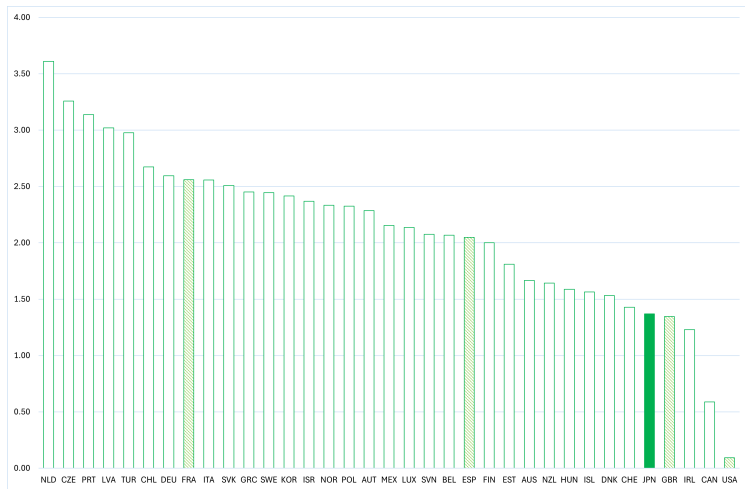
- The low level of inward FDI in Japan may be attributable to the low flexibility of the labor market
  - JETRO (2019) pointed out that low labor mobility is one reason for the difficulty in securing human resources for foreign firms in Japan
  - Cabinet Office (2014) and METI (2022) made similar points
- However, it is not necessarily clear whether the flexibility of the Japanese labor market is low or not



# Labor market flexibility and employment protection

- One measure of labor market flexibility is the degree of employment protection
  - Dewit, Görg, and Montagna (2009) and Olney (2013) argued that high levels of employment protection tend to deter FDI
- Another measure of labor market flexibility is the change in the ratio of short-term unemployment
  - Nakamura, Kaihatsu, and Yagi (2019) measured labor market flexibility as the change in the ratio of short-term unemployment to the total labor force, where short-term unemployment is defined as unemployment occurring within the last three months
- I check the degree of employment protection that is measured by the strictness of employment protection legislation for regular employment and labor market flexibility

# Employment protection, 2019

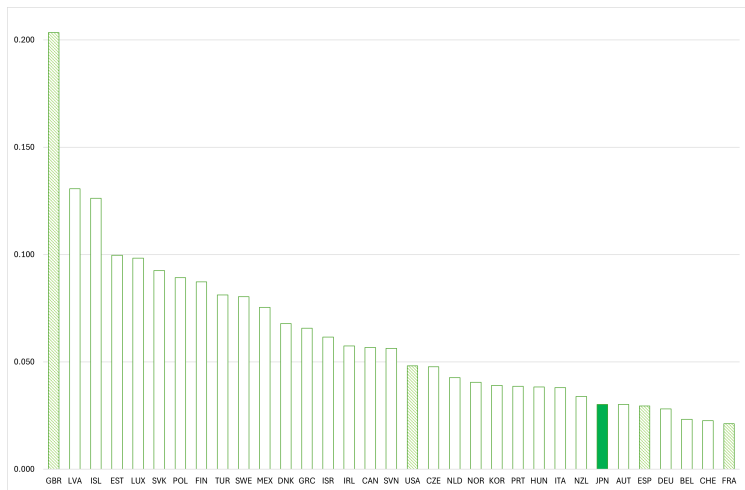


Note: The degree of employment protection that is measured by the strictness of employment protection legislation for regular employment

Source: OECD (2020) *Employment Protection Legislation*.

- The degree of employment protection in Japan is low compared with most OECD countries

# Labor market flexibility, 2019



Note: The labor market flexibility is defined as the change in the ratio of short-term unemployment to the total labor force.

Source: World Bank (2020) *World Development Indicators* and OECD (2020) *Labour Force Statistics in OECD Countries*.

- Japan's labor market flexibility is not necessarily extremely low
- Some OECD countries (e.g., Spain, France) indicate lower flexibility

# Women's rights and aging population, 2019

- In conjunction with labor market conditions, women's rights could be a determinant of FDI
  - Blanton and Blanton (2000) found that aggregate FDI is positively and significantly related to women's political rights
- In this connection, the aging and declining population may also affect FDI
  - Bonfatti, İmrohoroğlu, and Kitao (2022) argued that aging population is an important factor to explain international capital flows
- I check the women, business, and law index that takes a value between 1 (low) and 100 (high) and measures how laws and regulations affect women's economic opportunities
- I also check the ratio of older adults, which is defined as the ratio of population over 65 to total population

# Women's rights, 2019

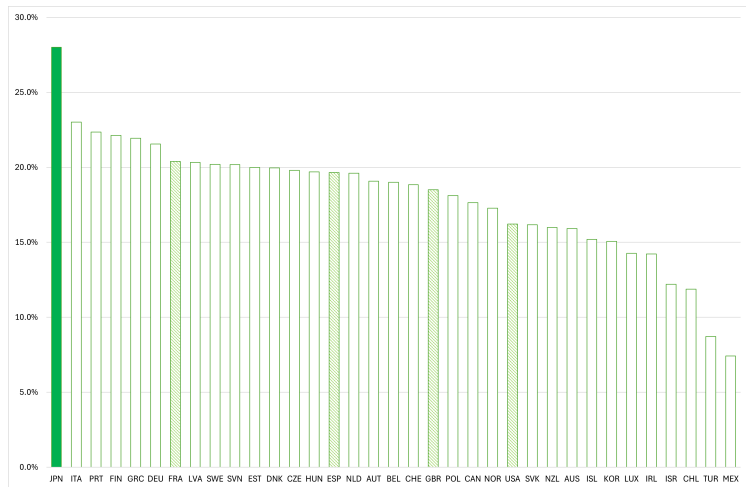


Note: The women, business, and law index takes a value between 1 and 100 and measures how laws and regulations affect women's economic opportunities. The score is calculated by taking the average score across eight areas of opportunity (going places, starting a job, getting paid, getting married, having children, running a business, managing assets, and getting a pension).

Source: World Bank (2020) World Development Indicators.

- Women's rights in Japan are low compared with most OECD countries

# Old population ratio, 2019



Note: The ratio of older adults is defined as the ratio of population over 65 to total population.

Source: World Bank (2020) it World Development Indicators.

- It is true that Japan's old population ratio is extremely high among OECD countries

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# Tax and debt

- Low-tax countries tend to attract more FDI than those with higher taxes
  - Blonigen and Piger (2013) found that corporate tax was an important determinant of FDI
- In this connection, the size of the public debt also may affect FDI
  - Dell'Ebra and Reinhardt (2015) confirmed that higher stocks of public debt to GDP decreased the probability of FDI
- I check countries' corporate tax rates, defined as combined (central and subcentral government) statutory corporate income tax rates and public debt-GDP ratio



# Corporate tax rate, 2023

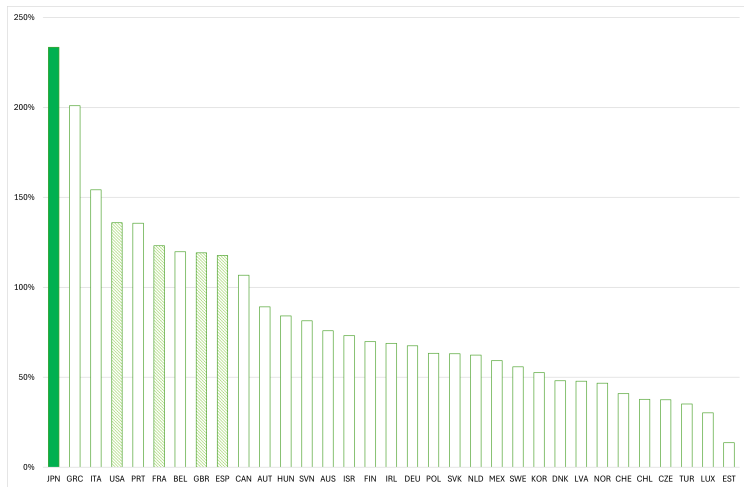


Note: Corporate tax rates are defined as combined (central and subcentral government) statutory corporate income tax rates.

Source: OECD (2023) *OECD Tax Database*.

- Although the corporate tax rate in Japan is relatively high among OECD countries, it is not extremely high

# Government debt, 2019



Note: Government debt is measured as the ratio of GDP.

Source: World Bank (2020) *World Development Indicators*.

- Japan's government debt to GDP ratio is extremely high among OECD countries

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- English language abilities may also affect FDI
  - Hejazi and Ma (2011) found that even when the foreign country has an official language other than English, having an ability to speak English also enhances multinational activity
  - However, it is not easy to obtain relevant data for all the OECD countries
  - Note that people can learn English relatively easily if their language is linguistically close to English
- I use linguistic proximity, which is a measure of the closeness of the host country's language to British English

# Linguistic proximity to British English



Note: This is a linguistic proximity index, which is a measure of the closeness of the host country's language to British English. It takes between 0 (far) and 1 (close).

Source: CEPII (2020) *Gravity Database*.

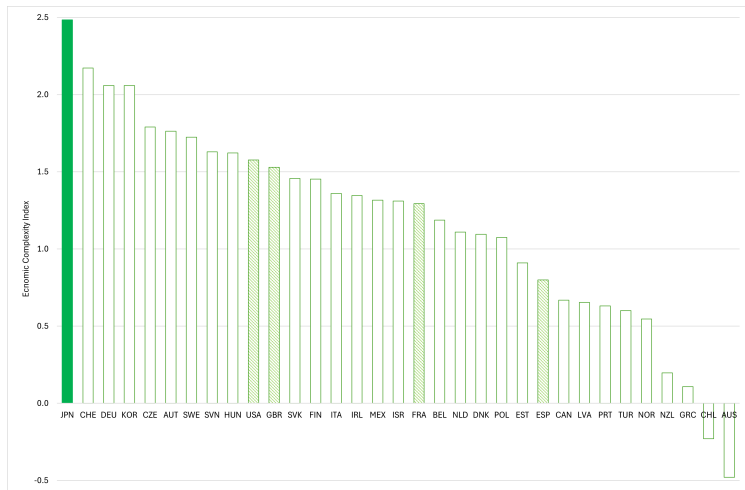
- Japanese language is very different from English

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# Economic complexity index

- The ability to produce complex products may attract FDI because foreign firms can access to high technology
  - Sadeghi, Shahrestani, Kiani, and Torabi (2020) found that economic complexity is one of the main determinants of FDI inflows
  - High export complexity index indicates high levels of complexity of the country's export products
- To investigate this possibility, I check the economic complexity index that measures the complexity of products, using export product data

# Economic complexity index, 2019



Note: Economic complexity index measures the complexity of exports, with high values indicating high levels of complexity of the country's exports.

Source: Harvard Growth Lab (2020) Economic Complexity Index.

- Japan's ECI is extremely high among OECD countries



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# Conclusion

- Inward FDI in Japan is extremely low: The ratio of inward FDI stock to GDP is 5.7%, which was ranked 196th of 199 countries (the lowest among OECD countries)
- In this speech, I highlight some unique aspects of Japanese economy that could be obstacles and/or potentials to expand inward FDI in Japan:
- It is true that:
  - Japan is facing aging population
  - Japan has very high government debt
  - Linguistic proximity between English and Japanese is very low
- However, labor market flexibility is not necessarily low, and employment protection is not necessarily high
- Moreover, Japan is the best country to produce complex products
- Now may be the time to invest in Japan when not so many other foreign companies have entered the market...

# Conclusion

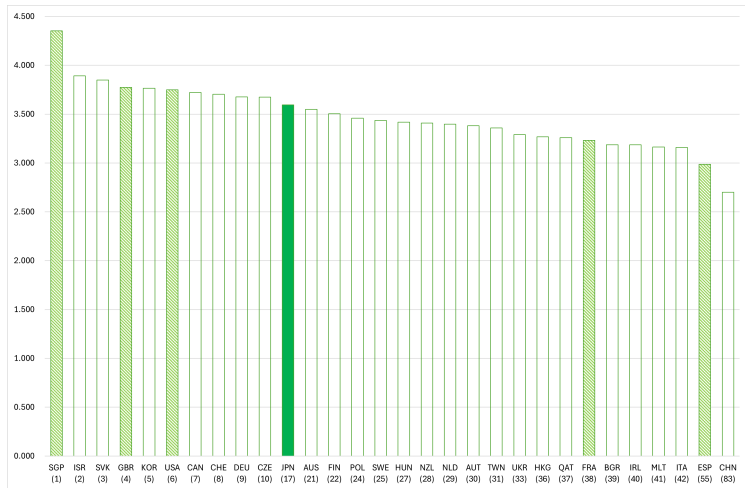
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# References

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# Human capital index, 2019

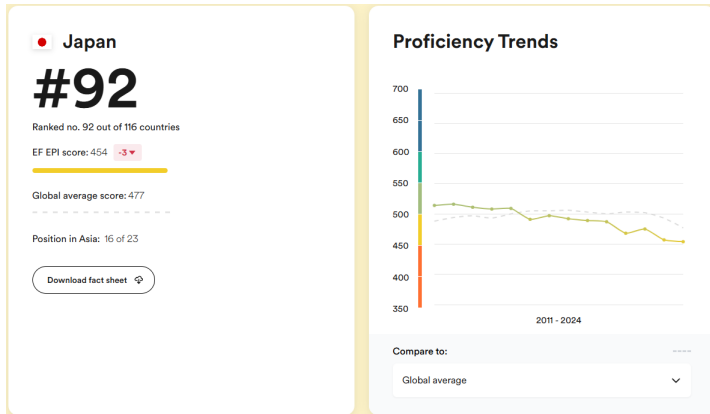


Note: Human capital index is measured by the average years of schoolings.

Source: Feenstra, Robert C., Robert Inklaar and Marcel P. Timmer (2015), "The Next Generation of the Penn World Table" American Economic Review, 105(10), 3150-3182, available for download at [www.ggd.net/pwt](http://www.ggd.net/pwt)

- Japan's human capital index is comparable to other European countries

# English proficiency index, 2023



Note: English proficiency index is based on test data from more than 2,100,000 test takers around the world who took the EF Standard English Test (EF SET) or one of EF English placement tests in 2023.

Source: Education First (2024) *EF English Proficiency Index*.

- There is still room for improvement in the English language skills of the Japanese...

# Effects of FDI on host countries

- Job creation
- Productivity spillovers
  - New technology
  - New business model
- Welfare improvements
- However, in order to gain from FDI, it is necessary for host countries to create an environment in which productivity spillovers can take place
  - Financial and institutional development: Durham (2004, European Economic Review)
  - Well-developed financial markets: Alfaro et al. (2004, Journal of International Economics)
  - Stock of human capital: Borensztein et al. (1998, Journal of International Economics)