

The SII Outcome: In Whose Best Interest?

By Jeffrey A. Frankel

*In the Structural Impediments Initiative talks,
Japan once again agreed to make its economy more efficient*

IN THE HISTORY OF NEGOTIATIONS between countries, the Structural Impediments Initiative (SII) talks between the U.S. and Japan, on which an agreement was reached June 28, 1990, stand out. The normal pattern in such bilateral negotiations is that one country makes demands that are in its own interests and the other country responds in a similar vein. A successful outcome is one in which each gives in to the other's wishes a bit, and the two sides reach an agreement that leaves both better off, as compared to failure to reach an agreement. Of course, if one country is more powerful than the other it may be able to attain more of its demands than the other side and therefore—in the usual case—profit more from the agreement.

What was most unusual about SII was that each side made demands that were in the interest of the other side, rather than being in its own interest. The U.S. government asked Japan to reform some aspects of its economy: for example, to restructure its inefficient multi-layered distribution network, in particular to repeal its Large-Scale Retail Sales Law (which allows small shopkeepers to delay the opening of large department store chains in their area for a period as long as 10 years); to tighten enforcement of its anti-trust laws, in particular to increase the monetary penalty for violations; to loosen ties within Japanese *keiretsu* (industrial groups), for example by enhancing the rights of individual shareholders relative to corporate management; to take measures to increase the supply of land (in particular, to reduce the bias toward rice cultivation) and thereby reduce the price of land; and, to increase spending on public works (for example, on waste disposal systems).

Many of these measures would be in the interest of the Japanese people because they would help translate the tremendous gains in production and wealth that Japan has made into gains in the standard of living, which is precisely what Japan now needs. A more efficient retail system, for example, would greatly benefit Japanese consumers, and measures to increase the supply of land would help increase the affordability of housing to those who currently cannot afford it.

The Japanese government asked the U.S. side to take measures to increase its household savings rate (such as reducing reliance on credit cards); to try to reduce the cost of capital to corporations (such as encouraging the financial system to focus less on short-term profits and more on long-term competitiveness; and reducing the bias toward home ownership in the tax treatment of borrowing); and, to spend more on education, training and research.

Such proposals are very much in the U.S. interest. They are precisely what the U.S. needs to boost national savings. Boosting national savings would, in turn, improve the current account balance, raise investment in fixed and human capital and help to attain the capacity to produce competitively in the future.

One other item especially in the interest of the U.S. economy was one mentioned by Japan early in SII: an increase in U.S. gasoline taxes or, better yet, a more general tax on carbon fuels. If the U.S. put a \$1 per gallon tax on gasoline—not a large amount by Japanese or European standards—it would probably raise enough money to resolve the U.S. budget and trade deficit problems in a single stroke. Among its side benefits would be a reduction in congestion and pollution.

These side benefits should increase the political appeal for a president who pledged when elected not to raise taxes, especially not income taxes. Fuel taxes can be sold as “user fees” for using the roadways or the atmosphere, or as an emergency measure to prevent global warming.

As usual in Japan-U.S. negotiations, it appears that the larger country wielded the greater bargaining power in the sense that the Japanese government made more substantive concessions in the June agreement. As a result of SII, Japan has agreed to:

- increase its spending on public works with a \$2.8 trillion comprehensive government infrastructure plan over fiscal

Dr. Frankel is Professor of Economics at the University of California at Berkeley and was recently a Visiting Scholar at the Institute for International Economics in Washington, D.C.

years 1991 to 2000 (figured cumulatively) plus more for investment by NTT and Japan Railways;

- adopt a number of measures to reduce land prices, such as relaxing zoning limits and reforming the system of land taxation that currently encourages landowners to sit on empty lots rather than sell them;
- reform the distribution system to make it more efficient and to ease import penetration, most notably by reducing the period by which small shopkeepers can delay the opening of department stores (first to 18 months and then to one year);
- strengthen enforcement of the Antimonopoly Act, discourage bid-rigging on government-funded projects, reduce the time it takes to issue patents from 37 months to 24 months and otherwise eliminate exclusionary business practices; and,

- move to loosen up *keiretsu* relationships by limiting the number of each other's shares that member companies can hold, and otherwise to ease inward foreign direct investment.

Almost all these measures should have a favorable effect on the efficiency of the Japanese economy.

On the U.S. side, the commitments the government made would mostly be beneficial for the U.S. economy were they to be fully implemented. These measures have received much less attention in the press than the Japanese concessions. The U.S. has agreed to:

- work to eliminate the federal budget deficit through negotiations with congressional leaders;
- encourage private saving;
- otherwise seek to reduce the cost of capital to corporations, as by supporting reduction of capital gains taxes;
- maintain non-discriminatory treatment of Japanese investors in the U.S.;
- reduce U.S. export controls by such means as relaxing the irrational existing ban on exports of crude oil from California;
- increase federal funding for research and development (for example, funding for the National Science Foundation); and,
- to increase support for education (with an emphasis on federal funding for science and mathematics).

Most of these measures, if enacted, would work to raise national savings, improve productivity and competitiveness and boost exports. The one exception, argue many

economists, is that a cut in the capital gains tax would probably raise the budget deficit rather than lower it when the effects on other categories of reported income and on future tax revenue are added to the immediate impact on capital gains tax revenue.

The major difference is that most of the important items to which the Bush administration has agreed concern measures that it has proposed to Congress, but are by no means assured of passage. The U.S.-Japanese working group that negotiated the SII agreement plans future meetings to check on its implementation; but with past bilateral agreements as a guide, few expect the U.S. side to be held fully accountable for its share of the commitments.

This is the SII paradox. If the U.S. were to enact fully all the Japanese proposals, it would experience a rapid surge in

national savings and reduction in the twin deficits, and would set the stage to enter the 21st century with a healthy and up-to-date stock of fixed and human capital. But because the U.S. has more bargaining power, the most substantive concessions were made on the Japanese side. The Japanese government is more likely to deliver on its commitments and, therefore, the more substantive gains will accrue to the Japanese people.

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President Bush's recent revocation of his "no new taxes" pledge is a very important step in the effort to bring down the U.S. budget deficit. Did it occur as a result of the negotiations with Japan? The revocation took place precisely two days before the announcement of the agreement in Tokyo, and its words were written into the SII Report. It is particularly interesting that Under Secretary of State Richard McCormack (sherpa for the G-7 Summit in Houston) listed the SII negotiations with Japan as one of the three reasons why the president made the tax concession. But it is doubtful that citing Japanese pressure will increase U.S. public support for a rise in taxes. Most observers believe that this was a case of the U.S. government trying to claim credit internationally for a step that was necessary in any case for domestic reasons and that the June 28 SII agreement merely influenced the timing.

Many Bush administration officials knew that the specific measures the other side proposed would in reality be of benefit primarily for the U.S. Similarly, policymakers in Japanese Prime Minister Toshiki Kaifu's government knew

that the measures proposed by the U.S. would primarily benefit Japan. One can make a case for international negotiations of this kind as a way for each government to mobilize political will and justify to its own constituents the need for difficult policy changes that are in its country's overall best interest. The Japanese government has long used *gaiatsu* (foreign pressure) as an excuse for policy changes that it wanted to make anyway. The 1984 Yen-Dollar agreement is a good example.

Perhaps as the wealth and prestige of Japan rise relative to the U.S., the Japanese will no longer be able credibly to invoke *gaiatsu* when the policy changes are all made on their side. Then symmetric U.S. policy "concessions" will be a necessary complication from the Japanese perspective and a salutary opportunity from the U.S. perspective. Perhaps in this way, the U.S. economy will finally begin to reap from negotiations with Japan the major improvements in international competitiveness the U.S. has always said it was seeking.

The U.S. did not enter into the SII negotiations with the goal of attaining political "cover" for a tax increase, nor with the goal of making Japan more competitive. Each government believed that the primary source of potential gains lay instead in SII's potential to diminish protectionist sentiment in the U.S. Congress, media and public. SII was one of the ugly progeny of the Omnibus Trade Act passed by Congress in 1988, which mandated U.S. retaliation if the proper concessions were not forthcoming by July 1990. Given this imminent deadline—as well as the benefits that many of the SII proposals could bring if actually implemented, the Bush and Kaifu governments took the wisest course in coming up with a timely agreement.

This is a dangerous game, however, as is apparent from examining the origin and logic behind SII. The U.S. has been pursuing bilateral negotiations with Japan on specific sectors for years. Agreements are announced, yet U.S. politicians complain that the bilateral Japan-U.S. trade balance does not shrink. Earlier SII rounds focused on such areas as beef, citrus products and semi-conductors. The most recent sector-specific topics have been wood products, satellites and supercomputers.

One widespread view among U.S. politicians is that the Japanese are somehow evading the agreements, in the spirit if not in the letter. Under the "results-oriented" approach,

the fact that the other team is winning—running a trade surplus—is taken as *prima facie* evidence that the playing field is not level (an inference that an umpire would never be permitted to make in a baseball game). In the view of U.S. critics, it isn't considered relevant that:

- Japan does tend to live by its agreements better than most countries;
- removing import barriers will result in more imports of U.S. goods only to the extent that they are desired by Japanese buyers;
- the size of the sectors involved in such negotiations is in any case only a small fraction of total trade;
- greater imports into Japan would not necessarily show up in the trade balance (especially the bilateral trade balance) if, for example, those who succeed in selling to Japan then

spend their earnings on Japanese exports; and,

- the U.S. deficit and Japanese surplus are determined by the respective gaps between savings and investment.

SII almost has the right idea: It would take broad macroeconomic changes, rather than microeconomic changes in trade policy for specific sectors, to reduce the trade imbalance. But most of the changes that Japan was asked to make

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under SII, even if they are fully implemented, will not have much more effect on the trade balance than did the earlier sectoral agreements.

The danger is that even though Japan abides by its specific commitments under the agreement, the bilateral trade balance will fail to shrink, and again U.S. politicians will claim that the Japanese must somehow be cheating and that a tougher trade policy is needed.

The two countries have a strong mutual interest in keeping the international trading system open. One international trade agreement which should be aggressively pursued is the Uruguay Round of GATT, which has a December deadline. Bringing agriculture, services and patents into the multilateral framework of GATT for the first time—of particular interest to the U.S.—as well as bringing textiles back into the process—of particular interest to Third World countries—and improving dispute-settlement procedures—of particular interest to Japan—would make more of a contribution to the efficiency and prosperity of the world trading system than continued bilateral negotiations between the U.S. and Japan.