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Digital Transformation a key factor in making wage increases sustainable

17 January 2022

- In order to achieve the Kishida administration's vision of a "virtuous circle of growth and distribution", current tax system incentives have been expanded to promote wage increases as part of the 2022 tax reform. However, we believe that sustained wage increases will require not only a boost from the tax system, but also improvements in labour productivity and growth expectations.
- The next focus will be on moves to strengthen Digital Transformation (DX) capabilities essential to increase labour productivity.
- Wage increases will ease households' deep-rooted desire to save money, and we believe that there is potential for a virtuous circle to be set in motion that enables sustainable wage increases by securing corporate profits through appropriate pricing rather than price competition, and by improving labour productivity.

Yuko Iizuka, Economist

"Stronger incentives for companies to raise wages at the core of 2022 Kishida Tax Reforms"

With a view to realising Prime Minister Kishida's vision of a "virtuous circle of growth and distribution", the focus of the 2022 tax reform will be on a tax system that encourages companies to raise wages. The ruling party plans to expand the tax incentive for wage increases by deducting a certain percentage of the increase in wages from the corporate tax rate if companies meet the applicable requirements. Specifically, it intends to increase the deduction to an unusually high level of up to 30% for large companies and up to 40% for small and medium-sized companies.

On the other hand, the requirements for application will become more stringent. Currently, large companies are eligible for the investment tax credit if their total payroll of continuing employees has increased slightly over the previous financial year or if they have made certain domestic investments. This requirement will be strengthened so that large companies whose total payroll growth does not reach 1% (0.5% in FY2022) will no longer be eligible for tax incentives for research & development and productivity improvements. In addition, large companies will be required to declare on their websites that they have a policy of increasing salaries and other payments, and that they also take into account the development of appropriate relationships with business partners (e.g. on an equal footing with subcontractors) (Figure 1).

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Figure 1: Measures to encourage active wage increases in tax reform

	Large-sized companies	Up to 30% deduction	Small and medium-sized companies	Up to 40% deduction
Payroll	Increase of 4% and above (YoY)	25%	Increase of 2.5% and above (YoY)	30%
Education and training expenses	Increase of 20% and above (YoY)	5%	Increase of 10% and above (YoY)	10%
Make it a requirement for large companies to declare their commitment to multi-stakeholder-friendly management.				
Suspend the application of special taxation measures to companies that are particularly reluctant to raise wages or investment despite growing profits.				

Source: The Liberal Democratic Party

This tax system to promote wage increases has been in place since the Abe administration. Abenomics, which sought to end deflation, aimed to create a virtuous circle of rising prices and rising wages. At the time, the government pressed for wage increases at the Shunto (annual wage negotiations between enterprise unions and employers) so that the recovery of corporate profits would lead to a prompt increase in wages. As a result, the rate of wage increases at the Shunto (including regular pay rises) has been around 2% per annum since 2014. However, wage increases excluding regular planned pay rises have remained in the zero per cent range.

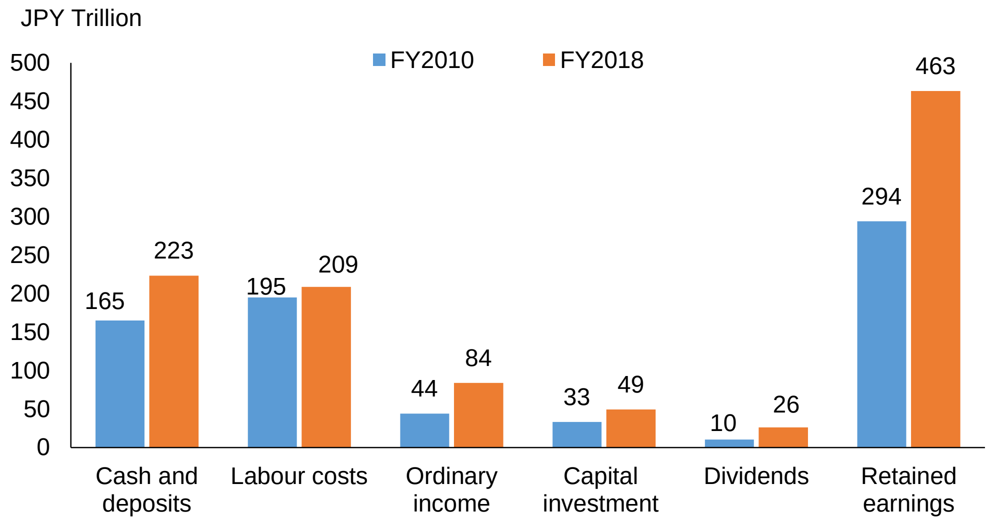
"Looking to break the status quo"

Against this backdrop, the ruling party's tax reform package contains an in-depth message on the so-called negative spiral of corporate behaviour. It notes that wage levels have been virtually static for more than 30 years, and that the scale of investment in human capital and intangible assets is inferior to that of other major economies. At the same time, shareholder returns and retained earnings have continued to rise, and the economy as a whole has been in a state of contractionary equilibrium as companies continue to look to cost-cutting and price cutting rather than innovation as a source of competitiveness.

In fact, looking at the increase in corporate finances between FY 2010 (before Abenomics) and FY 2018 (before the Covid pandemic), labour costs increased by only about JPY14 trillion and capital investment by about JPY16 trillion. On the other hand, cash and deposits increased by about JPY58 trillion and retained earnings increased significantly by about JPY169 trillion. Dividends also increased by about JPY16 trillion, exceeding personnel expenses (Figure 2).

The "virtuous circle of growth and distribution" can be broken down as follows: companies, backed by expectations of higher profits, invest aggressively in capital expenditure to enable them to offer new products and services through innovation. In response, labour productivity (value added per worker) increases, making it possible to raise wages and, as a result, to justifiably raise prices. Until now, companies have been unable to participate in this cycle. In order to achieve a sustainable, rather than a one-off, wage increase, we need not only a boost from the tax system, but also an increase in labour productivity and growth expectations.

Figure 2: Financial Situation of Companies



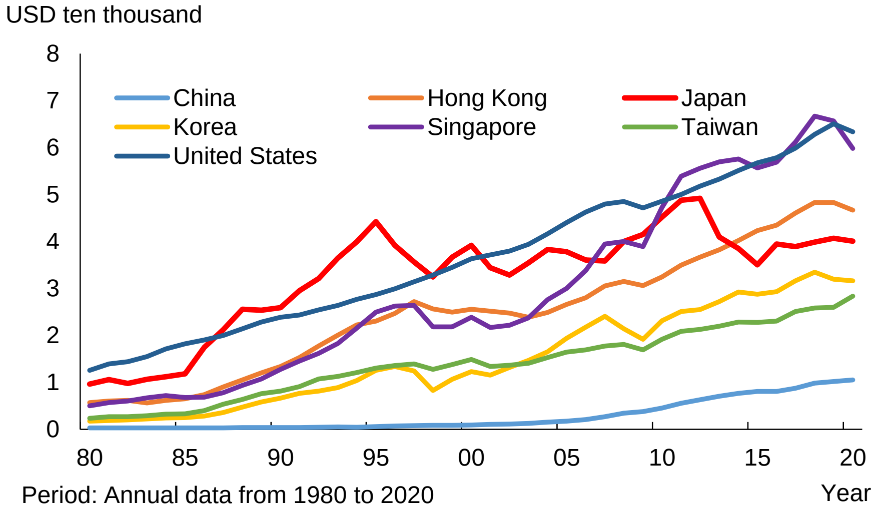
Note: All market cap sizes across all industries (ex insurance and financial services)
Source: Ministry of Finance

The Japan Center for Economic Research has published a report on Japan's growth potential based on a long-term forecast. Japan's GDP per capita has already been overtaken by Singapore and Hong Kong (Figure 3), and will be overtaken by South Korea and Taiwan in the 2020s. This is due to Japan's lack of DX capabilities. According to the report, while Japan has a high number of mobile phone subscribers and is making progress in developing communications and other DX infrastructure, its IT-related industries, human capital and research & development are weak.

DX capabilities are related to labour productivity. As Japan's working population inevitably declines, improving labour productivity and increasing investment to achieve this is a top priority. Based on corporate finances, the labour productivity (value added per employee) and labour equipment ratio (capital investment per employee) have stopped growing since 2000 (Figure 4).

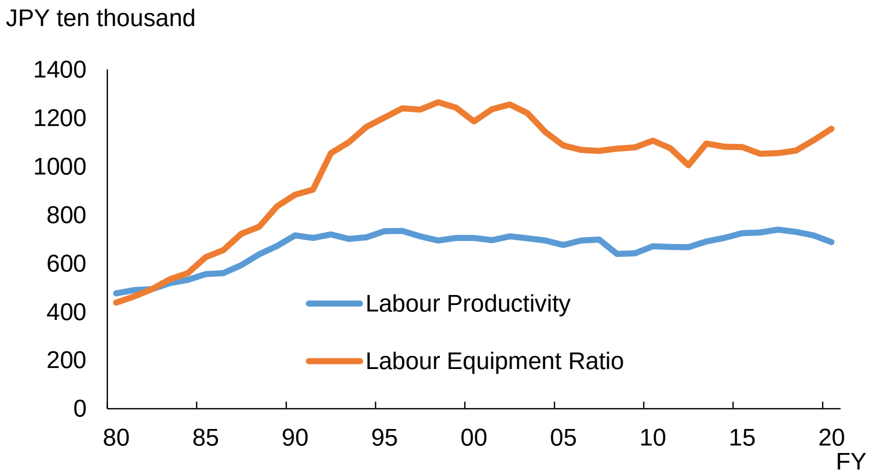
"Role of DX in unlocking Japan's growth potential"

Figure 3: GDP per capita



Period: Annual data from 1980 to 2020
Note: 2020 data is estimated (Japan data since 2015 is estimated)
Source: IMF

Figure 4: Labour Productivity and Labour Equipment Ratio



Period: Fiscal year data from FY1980 to FY2020
Note: All market cap sizes across all industries (ex insurance and financial services)
Source: Ministry of Finance

The pandemic highlighted a number of issues in Japan, including hanko (physical seals used for approval), fax machines, face-to-face oriented business practices and the lack of IT in education. Out of necessity, progress has been made in streamlining face-to-face business practices, symbolised by the hanko, and in the use of IT in education. The Digital Reform Bill, which includes the abolition of stamps in administrative procedures, was passed in May 2021. This will eliminate more than 99% of stamps in administrative procedures. In the field of education, the implementation of the GIGA school concept (development of the ICT environment in education) has been brought forward, and as of the end of March 2021, the provision of one educational terminal for each primary and junior high school student is almost complete.

"Human resources and research & development accelerate DX"

Among the economic measures approved by the Cabinet in November 2021, in addition to "strengthening the development of digital human resources", a field Japan has been shown to be lagging peers in, human resource development for young researchers and support for start-ups were also included. Although the size of the budget is still small, we note that the Kishida administration has also demonstrated commitment not seen from previous administrations to digital transformation by establishing two new [1]digitally-oriented committees and [2]councils. The first of these is a digital garden city panel, which seeks to utilise technologies to revitalise Japan's ailing regional economies, while the other focuses on promoting wide-ranging digital regulatory and administrative reforms.

In the near term, wage increases will help to ease households' deep-rooted tendency to save money. This initiative, coupled with a new level of support from the Kishida administration towards digital transformation has the potential to set in motion a virtuous circle enabling sustainable wage increases by securing profits through appropriate pricing rather than price cutting competition, and by improving labour productivity.

1. Council for a Vision for a Digital Garden City Nation Realization
2. Digital Extraordinary Administrative Advisory Committee
Source: Prime Minister of Japan and His Cabinet

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