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THE JAPANESE ECONOMY

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BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

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CONTENTS

WITNESSES AND STATEMENTS FOR THE RECORD

TUESDAY, JULY 26, 1994

SUBMISSIONS FOR THE RECORD

THE JAPANESE ECONOMY

TUESDAY, JULY 26, 1994

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met, pursuant to notice, at 9:55 a.m., in room 2359, Rayburn House Office Building, the Honorable Lee H. Hamilton (Member of the Committee) presiding.

Present: Representatives Hamilton and Cox.

Also present: Lee Price, Kenneth Nelson, Edward McGaffigan and Kris Hurley, professional staff members; and Caleb Marshall, Communications Director.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, MEMBER

REPRESENTATIVE HAMILTON. The Joint Economic Committee will come to order.

Welcome to today's hearing on prospects for Japanese growth in the next decade. The Japanese economy grew at double digit rates in the 1960s. Although Japan's growth rate slowed somewhat in the 1970s and 1980s, it still exceeded the U.S. growth rate by a substantial margin.

As a result, Japan's weight in the world economy grew enormously. This hearing will look beyond the current recession and examine the growth rate that might be expected once the recovery and expansion are established. Some analysts have argued that with its high rates of investment and close ties to the rapidly growing economies of the rest of Asia, Japan will once again enjoy growth in the 4 to 5 percent range over the next decade. Other economists forecast slow growth for Japan because of its aging population and the difficulties in raising productivity for industries at the technological frontier or that have rigid low-productivity institutional arrangements.

Still others point to Japan's past successes in overcoming economic obstacles and predict that Japan will soon be growing as fast as any other advanced industrial country. We have asked our witnesses to provide their own forecasts of Japanese growth in the coming decade and to identify the key factors contributing to faster growth and the barriers causing slower growth over the medium turn.

In addition, we have asked them to consider policy alternatives that might affect the long-term sustainable rate of Japanese growth. We are very fortunate to have three witnesses today who have strong backgrounds for addressing these issues; Arthur Alexander, President of

Japan Economic Institute; Dick Nanto, head of the Japan Task Force of the Congressional Research Service; and Hiroyuki Tezuka, senior representative of NKK America, Inc. and visiting scholar at The Brookings Institute.

We want to apologize to you for the late start. I think you have been informed that I had a conflict, and as you know, the House goes into session here fairly soon. So what I would like to do is take your statements and put them into the record, and we will proceed immediately to questions, if that is all right with you.

[The prepared statements of Mssrs. Alexander, Nanto and Tezuka start on pp. 15, 23 and 31 of the Submissions for the Record, respectively:]

REPRESENTATIVE HAMILTON. I know some of this will repeat some of the information that you have in your prepared statements, but that is all right.

First, I would like to get each of you on record with regard to what you see the flight path for the Japanese economy. Is it in the doldrums for a long period of time? Is it going to spurt quickly ahead and be an economic leader as it once was a few years ago? What is the outlook for the Japanese economy?

Mr. Alexander, let's start with you, and we will move across.

RESPONSE OF ARTHUR J. ALEXANDER, PRESIDENT, JAPAN ECONOMIC INSTITUTE OF AMERICA

MR. ALEXANDER. I see the Japanese economy as slowing down over the next 10 years or so for three main reasons: First, its labor input is declining as the society ages, so there are fewer people to work. Also, the quality of people has plateaued. The education and training levels really has not increased since the 1970s, so the formal qualifications and education of the work force have not increased at all. Second, investment is slowing down, partly because of declining rates of return as Japan became the most capital-intensive economy in the world. Inevitably you slide down your yield curves; you get lower returns from that. But also the financial markets are being deregulated, and the Japanese companies now have to compete on the world stage for funds, and they are being faced with competitive market rates of financial capital.

Third, productivity is slowing down. Past productivity growth partly came from very rapid rates of investment where companies got into the most productive, the newest pieces of equipment. But once you get to have the most productive, the youngest capital stock in the world, you can't do much better than that. The second part of the productivity slowdown is that there are institutions within the Japanese economy that are dragging it down.

So for all those reasons, slowdown of input, slowdown of productivity, and institutions that are dragging down the economy, I see it growing at much slower growth over the next decade or so.

REPRESENTATIVE HAMILTON. What does that mean, "slower growth"?

MR. ALEXANDER. Slower growth means down to about 2 percent a year on a real per capita basis—2 percent or less.

REPRESENTATIVE HAMILTON. You said in your statement, I was quite struck by it, the Japanese economy overall runs only 61 percent of U.S. productivity.

MR. ALEXANDER. That is right.

REPRESENTATIVE HAMILTON. So they are not the productivity giants that we often think them to be.

MR. ALEXANDER. That is right. In certain sectors, they do quite well—automobiles, steel. We have somebody here today from the steel industry who has invested huge amounts in American steel industry. In steel, electronics' productivity is better than in the United States, but these are relatively small sectors.

REPRESENTATIVE HAMILTON. Why are they so low?

MR. ALEXANDER. Mainly competition, lack of competition. About 40 to 50 percent of the Japanese economy is regulated; that controls competition. There has also been a pretty weak pro-competition policy.

REPRESENTATIVE HAMILTON. We know where they are strong. Where are they really weak?

MR. ALEXANDER. For example, food processing is one industry that many economists have looked at. Productivity is a third of America, and there are more people employed in food processing than in automobiles, automobile parts, steel, electronics and machinery, all put together. They are very poor in services, everything from finance to transportation to trade, retail and wholesale trade. So areas that basically have been protected from both domestic and foreign pressures are also low in productivity.

REPRESENTATIVE HAMILTON. So if they really wanted to get their productivity up, if you were looking at it from the larger perspective, the thing for them to do would be to focus on the lagging sections.

MR. ALEXANDER. Exactly. I think to deregulate the lagging sectors, to open them up to domestic and international competition, would be the best thing possible.

REPRESENTATIVE HAMILTON. Okay. I want to get back to that opening comment in a minute, but, Mr. Nanto, why don't you take off on the original question?

RESPONSE OF DICK K. NANTO, SPECIALIST, JAPAN TASK FORCE, CONGRESSIONAL RESEARCH SERVICE

MR. NANTO. Yes, thank you. As we at the Congressional Research Service in conjunction with Data Resources, Incorporated have looked at projections for the Japanese economy, we see a recovery occurring late this year and next year, an average of 2.5 percent growth or so in the latter half of the 1990s. Then after that, after the year 2000, dropping to about 2 percent per year.

But that means that Japan still will be the second largest economy in the world—a GNP in the year 2000 of about $6 trillion, two-thirds or so the size of the United States—with per capita GNP of $50,000. Now, of course, Japan has higher prices so the actual purchasing power of that is much less, perhaps 50 percent or less of that in real purchasing power. Japan will become more like the other industrialized countries of the world—Europe and the United States—growing at 2 percent or so and facing some of the same problems.

One of the large differences, however, with Japan, is that they are projected to continue to have a large current account surplus; a surplus rising perhaps from 130 billion this year to 145 billion over the latter half of the 1990s. And that is going to be a large problem that is going to cause more trade friction with other countries of the world.

REPRESENTATIVE HAMILTON. So the days of the double digit growth and even high single digit growth in Japan are over; is that it?

MR. NANTO. Yes. About the time that some economists wrote about accelerating growth in Japan, Japan was starting to decelerate. And it is now down to the point where it is having to face the same problems of most industrialized countries.

REPRESENTATIVE HAMILTON. You don't think then that their record of overcoming past economic obstacles suggests that they will be able to overcome these and return to a strong rate of growth?

MR. NANTO. Well, in the past they were able to exploit the gap between many industries in Japan and the best practice in the world. Now, there still are gaps in services and agriculture and some of the low-tech manufacturing areas. But those gaps have disappeared in most of the medium- and high-technology industries. And so they are less able to increase productivity through investment, and by buying and importing technology. So their growth rate will be more like the growth rate of any country at the frontier.

REPRESENTATIVE HAMILTON. How do you think their growth rate is going to compare with the other industrial countries?

MR. NANTO. It will still be slightly higher. Most of the forecasts are for the U.S. long-term growth rate to be around 2 percent or so. In a good year, we have maybe 3 percent. In a recession, of course, it is lower than that. But Europe also is not growing that quickly.

I don't have the figures for Europe right at my fingertips, but Europe is having some serious problems with growth. Okay, here they are. The European Economic Community, on average, is forecast to rise from 1990 to 1995 by about 1 percent per year, on average; but from 1995 to the year 2000, to rise to about the same as Japan—2 or 3 percent—and then in the year 2000, a little more than 2 percent per year.

REPRESENTATIVE HAMILTON. Is Japan in a recession today?

MR. NANTO. They are trying to recover. Now, the recession started in April 1991. The Bank of Japan keeps saying that they are going to recover.

Representative Hamilton. What is their growth rate going to be this year?

Mr. Nanto. This year, it will be around 0.3 percent or so.

Representative Hamilton. So they are still stagnant?

Mr. Nanto. Yes, they are still stagnant; they have been that way.

Representative Hamilton. Are there signs that they are coming out of that pretty solidly, or not?

Mr. Nanto. Recovery is going to be slow. It is going to be much like the United States came out of our recession.

Representative Hamilton. So next year is not going to be too good.

Mr. Nanto. Next year, if things pick up, it could reach 3 percent or so. But it is not going to be the usual growth rate for them, from after a recession of 4 or 5 or 6 percent.

Representative Hamilton. Okay. Mr. Tezuka, why don't you go ahead with that basic question?

RESPONSE OF HIOYUKI TEZUKA, SENIOR REPRESENTATIVE, NKK CORPORATION; AND FORMER VISITING SCHOLAR, THE BROOKINGS INSTITUTION

Mr. Tezuka. I am a professional economist also, but I have a long background in corporate strategies. So I am going to talk from the view of the management of private sectors.

The crash of bubble economy may bring some very tremendous impact on Japanese economy towards the future, because the existence of bubble and asset-based values are the sole source of the Japanese competitiveness in 1980s. The reason is that because of the asset-based inflation, most of the big Japanese companies had their pretty heavy asset base, which can support their investment using the very low or virtually zero cost capitals.

But because of the bubble crash, we lost almost 70 percent of the entire Japanese GNP in 1992. So for the first time after the rapid growth, Japanese management is now facing real cost of capital—a kind of credit crunch. But in the past couple decades, Japanese management has been experienced and has been doing low-risk management, because everyone else is getting free capital—the best solution for management is doing the same things as others. And they invest a lot in domestic production for cities.

So during that period, Japanese management has been losing capitalistic mind. This is going to be a serious problem throughout the next decade, because we are lacking in the capitalist mind, which may generate or should generate the next decade of industries and the business opportunities. But facing with our bubble crash recession, managers are following the traditional Japanese system; that is, following everyone else's strategy.

Representative Hamilton. Excuse me, Japan continuing its very, very high savings rate?

MR. TEZUKA. Yes.

REPRESENTATIVE HAMILTON. What is happening to those savings?

MR. TEZUKA. Those savings are still pretty high, because everyone in Japan is having a very ambiguous image toward the future. So people are waiting to save more than they spend.

REPRESENTATIVE HAMILTON. Doesn't that create a lot of pool for investment?

MR. TEZUKA. Yes. But that is the source of money. I am talking about the asset base of individual corporations. Now, big corporations could invest a lot because they had the pretty heavily inflated asset base. That created for them a huge credit try for bank loss. And the banks are very much willing to lend money to those established big corporations where it has a huge asset base with very generous interest rate.

REPRESENTATIVE HAMILTON. Where do you come down on this question of Japan's future growth? Are these gentlemen right, that it is going to be in the 2, 2.5 percent range?

MR. TEZUKA. Yes. He is talking, Dr. Alexander, from the macroeconomic viewpoint. I am talking from microeconomic viewpoint.

REPRESENTATIVE HAMILTON. I understand.

MR. TEZUKA. But the conclusion is almost the same.

REPRESENTATIVE HAMILTON. We don't have any optimists out there this morning. Nobody thinks Japan is going to take off again.

MR. TEZUKA. I do believe that we do have two scenarios. One is continuing the traditional system as long as possible, and losing the possible savings gradually, and getting into the vast negative cycle.

Another scenario is to give up the traditional system and start creating a new system that will be more dynamic. That means give up the asset-based management and get into flow-based management that is focusing on the profit rather than asset creation, and give up keeping the weaker players—that is, weaker industries—or in company unemployment. We have been paying a lot of costs to keep those weaker players in society. And that is going to be the burden to our next decade.

So the choice is whether we are getting into a winner-loser kind of society, or keep-everyone-happy-and-gradually-decreasing-our-wealth kind of a society. I prefer the second scenario, but currently most of our Japanese top executives still believe in the first scenario.

REPRESENTATIVE HAMILTON. But overall in Japan, we have had in the last several years a decline in the rate of Japanese investment; is that right?

MR. TEZUKA. Yes.

REPRESENTATIVE HAMILTON. Is that going to continue, are you saying?

MR. TEZUKA. Yes.

REPRESENTATIVE HAMILTON. Okay. I suppose that is one of the things you factor into your estimates, Dr. Alexander, with regard to productivity?

MR. ALEXANDER. That is right. I would like to come back to one question that you raised about what happens to all those savings. The savings that are not used in Japan are going on around the world and financing Japan's trade surplus. So as long as we continue to have this gap between the domestic investment requirements and the domestic savings flows, we will have those surpluses that Dick Nanto referred to. As we look to the future, savings is coming down a little bit slower than investment, so we can foresee a surplus for the next several years.

REPRESENTATIVE HAMILTON. Congressman Cox, please proceed.

REPRESENTATIVE COX. Having come into the middle of this, I am not quite certain where to begin, except that I have been interested in the conversation I have been hearing. I don't want to mispronounce your name, is it Tezuka?

MR. TEZUKA. Yes.

REPRESENTATIVE COX. Mr. Tezuka mentioned in his testimony, and to quote his words, "Huge bad loans that are requiring banks to charge an abnormally high spread between what they pay in savings and what they earned on their loans, that amounting to about 4 to 5 points." I wonder if you could tell us a little bit more about the nature of what you consider to be an impending problem—I take it, one that hasn't been completely realized yet, otherwise people wouldn't be reserving against it. What is the depth of the lending problem nationwide in Japan?

MR. TEZUKA. Most of the bank loans of Japanese financial institutions are backed up by the land asset value. And during the bubble economy, Japanese land asset value escalated almost double and triple. But right after the bubble crash, the whole value decreased by almost 50 or 60 percent. As far as their loans that are creating interest, they would be okay.

But in the back scene, the sound background mortgage ratio is declining a lot. So most of the banks have become very conservative about their lending money policies. So that is going to be a problem for Japanese growth. They are looking after a low risk/high return investment, which is impossible anywhere in the world. But their lending policy is very much conservative right now, and the area of the bad loan is officially announced to be 13.73 on the yen.

This is a Japanese government official announcement. But this is the really, truly bad loans. There are other potential bad loans. That is one private estimation, that a potential bad loan could be somewhere around 63 on the yen, which is far more than the American banks' financial problems in late 1980s and early 1990s.

The American banks have been experiencing tremendous difficulties to write off those bad loans in the past couple of years. So it would take a longer time for Japanese banks to write off. They are not as drastic as the American banks in writing off those bad assets, so it would take a much, much longer time. And this attitude may create a very conservative, entire economic trend in Japan in private sectors.

REPRESENTATIVE COX. I wonder if the rest of the panel would agree with the general assessment that there is a looming—if not a credit crunch—safety and soundness problem for the banking system in Japan.

MR. NANTO. Yes, the banking system in Japan really is a problem area and one of the reasons that the Japanese economy is going to slow down in the future. They are just not as willing to make loans based on real estate and increases in the stock market as before. One of the indicators of the severeness of this bad loan problem is that I believe it is the Mitsubishi Bank has to report also to the SEC in New York about its bad loans. And the numbers that it reports to the SEC are something like 40 percent higher than those it reports to the Ministry of Finance, because our definition is more strict.

In Japan, for example, I think you have to count something as nonperforming—a loan is nonperforming only after interest payments have not been paid for six months, or something like that. It is a fairly liberal definition.

The other problem is that many of the loans that Japanese banks made, for example to construction companies, are now being questioned because of the scandals in the construction industry. What usually gets the Japanese economy going is construction, public works, things like that. And that is not happening as much now because the banks are less willing to make those loans.

So this is a severe problem that is going to take a long time to work through, as Mr. Tezuka said, in Japan. It is also one that the Ministry of Finance has been taking policies to try and cure.

For example, the Ministry of Finance has funneled Japanese postal savings into the stock market to try and keep the stock market from collapsing so that the banks could keep these assets on their books. Another problem is the Bank of International Settlements requires the 8 percent capital asset ratio, and that is causing problems with Japanese banks trying to meet those ratios.

REPRESENTATIVE COX. Mr. Alexander, do you want to comment?

MR. ALEXANDER. The whole area of regulation enters in here. American banks have been able to do things like securitize many of their bad or questionable mortgages and sell them. The regulations in Japan have not allowed them to do that, so they are limited by the kinds of things that they can do; they are very limited in how they can deal with it.

Also, we have bank regulations that reduce the amount of competition within the banking sector and between banks and other financial institutions, which reduce the ability to recognize different qualities of risk so that they don't charge more for higher risk loans or higher risk bonds than for low risk ones, which again cripples the financial sector. So we have here customary business practices that are dragging down the system, and we have regulation which is dragging down the system. And both of these things will take years to work off unless we have some major changes in both kinds of practices.

REPRESENTATIVE HAMILTON. Would the gentleman yield?

REPRESENTATIVE COX. Of course.

REPRESENTATIVE HAMILTON. What about all this reform going on the political side, how does that impact the prospects for economic growth?

MR. ALEXANDER. I think the political reform is the most important thing that is happening right now. The changes that we have been talking about that are required are fundamentally political, because there are people there who are benefiting from the status quo and the society as a whole who will gain from major change. What we have seen over the last 10 or 15 years are major shifts in the political weight of different parts of the community.

People have left the farms; they have moved to the cities; they have moved out of the small towns; they have moved out of heavy industry into services. Very little of that has been reflected in politics so far, so there has been a kind of tectonic plate problem here: Major underlying shifts, but without the shaking on the surface that would reflect this.

With the fall of the Liberal Democratic Party Government last year, we are now in the middle of a transition to something new. It will take several years to work its way out, and depending on how that works its way out will determine whether the economy can get on to new ground; whether we will get the deregulation, or get rid of the old habits, or what the Russians call old thinking that is dragging down the system. So I think this is the most critical thing that we are seeing, this political transition.

REPRESENTATIVE HAMILTON. Thank you to the gentleman for yielding.

REPRESENTATIVE COX. I would like to hone in on the private estimate of 60 trillion yen that Mr. Tezuka referred to. There is a significant spread between the official estimate of 13.7 and this other of 60 trillion, but in either case, we are talking about an enormous number, even for the second largest economy in the world. You suggested that because so much of the lending in Japan is real estate backed, real estate prices will have a big influence on whether or not we actually come face to face with this 60 trillion yen nightmare. What is the prognosis for real estate of the character that is used as mortgage security for loans in Japan?

MR. TEZUKA. I am not a professional financial person.

MR. NANTO. One thing I might say is that the Japanese Government has a five-year plan. One of the goals of the five-year plan is to have the price of a house equal to, I think, five times income, which is similar to that in the United States. The policy of the Japanese Government is to keep land prices low, and so they are not inclined, I think, to start another bubble where you have this great asset and inflation in land and stock prices.

REPRESENTATIVE COX. So literally, the government policy is working to exacerbate the risk of bad loans?

MR. NANTO. Well, the government is the one that caused the asset inflation to begin with, so they have tried to correct that. At one point, land in Japan was so expensive that the value of the Imperial Palace grounds was worth all of Australia. And that was just ridiculous. People could not buy homes; there were complaints about inequities in society between the landowners and the nonlandowners. That was causing tension within society to the point that the government said this is not good either.

REPRESENTATIVE COX. Further evidence of the old truism—location, location, location, I guess.

MR. ALEXANDER. I would like to add to that a bit. The Japanese Government doesn't speak with one voice, and so we have other parts of the Japanese Government who fear the decline in land values and have been trying to keep it up. And they have been accomplices to the banking and real estate community who are trying to keep the true value of property from appearing on the books—because if they did, the asset base of the companies and the banks would decline. So there has been a kind of double policy here, one of trying to get land prices down to favor the average Japanese person. On the other side, we have sections within the Ministry of Finance who would hate to see that happen because their clients—the banks and financial companies—would suffer. So we have dual policies here, dual voices throughout the government.

REPRESENTATIVE COX. Obviously, the security for the loans is a second order problem. The first order problem is whether they continue to perform, and that directly relates to the current health of the economy. But I am struck by the sheer magnitude of the estimate. How is it that the private estimate to which you referred classifies loans so that they are called troubled loans, or risky loans, or whatever it is that accumulates that 60 trillion yen total?

MR. TEZUKA. As far as I know, the base of that is measuring, as Dr. Nanto mentioned, the difference between the government official announcement and Mitsubishi Bank's statement to the New York Stock Exchange market.

REPRESENTATIVE COX. If that is the case, then the 60 trillion yen number is the real one, and the 13.7 yen number is an artificially low one, and we are left with——

MR. TEZUKA. Not necessarily artificially low, but very much liberal estimation.

MR. ALEXANDER. As one person from the Bank of Japan said, it is a precise estimate of an arbitrary definition.

REPRESENTATIVE COX. Focusing then on the latter estimate, the private estimate, what causes a loan to make this list? I mean how risky are the loans that are included in that 60 trillion yen total? Is this an imminent failure; is it a watch list? How would you relate it to our U.S. system of classification? Or how would you just explain it in common parlance? What would be the character of a loan that would be included in this estimate?

MR. NANTO. I think the 60 trillion—actually, I have heard 40 trillion from various sources. That is probably a little more realistic. It is just that potential, which means that these loans are in trouble. In some cases——

REPRESENTATIVE COX. Are they nonperforming?

MR. NANTO. Some are nonperforming in the U.S. definition. Some are being restructured. I might add to this that a lot of the foreign investment also is nonperforming. Much of the investment in the United States in real estate, in the U.S. stock market, many of those loans now have turned out to be more than the value of the assets.

REPRESENTATIVE COX. And I take it that this exceptional spread of 4 to 5 points that the banks are charging, again, exacerbates the problem because the ability of a borrower to meet its interest payments is made all the more difficult by the high price they are paying.

MR. TEZUKA. Yes.

MR. ALEXANDER. This whole problem of the bank loans illustrates a major problem within the Japanese economy, of how the whole banking sector and the financial sector has been tied up in its regulations and, you might say, by attempts by the government to manage the situation. It illustrates also the failures within the Japanese financial system to do things like finance new innovations, to finance start-up companies, to finance the kind of new technology companies that we have in the United States.

So this is illustrative of the broader issues of long-term growth here and the problems of overmanagement, overregulation, of the financial sector in this case, but more broadly throughout the economy.

REPRESENTATIVE COX. Well, I don't mean to press this one point to the exclusion of all others. Access to capital is, of course, at the heart of what each of you has described as the challenge for Japan's future growth. So if we have a built-in major problem with the current system, which is apparently inescapable, it certainly bears our attention.

How might the Government of Japan, whoever runs it in the future, respond to this problem, if in the short term what is done is to temporize and to sweep it under the rug in the ways that you have described? As this problem grows, whether we are admitting it or not, at some point we will come to the juncture where the government has to do something. What is that something likely to be?

MR. ALEXANDER. Some of the things that have been discussed would involve things like securitizing the loans so that they could be marketed and written down, and yet bring some liquidity to the banking structure. That is one thing. That is now prohibited by regulation.

A second is just simply writing down the loans, recognizing them. Some bureaus within the Ministry of Finance don't like that because it would reduce the taxes the banks would pay, and they want to maintain the revenues, so they don't like the idea of writing off these bad loans. But to get rid of them, to get them behind you and off the balance sheet as quickly as possible, would go a long way to bringing more health into the economy.

REPRESENTATIVE COX. Is the banking structure in Japan sufficiently large to write off 60 trillion yen?

MR. ALEXANDER. They probably would not have to write off that amount, but some smaller amount. But one of the problems is transparency; we really don't know what the true scale of the problem is. So creating greater transparency into the records of the banking system would also be helpful. Right now, public policy and private decisions are resting on a lack of information. So this is another major shift in what the government could do to help alleviate this problem.

REPRESENTATIVE COX. I take it that at the two ends of the spectrum, we are looking at institutional failure, bank failures, to the extent that the write-offs are that significant, and at the other end, we are looking at a hit to the portfolios of all the investors who may have helped capitalize these banks. And to the extent that bank securities are owned throughout the system, a further depressing effect on everybody's wealth, and thus access to capital.

MR. ALEXANDER. Yes, right.

REPRESENTATIVE COX. Very gloomy scenario.

REPRESENTATIVE HAMILTON. We hear a lot about the aging problem in Japan and that is going to have a major impact, is it, on their productivity?

MR. ALEXANDER. Yes. Several things happen there. As society ages, the more vigorous part of the work force declines. In many ways, the United States has been very lucky in that we have had a very vigorous work force, and it has increased our ability to produce and compete. That is one aspect.

A second is that the savings rate will be declining, and that by the turn of the century some estimates are that those surpluses will disappear. That will inevitably drive up the cost of capital domestically. Even though the markets are now globalized, borders still make a difference, and it is easier to borrow from the bank down the street than from one across the ocean. So interest rates will rise. And third, the price of labor, wages, will inevitably rise in the future as the supply declines.

What I expect to see is that as wage rates rise, profits will be squeezed, and this will drive companies into the market more and more in the future for their funds. So rather than using retained earnings, they will have to go to the market for more of their investment funds, which will make them even more sensitive to their internal rates of return and to the financial cost of capital. So all of these things are happening.

REPRESENTATIVE HAMILTON. We hear a lot about lifetime employment in Japan, and the seniority wage concepts. Are those institutions, which I gather are very deeply embedded in the Japanese economy, are they just going to simply have to throw those out?

MR. ALEXANDER. Yes. I think Mr. Tezuka has done a lot of work on this area.

MR. TEZUKA. For a short-term viewpoint, Japanese companies have started giving up the lifetime employment system. But this is because we are facing a recession. But in the long run, I think the lifetime employment system is going to be a problem for Japan's entire economy, because it is the sharing burden by everyone, and we do have our baby boomers in the middle management layer of the corporation. They are between 38 years old and 45 years old. Those people are moving up their career in the next decade and getting much higher wages and the strong seniority base lifetime employment system.

But at the same time, Japanese companies are now facing a strong severe cost competition. So we may not be able to keep this system anyway, regardless whether we are facing recession or not. Also, that system is so much structured into the Japanese society, which means that the young generation may not be able to have real business opportunities or chances to use their skills to show their abilities.

Those new generation people are the potential source of next generation growth. So I think, in the long run, Japanese companies will start introducing the merit-based wage system and also a short time contract-based professional service employment system, combined with some lifetime employment traditional system. That is going to be a transitional period, but on the other hand, I think it is inevitable.

REPRESENTATIVE HAMILTON. What is the impact for the United States and U.S. policy with a Japan having the kind of economic problems that you are describing? What does it mean for the United States?

MR. NANTO. I think the largest problem is that Japan is going to have this slower growth with a large trade surplus. And it means that in order to provide concessions on imports, there is going to be direct harm to domestic industries. In the past, Japan could open its markets and everybody could take a share of a larger pie. But when you are not growing anymore, then it is more of a zero sum game in terms of domestic industries. So I think there is going to be a lot more trade friction in the future over access to Japanese markets. And it is not only going to come from the United States, but from other countries in Asia. Japan runs a $77 billion trade surplus with ASEAN, China, Taiwan, Korea and Hong Kong. China, of course, has turned this around by force, brute force, but the other countries are taking fairly aggressive policies to try and turn this around.

REPRESENTATIVE HAMILTON. The rest of you agree with that, that we are going to have more tensions in the U.S.-Japan trade relationship than we have had in the recent past?

MR. ALEXANDER. Well, I will agree mainly with what Dick Nanto said, but let me put a little different spin on it. The main direction that Japanese policy is heading today is towards deregulation. This is the byword of all the political parties today. I think, to the degree that that is succeeding, we can help that along.

We have been helping it along with our traditional trade policies of opening up markets. We have done it in area after area to both American and Japanese advantage. To the degree that we can continue to support that kind of development, it will make it easier for American and foreign products, in general, to enter the Japanese market.

It will be good for Japan; it will be good for the rest of the world. So I would see the possibilities of reducing those trade frictions by deregulation, by the opening and liberalization within Japan, that we should be encouraging.

Now, the question is, will it move fast enough? If it moves very slowly, if they become stagnant and this process stops in its tracks, I think the scenario that Dick Nanto mentioned will prevail. However, to the degree that it continues, that the Japanese economy and political system continues to deregulate and open, it will reduce many of the frictions. They clearly recognize that their own internal behavior is creating political problems from the rest of the world. But it is also creating problems domestically, and all the pressures internal and foreign are for it to continue this process of opening. We ought to be helping them do that.

REPRESENTATIVE HAMILTON. You think there will be a lot more import competition as they open their markets more?

MR. ALEXANDER. It ought to happen that way, if things go the way we expect. It is hard to imagine deregulating, opening up, liberalizing, without there being more import competition. If we just look at sectors like retail trade, there are companies around the world dying to get into that market, who have methods of organizing business practices that far surpass what we see in Japan today; these are not only American companies like Wal-Mart or Toys "R" Us, but European companies like IKEA who could come in and transform the retail sector. And I expect some of this to happen. We are already beginning to see it happen.

REPRESENTATIVE HAMILTON. Well, I have a lot of things I would like to go over with you, but unfortunately I have to leave at this moment to go on to some other matters. I regret that we haven't had more time, but I think we have had a good discussion in the few minutes we have had, and your excellent statements will certainly contribute to our understanding of the Japanese economy and its prospects for growth in the next decade.

Thank you very, very much. There are too many things going on here, so we stand adjourned. Thank you.

[Whereupon, at 10:41 a.m., the Committee adjourned, subject to the call of the Chair.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF MR. ALEXANDER[1]

Abstract: The Japanese economic miracle has been over since the early 1970s. From 10 percent real annual per capita growth rate of gross national product between 1955 and 1970, Japan's economy slowed to 3 percent growth in the next fifteen years. The 1990s and beyond are likely to witness further declines because the sources of earlier growth—investment, increases in labor supply, and productivity growth—are drying up. Higher productivity is key because it allows greater outputs from the same inputs, higher personal income, superior products, more convenience, and additional leisure; higher productivity also makes business more competitive by reducing costs and improving products.

Political choices in the future will determine whether Japan's maturity will be vigorous or stagnant. Many of the very policies and behavior linked to Japan's post-World War II economic success could endanger its transformation into a successful twenty-first century society if left unchanged.

THE MATURING JAPANESE ECONOMY

Introduction. Japan's economic performance since 1945 has been nothing less than extraordinary. It has demonstrated rapid growth, vigorous productivity improvements, strong export performance, and rising incomes. Japan has been a role model to other developing countries who have seen that the path to modernization and improved economic welfare is open to peoples of all continents, not just to Europeans and North Americans. Even in its excesses, Japan has been extraordinary. Its trade surpluses of the last 15 years have transformed it from a debtor country to the world's largest creditor. Japan's bubble economy of the late 1980s created a property and stock market boom that startled anyone calculating the price of a square meter of land in the Ginza or the market value of the Tokyo Stock Exchange. The domestic and international investment bonanza accompanying the bubble promoted its own glut of books and analyses proclaiming the rise of a new economic superpower based on the launching pad of Japan's enormous investments in plant and equipment, in R&D, and in foreign acquisitions.

The bubble burst, as bubbles inevitably do, and the Japanese economy is now at the bottom of its worst recession since 1945. The returns to those investments made only five or six years ago seem to have turned mainly negative. Renowned institutions such as lifetime employment are crumbling. A recurring question is whether there is a permanent change in the works or whether the Japanese economy will bounce back to its 100-year trend of extraordinary growth.

The short answer is that Japan is undergoing a permanent transformation into a regular economy. Economic growth can come from increases in the physical capital stock, from improvements in human capital, from growth of labor inputs, or from productivity improvements in the use of inputs. All of these sources of growth are slowing down. Japan is no longer small and backward and catching up, but large and mature and a major player on the global

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[1] The Japan Economic Institute is partially supported by Japan's Ministry of Foreign Affairs. This statement is the result of the author's research and analysis; the views expressed here are not necessarily shared by JEI or its sponsors.

stage. Many of the institutions and practices appropriate to a developing economy no longer work in a regular country. Even worse, the rules of thumb and routines mastered so laboriously over the past 45 years may retard further progress.

The drama, though, is still unfolding. Japan is not the first nation to attempt the transition from underdevelopment to maturity. Brazil and Argentina, for example, have been attempting this move for 75 years, but the beneficiaries of the status quo and others who perceived harm from change thwarted the necessary policies. Such changes require great political and economic adaptation, which though already begun in Japan is still in the early stages. Since the 1860s, that country has shown a huge competence to transform itself, but the past is not necessarily prologue of things to come. The drama should be absorbing and enlightening, both to the participants and to the audience, who will themselves be caught up as supporting players.

Declining Returns to Investment. Economists have long recognized the possibility of economic stagnation as the returns to investment decline with the increasing capital intensity of production. Japan's economic growth, in particular, is susceptible to that prospect since it was driven by high rates of business investment: in the 1960s, for example, more than one out of every five yen of output was plowed back into equipment investment. As the capital intensity of Japanese production overtook the levels of the United States and other advanced industrial economies, the nation's industries earned ever lower returns on their investments; economists estimated that the 1990 marginal returns to capital investment in Japan were about one-third less than in the United States. The Economist magazine reports that post-tax profit as a percentage of equity capital of firms listed on the Tokyo Stock Exchange is only 2.5 percent, compared with rates of 8 percent to 16 percent for Germany, France, Britain, Singapore, Hong Kong, and the United States.

Business Investment Shrinking. Prior to the 1980s, the government channeled high domestic savings to favored industries through regulated financial institutions, which provided a below-market cost of funds to many Japanese manufacturing firms. Now, however, Japanese companies must pay competitive global rates because of financial market liberalization and globalization. In contrast to the time when companies could rely on large profits or low interest rates, they now will have to make investment decisions balancing real financial costs against declining investment returns. This changing financial reality will require shifting business strategy from growth to profits. In the first half of the 1980s, before the unsustainable investment boom later in the decade, plant and equipment investment already had fallen to 15 percent of GNP from the high-growth era of rates topping 20 percent. The future will likely see this downward trend continue.

Declining Investment and the Current Recession. Investment is the link between the short run and the long run. Not only does investment provide the productive base for the future, it also adds to current demand and thereby stimulates the economy. When plant and equipment investment surged to more than 20 percent of GNP in 1990 from 15 percent just a few years earlier, many Japanese observers proclaimed the return of the good old days. However, the subsequent collapse of business investment was a major contributor to recession, which will continue until demand rises to the level of productive capacity. Equilibrium is likely to be reached at investment-to-GNP ratios of around 14 percent, or possibly even lower. The implication of permanently lower rates of investment is that this old locomotive of growth is slowing down. Whereas Japan used to pride itself on its "growth" recessions during which GNP continued an upward trend, the future is more likely to see recessions where growth turns negative. The current economic slowdown is Japan's first "regular" recession with real (though, modest) declines in GNP not caused by uncontrollable external events like energy price shocks.

Stagnant Investment in Human Capital. Investment in education, which complements investments in physical capital, reached a plateau in the 1970s with almost 100 percent literacy and a large proportion of the population completing high-quality secondary education. The average level of formal education barely has changed since then. The gains from further extensions of educational attainment will have to come primarily from increasing the caliber of university education as well as the share of people with university degrees, which now is almost 30 percent below the American level for 22-year-olds. Impending labor shortages and a shift to electronics technologies in manufacturing and services could increase the demand for more educated employees to help offset higher real wages and to operate the more complex technology; this change in the demand for educated workers has been witnessed in the United States since the 1970s.

Shrinking Labor Force, Demographic shifts in Japan will cause the labor force to decline in the late 1990s. As wages rise due to the falling labor supply, more older people and women will be drawn into the labor force, which will mitigate somewhat the shortage. Nevertheless, higher wages could raise the cost of output in Japan and erode the share of income going to profits, which—in turn—would further reduce the internal company funds available for investment.

THE PROBLEM OF LOW PRODUCTIVITY

Productivity and Investment Linkages. Productivity growth and investment are related because new equipment typically includes the most advanced capabilities. As investment falls, productivity growth from this source is likely to shrink. Another retarding factor is that countries gain an extra boost from their investment when they are technological laggards. Japan's manufacturing productivity seemed to have stopped benefiting from the laggard effect in the 1970s when its capital stock was the youngest of the industrial countries.

The Productivity Puzzle. Productivity gains among mature economies, however, need not go to zero. Over the twenty-year period to 1989, the so-called total factor productivity (which accounts for the contributions of all inputs) of the ten industrial countries with the highest per capita incomes increased at annual rates of 1 to 2 percent. Although explanations for this growth and its variations are not fully satisfactory, international openness and competition, R&D (especially basic research), and the adaptability of the economy seem to be the key ingredients for success of the mature economy. Japan's prospects in these areas are mixed.

R&D Quantity and Quality. Japan's R&D system, mainly financed by the private sector, was widely and correctly regarded as a model of effectiveness because of its close attention to the objective of profitability rather than the technological choices of government bureaucrats; now, that same system is rightly criticized for insufficient support of basic research, which many studies have shown to be the source of tomorrow's innovations and industries. Several indicators place Japan's R&D efforts ahead of the United States; for example, the ratio of research scientists and engineers to the labor force was 17 percent higher in Japan than in the United States in 1989 and the ratio of R&D to sales has been higher for several years. The absolute scale of American research is much larger than Japan's; U.S. expenditures on R&D and the total number of scientists are both about twice as great as Japan's. Moreover, Japan is relatively weak in basic research, which seems to have several times more impact on productivity than either physical investment or applied research. For example, American authors turned out more than 35 percent of the world's scientific and research literature in 1991 versus 8.5 percent for Japanese scientists, a difference that is twice as large as would be expected on the basis of expenditures.

Competition and Productivity. Cross-country studies of productivity conclude that variations in the intensity of competition faced by managers and their exposure to producers on the leading edge are the factors most closely linked to productivity leadership. For example, Japanese productivity in motor vehicles, automotive parts, steel, consumer electronics, and machine and precision tools were all above American levels in 1990. These industries faced high levels of domestic or international competition and were challenged to come up with better ways of making things while adopting the best practices of others. One of the outstanding innovations of the 20th century, the Toyota production system, came out of this experience.

Low Average Productivity in Japan. On average, though, Japanese manufacturing productivity is only 80 percent of the American level. The partially regulated food processing business, for example, was two-thirds below American levels in 1990; this industry employed more people than steel, vehicles, automotive parts, and machine and precision tools combined. Japanese economy-wide productivity was even lower than the manufacturing figures; gross domestic product per employee in the market sector, which accounted for 81 percent of GDP and 87 percent of employment in 1990, was only 61 percent of the American value and fell below the levels of France, Germany, and the United Kingdom.

The Impact of Regulation. The principal reason for lagging sectors and firms in Japan is overt regulation or other forms of noncompetitive behavior condoned and sanctioned by government, either through formal laws and regulations or through informal and customary practice. Many of these practices were established for sound regulatory reasons: for example, to protect the public from financial instability in the case of banking and insurance; to guard against unsafe products in the case of numerous specification requirements; or to control the prices of monopoly producers in the case of telecommunications and transport. In other instances, regulation was explicitly designed to protect important political supporters: agriculture and small-scale retailing are examples. According to Japanese government estimates, approximately 40 percent of the economy is subject to explicit regulation. Regulatory constraints are retarding Japanese innovation in several of the most dynamic new industries such as multimedia, which combines telecommunications, computing, and the broadcast media. Without significant deregulation, Japanese participation in these emerging industries will be thwarted.

PRESSURES FOR CHANGE

Deregulatory Pressures. The negative side-effects of regulations intended to protect the public or support industrial growth became more apparent as economic growth slowed and as millions of Japanese who traveled abroad each year could see directly that other policies were both feasible and desirable. Additional pressures for change come from Japan's internationally competitive businesses whose efficiency is dragged down by their inefficient domestic suppliers. The international community is also urging Japan to continue the deregulation and market-opening process initiated in the 1970s. Foreign companies that believe they could be profitable in more open and less regulated Japanese markets are pressuring their governments, which need little additional encouragement, to negotiate market-opening arrangements.

Economic and Demographic Forces for Change. Slower economic growth and rates of productivity improvement combined with significant lags in productivity levels are combining with other forces to bring considerable pressure for change. The Japanese people are more likely in the future than in the past to question policies that have favored the narrow interests of producers and the special interests of politically favored groups over those of individuals. The pressure for change arises in part from demographic and economic changes. Relatively fewer people work in the formerly favored sectors. Manufacturing employment fell from a 1970s high of almost 30 percent of all worker to 24 percent in 1991; heavy industries such as steel and petroleum products lost more than one- third of their employees. Services (including transport, communications, wholesale and retail trade, finance, insurance, real estate, government, and other services) rose from 40 percent to 60 percent of the labor force between 1960 and 1991. Over these same years, agricultural employment fell by more than 10 million—from 30 percent of the labor force to 6 percent. From 1966 to 1991, the number of small retail shops fell by 22 percent and employed 430,000 fewer people while the economy as a whole grew by 400 percent. The inhabitants of smaller towns and villages fell from 36 percent to 23 percent of total population. All of these trends are continuing.

Political Inertia. Despite these substantial shifts, politics remained strait-jacketed. Incomplete adjustment of legislative districts over the postwar period gradually brought about rural overrepresentation in the national parliament by more than three to one over urban districts. The political alignments that brought the Liberal-Democratic Party to power in 1955 managed to hold the reins of government until 1993. During this period, government policy favored producers (especially heavy industry), agriculture, small shopkeepers, and small-town and rural interests.

The Political Battle Over Change. Economists in the 1950s came up with the idea of the Turnpike Theorem. (Now it would be called the Freeway Theorem.) Under certain conditions, they argued, it could make sense for a nation to reconfigure its economic structure to emphasize rapid investment and growth of production while sacrificing current consumption. In effect, the nation would take a detour from its current development path to get on the turnpike, zoom along at high speed, and then exit onto the road of high consumption. Japan's economic development was the embodiment of the turnpike theory. What economists did not foresee was that the turnpike to growth could become a treadmill to nowhere, with all exit ramps blocked by political barriers protecting the status quo.

Change in Japan will therefore be profoundly political. Many beneficiaries of the status quo will fight deregulation and pro-competition policies. Inefficient firms, workers facing job loss, cities and regions confronting decline, and government ministries giving up their authority all face real losses. Other political forces, though, push in the opposite direction. Political reforms passed in 1994 under the first non-Liberal-Democratic Party administration in 38 years should go a long way to begin shifting the balance of legislative influence in favor of urban and consumer interests and away from the traditional supporters of the old power structure.

SOME EFFECTS OF CHANGE

Japan's Future Trade Surplus. If an economy's total consumption—household, business, and government—is greater than aggregate production, it will necessarily have a trade deficit with the rest of the world. Another way of stating this proposition is that an economy with an external deficit over-consumes and undersaves. In contrast, a country like Japan with a perennial surplus has net saving; that is, saving is greater than the domestic investment it usually finances. Therefore the key to projecting trade surpluses over the long run is to consider the balance between saving and investment. It was noted above that business investment is likely to fall. Household saving is also likely to decline as the society ages and more people retire from the active labor force. Government surpluses, too, will probably disappear as transfer payments to older citizens rise to cover social security payments and medical care costs. (The government is currently running a small recession-created deficit, although it still has a structural surplus.) Since both saving and investment will be falling, the difference between these accounts, which determine net trade flows, is difficult to forecast with precision. It seems probable that business investment will fall earlier than will government and household saving, implying that Japan will continue to oversave for some years. Over the longer run, however, this trend most likely will come to an end as the declining saving behavior kicks in with full force. Several projections place this shift near the turn of the century. Therefore, Japan's surplus with the rest of the world has a few more years to run.

The Crumbling of Customary Business Practices. Slower economic growth is transforming customary economic relations. The pattern of lifetime employment, which made sense when growth was rapid, has been fading since the 1970s slowdown; its erosion will accelerate in the coming decade. Its passing, though, will not have entirely negative consequences for business. Lifetime employment bred a close alliance between employee and company, promoted training and personal development, and motivated managers to outstanding levels of effort, but it also encouraged conservative decisionmaking and stifled innovation. Since Japanese management in the coming decades will be facing the new challenges of adaptability in face of rapid change, the selection and promotion methods established in the high growth period could be dysfunctional.

Another Japanese business custom, high levels of corporate cross-shareholding, was an effective tool against takeovers as well as a method of cementing long-term relations. This type of mutual investment also was good for the bottom line and the balance sheet when profits were perpetually rocketing upward. Now, however, it is becoming a more costly practice when capital has to be raised in competitive markets and profits grow more slowly. Similarly, the deep pockets of *keiretsu*—the large vertical or horizontal groupings of companies either in the same business or affiliated with a corporate family bank—will not be as deep as they once were and likely will be less able to sustain unprofitable diversifications and ward off acquisitions and mergers. Therefore, we are likely to see more unfriendly business acquisitions—both domestic and foreign.

The Role of Women. Labor market shortages could have significant consequences for the role of women in society. Women are the great underused resource in Japan's economic life. Only very slow progress has been made by women in penetrating the upper levels of management and technical jobs. Higher labor costs and the gradual decay of the rigid lifetime employment system will aid in prying open opportunities for women. Already more women are attending four-year universities than previously, although their proportion is lower than that of men, which is the reverse of American experience. Also, women's age of marriage is on the rise as they take more time to try their hands at careers. However, sociologists suggest that changes in the attitudes of men and women toward work and family roles probably will be quite slow. Substantial change is only likely as new groups of both men and women move through gradually shifting work and home patterns. Economic forces could take a long time to alter traditional Japanese gender roles, although the direction of change is for fuller participation by women in the work of the nation.

The Potential Gains From Catching Up. If Japan takes the necessary steps to deregulate its economy and fully open itself to foreign competition and investment, the gains as well as the required adjustments could be substantial. The average productivity of Japan's market economy is 60 percent of the American level. If the productivity of this sector rose to the 1990 U.S. level, 40 percent of the affected work force could be released for more productive activities.[2] A transition to America's 1990 productivity level over a 20-year period would be equivalent to a 2.6 percent annual productivity growth rate in the market sector, which is 87 percent of the total economy; at the same time, such a transformation would create redundancies amounting to 1.75 percent of today's 65-million workers or more than one million people annually. *The central question about the future of the Japanese economy is whether it is sufficiently adaptable to absorb such changes.*

If Japan makes the correct policy choices to boost productivity, its economy could well continue to out-perform those of other advanced countries. Conversely, if no changes in regulation, education, R&D, the role of women, etc. are made, it could become a perennial under-performer inasmuch as its existing regulations and institutions are outmoded for an advanced, mature, large economy.

IMPLICATIONS FOR THE UNITED STATES

Competition and collusion. The Japanese economy contains many paradoxes for American observers, chief among them being the coexistence of cut-throat competition together with protection, regulation, and collusive relations within the business community and between business and government. Japan's most successful industries on the world stage were bred in a hotbed of domestic competition, often while protected from foreign dominance. The first few decades of the postwar period witnessed the emergence of entrepreneurial firms such as Sony and the development of one of the most important innovations of the 20th century in the Toyota system of production. It must be acknowledged, even by an economist, that government played a vital and creative role in these developments.

Foreign frustrations over collusive behavior. However, as the Japanese economy matured, the interplay of government authority, regulation, weak competition policy, and money politics created multiple webs of collusion protecting business from the full blast of competition. Foreign frustrations over the difficulty of breaking into Japanese markets and the frequent complaints of "unfair practices" and "unlevel playing fields" seem largely to have resulted from this collusive behavior. These complaints grew more numerous while Japan was in fact beginning to dismantle many of its regulatory restrictions in the 1980s and while American exports to Japan grew faster than the U.S. economy and faster than total trade.

At the same time, American government negotiations with Japan to open specific markets and to promote domestic and international competition often dragged on for years without any apparent success. Despite the frustrations produced by seemingly endless rounds of negotiations, measurable results flowed from these efforts. A Congressional Research Service study covering 60 products subject to negotiation between 1985 and 1992 shows that exports

[2] To say that Japan is only 60 percent as productive means that it requires 167 people to produce the same output as 100 people in the U.S. The redundant 67 Japanese workers are 40 percent of the market economy's work force.

of these products rose twice as fast as total U.S. exports to Japan or to the rest of the world.

American Policy. Vigorous economic growth for Japan will require unraveling these collusive webs through deregulation, strong pro-competition policy, and political reforms that break the powerful links between politicians and business. Such policies would benefit Japan as a whole. They would also contribute to American welfare and to the broader international community by opening the Japanese economy to greater foreign participation while reducing the corrosive trade frictions between Japan and its trading partners.

The United States can support such positive developments by orienting its policies toward Japan to support greater openness, deregulation, and other measures that curb the interventionist habits of the Japanese government and the cartelization preferences of Japanese industry. In the absence of such a strategy, the U.S. is liable to throw its weight behind policies that promote short-term goals but that may also undermine its own long-term interests. One example of such a policy was the 1986 semiconductor agreement according to which 20 percent of the Japanese market was expected to be gained by American producers by 1991. A Japanese government official described this agreement as equivalent to placing a glass of whiskey in front of a reforming drunk; the Ministry of International Trade and Industry, despite its attempts to swear off its interventionist habits, could not resist the temptation of coordinating the industry response through guidance, pleading, and outright threats. Although this agreement may have helped expand a particular market for American companies, it also played into the hands of those Japanese trying to preserve the status quo.

Indeed, American trade policy toward Japan over the past 25 years, by and large, has been allied with domestic Japanese moves toward deregulation and openness. In the current Japanese environment, the pressures for significant improvements in economics and politics are beginning to produce real results. However, without foreign involvement, some of these policy outcomes may be considerably delayed and others may be resolved in ways that depart from U.S. interests. It is therefore useful for American policymakers to search for natural alignments of interests and to stimulate these when they occur. In any event, both the United States and Japan will be better served by American policies that promote the goal of making Japan a more productive, more stable, and more open nation than by policies that give more weight to the past.

PREPARED STATEMENT OF MR. NANTO

In 1995, Japan will mark the half century mark since its surrender on the deck of the USS Missouri at the end of World War II. In the year 2002, Japan will celebrate the fiftieth anniversary of the signing of the San Francisco Peace Treaty that ended the Allied occupation of Japan and marked that nation's emergence into the world as a country that essentially rewrote the book on economic development. The lesson of the twentieth century, that other nations in Asia are emulating, is that Japan gained in peace what it failed to gain in war.

Now Japan appears to have fallen into relative chaos. Its economy is in recession. The country has greeted its first Socialist Prime Minister in more than 40 years. Banks are burdened with nonperforming assets that neither they nor the government wants to acknowledge, and manufacturers are scrambling to turn a profit. Japanese investors who snapped up American stocks, companies, buildings, and real estate in the 1980s now find the value of those assets sinking even more rapidly with each downtick in the value of the dollar.

The question is whether the Japanese sun is setting or merely passing behind a cloud. How will Japan change, and what do those changes imply for U.S. policy over the next decade?

A MACROECONOMIC FORECAST

In the year 2000, Japan's economy will likely have most of the same contours that it has today, but it will differ in many of its important respects. The changes will be on both the macro and micro sides of the economy.

GROWTH RATES

In terms of macroeconomics, the medium-term outlook for Japan is, well, medium. According to forecasts by DRI/McGraw-Hill and others, Japan's economy should recover from its current recession[1] and achieve growth rates in the neighborhood of 2 to 3 percent per year in the second half of the 1990s.[2] Growth is forecast to average 2.5 percent for 1995-2000 and then drop to about 2 percent for the next decade. The growth rates for 1995-2000 depend partly on how quickly and how strongly the nation recovers from its current recession which began in April 1991.

Compared with the double-digit growth rates of the 1960s and the 4 to 5 percent growth rates of the 1970s and 1980s, these growth rates are relatively low but slightly higher than those DRI/McGraw-Hill expects for the United States. In short, Japan's has become just another industrialized country that is growing fast enough to keep ahead of a rising labor force but not fast enough to perform any miracles.

At these growth rates, Japan will continue to be the second largest economy in the world. Currently, its gross domestic product at $4.3 trillion is about two- thirds the size of that of the United States ($7.3 trillion) and larger than Germany, France, and the United Kingdom combined. Since prices are higher in Japan, the domestic purchasing power of their GDP is only about $2.5 trillion. By the year 2000, Japan's GDP is likely to exceed $6 trillion at nominal exchange rates.

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[1] Sato, Masaru. Japan Economic Upturn Promised, But Yen Fears Stay. Reuters News Service. July 20, 1994.

[2] Forecasts in this report are based on the DRI/McGraw-Hill Japan model. Forecasts were provided directly by DRI/McGraw-Hill, but most are summarized in: DRI/McGraw-Hill. *World Markets, Executive Overview,* First Quarter 1994. Lexington, MA, DRI/McGraw-Hill. p. 51ff.

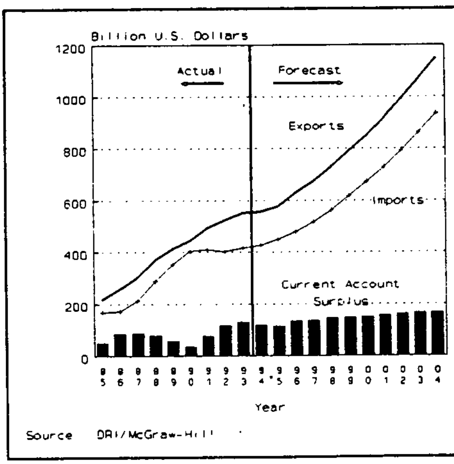
In terms of GDP per capita, at current exchange rates, Japan's $34,000 exceeds the American $26,000, although at purchasing power parity rates (adjusting for higher prices in Japan), it is considerably less ($20,000). Since Japan's population is growing slowly (less than half a percent per year), most of the increase in its GDP will raise GDP per capita. By the year 2000, Japan's per capita GDP will likely be around $50,000.

The Japanese consumer market already is rich and likely will become even more so in the next century. It is a market that should continue to receive high priority both in U.S. economic policy and American business strategy.

TRADE AND EXCHANGE RATES

What effect will the slower growth in Japan have on its external balances? Japan's current account surplus (trade with the world in goods, services, plus unilateral transfers) at $130 billion in 1994 is forecast to rise to about $145 billion in the year 2000 and stay above that level for the next five years. (See figure 1.) As a percent of Japan's GDP, DRI/McGraw-Hill forecasts the current account surplus to decline from its peak of 3.2 percent in 1992 to about 2.5 percent for the rest of the 1990s and then to roughly 2.0 percent by 2005.

FIGURE 1. Japan's Total Exports and Imports of Goods and Services and Current Account Surplus, 1985-2004



Under the ongoing U.S.-Japan Framework Talks, Japan agreed to take fiscal and monetary measures to achieve "a highly significant decrease" in its current account surplus. Some observers considered this to mean a reduction to 2 percent of GDP over the medium-term. This forecast indicates that such a reduction is not likely to be achieved for perhaps a decade or more unless the Japanese government changes its economic policies or the economy shifts in ways not anticipated by the forecasters.

Most of the continued large surplus in Japan's current account stems from the stagnation in imports into Japan over the past three years. Between 1990 and 1993, Japan's current account surplus jumped from $36 billion to $131 billion primarily because imports into Japan slumped with the bursting of its so-called bubble economy of the late 1980s and the ensuing recession. As the economy slowed, imports stagnated, particularly of foreign luxury goods. Even though growth in imports is forecast by DRI/McGraw-Hill to keep pace with the growth in exports over the next decade, the rise in imports is not likely to be fast enough to close the gap with exports.

This forecast, however, assumes only moderate appreciation of the yen over the next decade. It is based on a yen-dollar exchange rate of 98 yen per dollar in the year 2000 and 91 yen per dollar in the year 2004. Recent strength in the yen, however, already has pushed the exchange rate below 100 yen per dollar. If the yen continues to strengthen, Japan's current account surplus could decline fairly rapidly over the next decade.

The exchange rate that equalizes purchasing power for a basket of goods between the United States and Japan was variously estimated in 1993 to be from 160 to 187 yen per dollar.[3] This implies that Japan's exports carry the equivalent of a 60 to 87 percent surcharge.

The appreciation of the yen from and exchange value of 145 yen per dollar in 1990, to 127 in 1992, to 111 in 1993 and a current rate of 99 yen per dollar in July 1994 has had a powerful negative effect on Japanese exporters. For a product with a price of $100 in 1990, the exporter had to charge $146 in 1994 to generate the same amount of yen. If course, the higher yen also reduces the import prices of goods and services that Japan imports, particularly those of raw materials. But the major effect is to force their exporters to raise prices of products in foreign markets.

According to a recent Japanese government survey, at 117 yen per dollar, about a third of Japan's exporters can break even. At 105 yen, less than 6 percent of companies cover costs, and at 100 yen per dollar, less than 1 percent can break even.[4] According to this survey, therefore, 99 percent of Japan's export industries cannot break even on exports at current exchange rates, let alone make a profit.

If one looks back over the history of the appreciation of the yen, however, it shows that Japanese businesses have adjusted remarkably to each strengthening of the currency. The break-even point keeps coming down. In 1986, when the yen was 205 per dollar, the break-even rate was 210 yen per dollar. In 1990, when the yen was 150, break-even was 140 yen per dollar. Japan's exporters keep lowering their costs of production. They have had to adjust. Those that do not are being forced out of foreign markets.

If Japanese government policies do not bring more balance into Japan's current account, the yen is likely to appreciate even more and Japan's industries will face even greater competition both at home and in foreign markets. Government intervention can slow the process but not reverse it. Since first quarter 1993, the Japanese government increased its foreign exchange holdings by about $50 billion to the point where its reserves ($112 billion) now exceed those of Taiwan. Even the Bank of Japan, however, cannot keep intervening by buying dollars forever.

The next decade, therefore, is likely to be difficult for Japan. Its growth is likely to slow to the level of other industrialized nations, but its current account is likely to remain in surplus. This means that pressures on Japan to provide greater access to its markets will continue, but given the slower expansion of the domestic market, there will be less leeway for imports to expand without hurting domestic industries. The Japanese government is likely to face strong resistance to trade liberalization and deregulation from businesses who are benefiting from existing restrictions.

In terms of implications for U.S. policy, trade negotiations will continue to be difficult. The opportunities for competitive U.S. industries to expand in the Japanese market, however, should be numerous. The high yen is creating interests in Japan who favor many of the market opening measures being pursued by U.S. negotiators.

U.S. requests for deregulation of Japanese businesses also are likely to find allies in Japan. Although entrenched companies (particularly in financial sectors that have been hard hit by the current recession) are likely to remain opposed to new entrants, others are likely to develop interests in deregulation.

[3] The 160 yen per dollar rate is the U.S. Central Intelligence Agency's. The rate of 186.7 is DRI/McGraw-Hill's rate for 1993.

[4] Koll, Jesper. S.G. Warburg Securities Morning Note. May 6, 1994. p. 1.

The Japanese government, itself, has estimated that deregulation could add as much as a half of a percentage point to Japan's growth rate.[5]

MICROECONOMIC CHANGES

The above macroeconomic forecast underscores the point that over the next decade, Japan is likely to be similar in many respects to what it is today. Underlying the macroeconomic outlook, however, are numerous microeconomic changes that are likely to have significant and far reaching effects on life and business activity in that country.

It is difficult for any nation to overcome the inertia of the status quo and change, but change is being forced on the Japanese. Change is stemming from two primary forces: those that pull and those that push.

Forces that pull originate from a gap between one state and another, be it existing or envisaged, and actors who work to close that gap. They pull the status quo into change. In Japan's case, the primary pull factor was the prospect of catching up with the more industrialized world. There was the allure of Western income levels, standard of living, technology, business profits, and potential markets. Japanese planners could envisage where the nation needed to go because they could see precisely where the advanced countries, like the United States, were. Much of Japan's development in the postwar period was a process of pulling up industries, one by one, to the level of those in the United States and Europe.

Change also occurs because of push. Economies and the actors within them change because they are forced to do so. They are pushed in much the same way that refugees flee social and political unrest. They either move or face elimination. In Japan today, significant push factors include: low domestic growth, stagnant markets, low profitability, the high value of the yen, import competition, greater consumer price consciousness, deregulation, and a growing surplus of white collar workers in companies that value lifetime employment.

Among these push factors, the greatest currently seems to be the rising value of the yen along with soaring costs of production. Wages have been rising. In 1975, Japan hourly compensation costs for production workers in manufacturing was $2.25 as compared with $6.36 in the United States. By 1992, Japan's had risen to $16.16 as compared to $16.17 in the United States.[6] Over the next decade, Japan's wages are expected to continue to rise relative to those in the United States. Japanese manufacturers, therefore, appear to be going through an adjustment process that resembles the experience of the United States during the first half of the 1980s. Companies are restructuring and rationalizing their production—including moving some manufacturing offshore.

INDUSTRIAL TRANSFORMATION

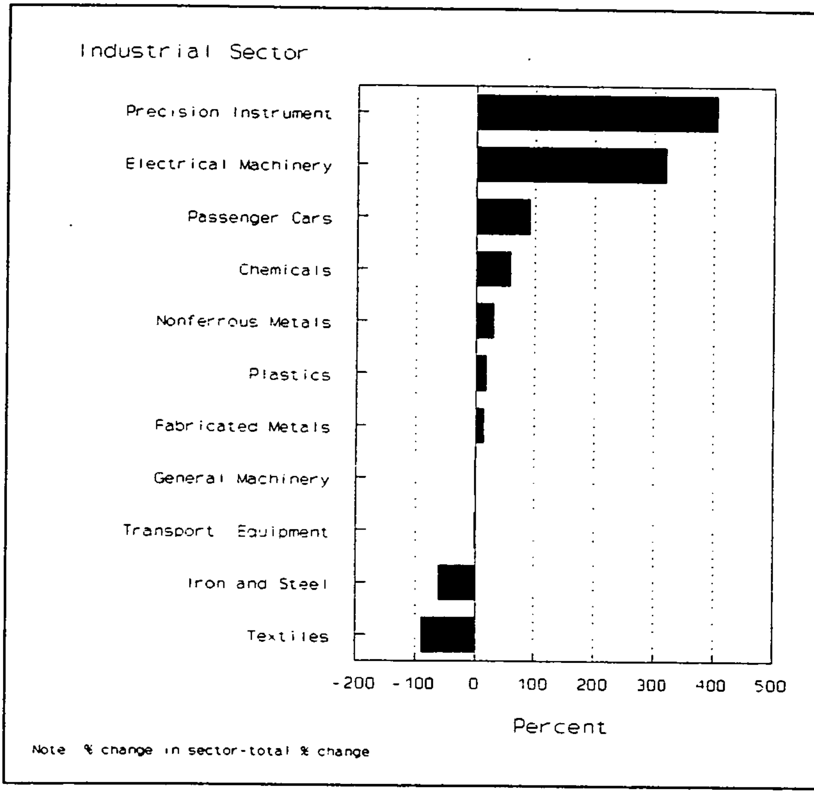
In essence, Japan has become a relatively expensive place to manufacture products, particularly for sale abroad. This has caused a transformation of the economy from one dominated by industries making textiles, toys, and TV sets to one producing cars, communications equipment, and computer components.

[5] *GDP 0.5% Pointo Age* (GDP 0.5% point up). *Nihon Keizai Shimbun*, July 17, 1994. p. 1.

[6] U.S. Bureau of Labor Statistics. Office of Productivity and Technology. Hourly Compensation Costs for Production Workers in Manufacturing (Unpublished data). March 1993.

Figure 2 shows the relative change in production from 1973 to 1992 for certain major manufacturing industries in Japan. The data show the percentage change in the production index for each industry minus the percentage change in the production index for all industries (68 percent). This shows how much more or how much less industrial production in each sector grew (in absolute percentage points) when compared with the 68 percent increase in all industrial production.[7]

FIGURE 2. Relative Change in Indexes of Production in Industrial Sectors in Japan, 1973-92 (Percentage change in production in sector minus percentage change in all manufacturing)



[7] The value of 405 for precision instruments indicates that the production index for that sector rose by 405 + 68 or 473 percent. The value of -62 for iron and steel indicates that the production index for that sector rose by -62 + 68 or 6 percent.

As might be expected, the greatest relative growth in Japan occurred in high- and medium-technology industries such as precision instruments, electrical machinery, and passenger cars.[8] Growth also was strong in chemicals, a sector that is considered to be fairly uncompetitive at current exchange rates, and nonferrous metals.

Sectors that grew at a rates close to the average were plastics, fabricated metals, general machinery, and transport equipment (growth in car production was offset by a decline in shipbuilding). Sectors that declined in relative terms were iron and steel and textiles.

The shift away from traditional industries such as apparel or iron and steel will likely continue in Japan over the medium term. Rising exports of light manufactures from the newly industrialized and emerging nations of Asia (some from Japanese subsidiaries) along with the development of heavy industry in countries like South Korea pose strong competitive threats to Japan's domestic factories. Even Japan's automobile companies are test-buying products, such a galvanized sheet metal, from South Korea. These previously were supplied almost exclusively through long-term buyer-supplier relationships. Japan now imports more television sets than it exports each year.

This transformation in the economy is one of the main reasons that growth in Japan is forecast to be slower for the next decade. When Japan was in the process of playing industrial catch up, almost all major industries could grow at high rates. Now, however, many are at the technological frontier. They do not have that gap to exploit. Not only is growth in the industries of the future slowing, but growth in some traditional industries has turned from positive to negative.

BUSINESS PRACTICES

Within sectors, businesses are having to adjust to the new climate of low growth and high yen. Japanese businesses are facing problems with excess labor and the need for restructuring. In the 1980s, Japanese companies confronted a tight labor market with insufficient numbers of new college recruits. Now they tend to have surplus employees, particularly in middle management.

Japanese companies are having to become lean and mean. That might seem strange to say, since many Americans think of Japanese companies as already being lean and mean—if not lean at least mean? (tenacious) in their pursuit of market share. Actually, in their production processes, Japanese companies already tend to be lean and mean. Systems of just-in-time inventory, zero defects, and cost reductions have long been a part of their manufacturing processes. These apply only to production, however. Relative to production workers, middle management and white collar workers are considerably less efficient. Desktop computers, for example, are less widespread than in the United States, and women tend to be underutilized. Combined with a general aging of Japan's population and an aging of the work force within companies, Japan's businesses now face a difficult situation.

Japanese businesses also are discovering that business philosophies and management practices that they considered to be based on their culture are highly dependent on rapid economic growth. As long as domestic and foreign markets were growing rapidly, Japanese companies could pursue traditional Japanese-style business methods. Once the economy slowed, however, compa-

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[8] Data for 1973 for some high-technology sectors, such as semiconductors, computer displays, and integrated circuits are not reported separately. These sectors experienced high growth. Passenger car production is also included in the transportation equipment sector.

nies have been compelled to shift more toward market-based practices common in other industrialized nations.

Japan's businesses found that as long as production was growing at high rates, they could promise permanent employment, promote by seniority, have automatic annual wage increases, focus on market share rather than profitability, train workers, and aim for the long-term. Companies also could hardly make mistakes in an economy doubling in size every seven to fifteen years. In fact, during the heyday of Japanese growth, the gravest errors a business could commit would be to underinvest in productive capacity, not hire a sufficient number of young workers, or allow its market share to erode even though its profits were high.

When growth slows and profits are squeezed, however, the relative cost of these practices becomes more apparent. What good is a long-term strategy for tomorrow if the company is faced with bankruptcy today? Under recessionary conditions each of these practices has been called into question. Companies now are confronted with excess capacity, surplus employees,[9] and insufficient resources to wage battles for market share that may debilitate profits.

Over the next decade, Japanese managers likely will continue to act as though they still hire employees permanently and follow other typical Japanese practices. They will have to temper those practices, however, with more flexibility. The net result will likely be a work force less loyal to a company and less willing to provide uncompensated overtime work. This could be offset, however, by more freedom by companies to discharge excess employees and raise the productivity of those left. This restructuring may raise company profits and worker productivity, but it also may raise the rate of unemployment unless those being discharged find other jobs. In the short-term, restructuring does not necessarily lead to higher growth for the total economy. It does imply, however, that U.S. companies seeking skilled and experienced employees in Japan now have greater prospects of finding them.

ASIAN TRADING BLOC

Since the end of World War II, Japan has depended heavily on the American market for its exports and imports. For the past two decades, the United States has accounted for about a quarter of all Japan's trade (26.7 percent in 1993).

A recent trend in Japan's pattern of imports and exports, however, has been its increasing reliance on imports from and exports to its neighbors in Asia. In 1992, the six Association of South East Asian Nations (Indonesia, Brunei, the Philippines, Singapore, Malaysia, and Thailand) accounted for 28.5 percent of Japan's total trade. China, Hong Kong, Taiwan, and South Korea together accounted for another 19.5 percent for a total for East and Southeast Asia of 48.0 percent—nearly half of Japan's trade.

Except for China, Indonesia, and Brunei, Japan runs a sizable surplus in its balance of trade with these nations. Its total merchandise trade surplus with these economies of $77 billion in 1992 nearly doubled the $44 billion it reported for its surplus with the United States.

Over the next decade, Japan's trade with its Asian neighbors is likely to continue to rise faster than its trade with the United States or other major trading partners. Its trade surpluses with these nations also is expected to remain

[9] In terms of the official unemployment rate, it is likely remain in the 2.5 to 3.0 percent range over the next decade. The number of surplus employees who remain on Japan's payrolls, however, is likely to remain high even after the economy recovers from the current recession.

high. These Asian nations, therefore, have a common interest with the United States in market opening in Japan. The United States, moreover, also has an interest in opening markets in many of these Asian economies but increasingly is being viewed in a negative light because of the pressures it places on these countries to liberalize their markets.

A question is how to pursue a trade policy over the next decade that will achieve greater access not only to the Japanese economy but to its neighbors in Asia. The United States likely will continue to rely on negotiations, external pressures, U.S. trade law, and international organizations such as the General Agreement on Tariffs and Trade (World Trade Organization). But one option remains open that seems not to have been fully explored.

Currently, the only trading bloc in Asia is AFTA, the ASEAN Free Trade Area, which encompasses the six countries of ASEAN. The goals of AFTA, however, are modest and progress slow. The Asia Pacific Economic Cooperation (APEC) council includes membership by the East and Southeast Asian nations as well as the United States, Canada, Mexico, Australia, and New Zealand. Discussions of trade liberalization under this organization have been initiated, but no concrete measures have been taken.[10]

Malaysia's Prime Minister has proposed the EAEC, the East Asia Economic Caucus, that would be restricted to Asian countries. The United States has opposed the EAEC primarily because of the threat that it would adopt policies adverse to U.S. interest or become a trading bloc. The prospect of a yen-dominated trading arrangement dominated by Japan also has not been welcomed.

In view of the increasing size of the Asian economies, their rising trade among themselves, and relatively less trade with the United States, however, an alternative long-term strategy might be for the United States to encourage free-trade areas (FTAs) in Asia. Such a strategy would bear certain risks, since such FTAs could raise trade barriers against the United States or form alliances in international organizations to oppose U.S. positions.

On the positive side, however, such Asian FTAs could work to reduce trade barriers in Asia without American pressures and negotiations. Under a Japan-South Korean or Japan-ASEAN FTA, for example, some of the burden of negotiating market opening could be shifted to the Asian nations, themselves. They would have to cut tariffs and eliminate nontariff barriers within their own economies. If Asian markets become more open, U.S. companies could then take advantage of opportunities, and particular barriers to U.S. exports could become easier to identify. Negotiations over those barriers could then be pursued.

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[10] See: U.S. Library of Congress. Congressional Research Service. *Asia Pacific Economic Cooperation (APEC) and the Indonesia "Summits"* in 1994. CRS Report No. 94-242E, by Dick K. Nanto. Washington, 1994. 6p.

PREPARED STATEMENT OF MR. TEZUKA

Recent economic statistics show slight and slow recovery of Japanese economy. After long recession, finally Japanese economy seems to start moving upward. However, this does not necessarily mean that Japan has been cured from the crash of bubble economy.

The impact of the bubble crash is more than publicly understood. For example, the total value of stocks held by Japanese corporations devaluated by 194 trillion yen between 1989 and 1992. From 1990 to 1992, the total land asset value held by Japanese companies also devaluated by 143 trillion yen. As a sum, Japanese corporations lost 337 trillion yen from their asset base. This is almost 70% of the GNP of Japan.

Those assets have been built and kept held for many years, and they are recorded on balance sheets with its historical value, rather than current market value, creating huge credit line to Japanese companies. In other words, Japanese companies were raising capital, making investment, and expanding operations by using this huge "hidden value asset" so called "Fukumi-shisan". Japanese corporations' competitiveness during 1980s was depend upon this "hidden asset base". The bubble crash means the end of this "management with hidden assets".

Sudden disappearance of asset value by 70% of GNP caused serious credit problem for Japanese banks. Officially announced top commercial banks' and top credit banks' bad loan amounted to 13.7 trillion yen, and an other private calculation estimated it to be more than 60 trillion yen. This number is by far the larger than the bad loan once held by American banks in 1991 at its peak ($120 billion). Japanese banks are not as healthy as they looks like.

Japanese corporations are actually loosing profitability. Even during economic boom between 1985 and 1991, 8% of the total pre-tax profit of Japanese public corporations was from sales of holding stocks. 10.3% was from sales of land properties. Japanese companies' return of equity is constantly less than half of the ROE of American counterparts', and even such low profitability was supported by realization of "hidden asset value" by selling of stocks and land. In this sense, Japanese companies' economic prosperity was a kind of illusion.

As the result of bubble crash, most of the Japanese corporations are suffering from financial difficulties. Its seriousness is much worse than the surface phenomena. For example, Nissan reported only 15 billion yen loss in 1992, but her consolidated loss amounted to 55 billion yen. In the same year, NEC reported 16 billion yen profit, while her consolidated loss was 45 billion yen. Thus Japanese corporations are making-up their financial reports by carrying over losses to their subsidiary companies.

Facing such serious economic conditions, Japanese companies have finally started reducing the number of employees. From 1990 to 1993, NTT, Japans largest company, reduced employees by 25,429, which is 9.9% of the total employment. Nissan cut by 3800 and Nippon Steel cut by 2200.

Future plan is much more shocking. Nissan announced that they will further reduce employment by 5000 by 1995. NKK, which is my company, decided to eliminate 4500 employees. Among them, 1000 is white collar employees. Nippon Steel also announced to reduce 7000 employees with 3000 white collars. As a sum, one calculation estimates that around one million jobs will be disappear from Japanese top corporations within three years.

Japanese lay-off is done silently and secretly. Japanese corporations are dispatching out those excess employees to subsidiary companies, where they may not find responsible positions. Those subsidiary companies are laying off their original employees to outside to keep spaces open for dispatchers from parent companies.

Japanese companies also stop recruiting new college graduates. In the past two years, and probably for a few more years, about 200,000 college graduates are not able to find jobs every year. Especially female students are facing miserable situation in job hunting. Sooner or later, this can be a cause of serious social problems.

Does this mean the end of lifetime employment? I think this is the beginning of the new era in Japanese work environment. Current official unemployment ratio in Japan is around 2.5 - 3.0%. But it is said that if you add potential unemployment, which is kept held by companies as in-company job-less employees, the figure will increase to 7%. Facing with rapid and constant appreciation of yen, Japanese corporations cannot continue holding such excess employment as a social welfare.

Especially baby boomers are facing difficulties. Japanese baby boomers are now between 38 and 43 years old. They joined big corporations as a mass during Japanese expansionary economy in 1970s. They have been working hard to make companies bigger and bigger, and climbing up the career ladders. But suddenly faced with deflationary economy, they finally realize that there are very few higher positions available for them.

Many Japanese big corporations start introducing new human resource management systems. For example, Matsushita Electric introduced contract base researcher positions, which offer higher annual wages with limited time employment guarantee. Nissan also reformed her wage system from seniority base to merit base system. Many companies introduced early retirement bonus system and other incentives to leave companies earlier than official retirement ages. In short, companies are not willing to pay wages for employees unless they contribute by their professional skills. This is the end of traditional lifetime employment.

In this trend, there are strong (potential) generational conflicts. During continuous growth period, Japanese corporate environment has been firmly structured. Promotion was based upon seniority under lifetime employment. Now average age of chairman of big corporations is 69.8 and presidents' is 61.7. Average age of corporate directors increased from 58.2 in 1990 to 58.5 in 1993. Those elder executives don't resign and stick to their positions longer and longer.

As I mentioned earlier, those executives are making-up financial performances of the companies by selling off the hidden assets, which are the savings from the past prosperity, to avoid being criticized for their mis-management. General managers, who are usually 50 to 55 years old believe that traditional Japanese corporate system may not change for the next five years or so, and that hidden assets may not be consumed up in the same period. Therefor, they think it is better for them to stick to traditional management system, which is based upon "hidden asset" value, rather than giving up and restructure it. They prefer such low-risk environment.

Knowing this, current middle managers are accusing higher executives of their irresponsibilities during bubble economy and current economic difficulties. They start understanding that there may be no past savings available for them in a few years, and even they may not be able to receive enough pension and retirement bonus. Much younger generations are, as I mentioned, not able to join those established corporations.

This is the description of current Japanese corporate environment. In a nut shell, Japanese companies are facing a fundamental question: that is whether they can keep traditional management system or not. My conclusion is that this is the end of traditional Japanese management. To keep hidden asset base management, together with lifetime employment, there must be continuous inflation of asset value, supported by rapid real economic growth. Traditional management system is the system which allow "Low-risk High-return" situation with steady rapid growth. However, Japanese economy has already been slowing down after 1980s. Bubble crash evidenced that Japan cannot keep 5-7% growth for long time.

Under expansionary economy, Japanese management system generated enough cheap capital available for companies to invest, and expanding positions for employees. But under slower economic growth, the same system functions to accelerate economic problems. Japanese corporations must change their management system. Otherwise, they are forced to go back to "Low-risk Low-return" or even "Low-risk No-return" situation, and consuming up all the past national wealth.

The biggest question is whether Japanese managers are ready to take high risk to pursue higher returns. They have been, in the past decades, accustomed to low-risk environment. There is no "capitalist mind" among Japanese managers.

Japanese banks have become extremely conservative in landing loans. Banks are charging interest margin between savings and loans by 4 to 5% to keep their profit enough to sustain huge bad loans. This higher loan interest together with asset base crash prohibit industries to invest on new business opportunities.

Japan as the world second largest economy does have enough resources to sustain sound economic growth such as high-technologies, efficient production systems, and skilled labors. But if she lacks in "capitalist mind" which utilize the resources to generate new industries and further wealth, she will be getting into declining economic cycle.

There seems to be two scenarios for the future of Japan. The first scenario is that, as the virtue of traditional Japanese management, she tries to recover from recession by sharing pain by everyone, and by consuming up past savings under government's generous supports. Companies can wait for government's economic stimulus, and incrementally reduce cost to keep competitiveness under strong yen era. This scenario may be easy to follow, but may not solve the fundamental problems of Japanese economy which I described. People may stick to traditional employment system, and may not want to take risks to change it. Everyone follows others and relies upon government support, then gradually lose economic dynamism. Once they succeed in reducing cost by incremental measures, further appreciation of yen may put another burden on them. The first scenario is merely a temporally cure, and may bring larger problems.

The second scenario is pursuing fundamental restructuring of the management system. Giving up helping relatively weaker players like less competitive companies and in-company unemployment, Japan can make stronger players more competitive. At the same time, dropping out of less efficient players may reduce excess capacities in industries, loosen export pressures, then finally depreciate yen against other currencies.

Companies are to be evaluated not by their holding assets, but by their ability to create values from operations. More prosperous companies can raise low cost capital, and less productive companies may force to pay expensive cost unless they commit to restructure their businesses.

Releasing trapped resources, financial and human, from such weaker side of the economy to other business opportunities may generate much more wealth. Removing government regulations, which are estimated to control more than half of the economy, may create new business opportunities. Giving up government help is painful, but may brings "capitalist mind" among corporate managers. This scenario is painful, because there must be clear distinction between winners and losers. But again, as I mentioned, Japan cannot keep inflationary economic growth by sharing risks and pains by everyone.

In conclusion, Japanese corporation's resurgence and its economic growth is depend upon whether Japan can successfully follow the second scenario by stimulating "capitalist mind" among corporate managers who is willing to take business risks. Regulations and bureaucratic controls over economy will be the biggest obstacle for this to happen. Younger managers, who may suffer more from keeping current system may take the key role for this movement. Ironically, the impact of the crash of bubble economy may be strong enough to force Japan to take the second scenario, though many people still believe in the first scenario.

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ROUNDTABLE DISCUSSION ON THE ECONOMICS OF HEALTH CARE

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

PART 2

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CONTENTS

WITNESSES AND STATEMENTS
FOR THE RECORD

THURSDAY, JUNE 30, 1994

ROUNDTABLE DISCUSSION ON THE ECONOMICS OF HEALTH CARE

THURSDAY, JUNE 30, 1994

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met, pursuant to notice, at 10:00 a.m., in room 2200, Rayburn House Office Building, the Honorable Lee H. Hamilton (Member of the Committee) presiding.

Present: Representative Hamilton and Senator Bennett.

Also present: Patricia Ruggles, George Foy, Steve Baldwin, Morgan Reynolds, Michelle Davis, Ken Nelson and Caleb Marshall, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, MEMBER

REPRESENTATIVE HAMILTON. The Joint Economic Committee will come to order.

Today is another in a series of roundtable conversations that the Joint Economic Committee is holding with prominent economists to discuss economic policy. Today's topic, the economics of health care, is certainly one of the most important economic policy issues of the 1990s. We are pleased to have as our guest today Dr. Uwe Reinhardt, James Madison Professor of Political Economy at the Woodrow Wilson School, Princeton University.

Over the years, Dr. Reinhardt has made important contributions on the economics of health care. Dr. Reinhardt wrote *Physician Productivity and the Demand for Manpower in 1975*, and he undertook a study of West Germany's health-care system for the Pepper Commission in 1990. He has published numerous articles on health care in leading journals, and has also served on the U.S. Physician Payment Review Commission since it was established by the Congress in 1986.

Dr. Reinhardt, we are very pleased to have you. We look forward to a good discussion with you.

I understand you were very cooperative last night. We kept changing the schedule on you because of the schedule here. This has been a fairly hectic week for us in the Congress.

I am reasonably sure I won't fall asleep in this meeting, but I am working on very few hours of sleep for the entire week.

Let's go ahead. Do you want to begin with an opening statement, or go right to questions?

STATEMENT OF UWE E. REINHARDT, JAMES MADISON PROFESSOR OF POLITICAL ECONOMY, WOODROW WILSON SCHOOL, PRINCETON UNIVERSITY

DR. REINHARDT. I might make a brief statement.

First of all, I express my pleasure to be here. I did want to mention that Dr. Ruggles' father actually taught me and made me a health economist. I was going to be something altogether different and he persuaded me to pursue this field, and his daughter apparently as well.

I see health reform having mainly two goals: One is to provide economic and medical security to every American family. We call that universal coverage, but it really means that when people are ill they have access to the care they need, and in addition that their household doesn't go broke.

We pretend it has to do only with getting care, but it has to do with an image of a society in which a family whose member is stricken with, say, cancer doesn't get the double whammy of also going broke. This is a luxury every other family in every other nation has, but Americans don't have that. That is one goal, universal coverage.

The other is cost control, and those are in some ways separate goals. I have a chart that I often use to explain the two facets. One is the cash intake phase and the other the cash output phase. In the middle, stands some insurance pot.

People say health reform is difficult. It is politically difficult. Technically, it is quite simple. There are only three ways you can take money from households into the insurance pots, and there are only two ways that you can pay it out. Health reform; picking one or a mixture of ways to pay in and to pay out. The traditional method is that households bought their own health insurance, and that advocated by many particularly conservative spokesmen.

However, only 11 percent of the American people buy their own health insurance. Virtually everyone who says people should be individually responsible for their own insurance has actually their own insurance bought by their employer or given to them. That is a bit of an irony.

I know of absolutely no spokesman who proposes individual responsibility, who is in fact individually responsible for his or her own insurance.

On the way out, we face either fee-for-service, which is piece-rate compensation, or capitation by which we actually mean we pay a private regulator a lump sum at the beginning of the year and we tell that regulator you must give the insured all the health care they need, and you can beat up on the doctors and hospitals any way you wish, and keep the change. That is called "managed competition." And those are the only two options that we have.

I think as things shape up, we may or may not get the reform on the intake side, which really means recycling some net $40 billion from the upper third of the income distribution to the lower third. If you wish to achieve universal coverage, that is what that would ultimately mean.

I am not sure if there is the political will to do that. Technically, it is a small amount of money given that we are a $6 trillion economy that spends $1 trillion on health care; $40 billion is not an insurmountable amount of money but politically it may be insurmountable.

The income distribution of the United States, in 1990, they chose the distribution breaks at $35,000; half American households have less, half have more, but some 17 percent have an income of $15,000 or less.

I make my students memorize this. I put it on the exam because many students think the upper tier is the bottom tier given the way our students live. In fact, many Americans couldn't afford even a community-rated health insurance premium if it were made available to them.

So insurance reform *per se*, which means to detach insurance premiums from the health status of a household and not excluding preexisting illnesses, insurance reform of that nature is helpful, but it will not really make available to the lower 17, 20 percent of the income distribution the security we wish to give them.

If we want to help them, we must take money from people like me and somehow funnel it to them. If we are not willing to do it, there will be no universal insurance.

[The prepared statement of Mr. Reinhardt starts on p. 29 of the Submissions for the Record:]

REPRESENTATIVE HAMILTON. We often hear that we have a health-care crisis and then other people say we don't have a health-care crisis. What do you think, do we have a crisis or not?

DR. REINHARDT. The way I explain this on the speaking circuit is that it depends on the software in your soul. You look at certain data that are out there, which are indisputable, and then whether you call it a crisis or not depends basically on your value system. Forty million Americans have no insurance.

REPRESENTATIVE HAMILTON. That figure is going up?

DR. REINHARDT. Yes, and most are hard-working stiffs and their dependents. One-third of them are children. There are people, for example, Fred Barnes wrote in the *American Spectator*: "Where is there a health-care crisis?"

There are others, myself included, who would consider that a crisis, that many children don't have insurance and possibly don't have the kind of care——

REPRESENTATIVE HAMILTON. How many of the people who don't have health-care insurance make a choice not to have it?

DR. REINHARDT. Probably about a third could afford it. It would strain them a little, but they could afford it if it were compulsory.

Representative Hamilton. We will jump around quite a bit.

Senator Bennett, come in, glad to have you.

I want to go first to the question of health-care costs and get an idea, what is driving health-care costs up? The things that I have heard usually are: Technology, the demographics, getting older; is that correct and what would you add to the list? What is really driving health-care costs? We have had this inexorable increase in health-care costs over the past few years; what is driving it up?

Dr. Reinhardt. Demographics is not.

Representative Hamilton. Even though we are getting older?

Dr. Reinhardt. My son, who also is a Yaley, wrote a paper drawing on the literature that exists and showed that if nothing had changed except the aging of the population, only a very small percentage of the growth in health-care spending could be explained by that. I think it was 1 percent. I would have to look at his paper. But it was quite small.

It is a surprising conclusion. You take the age distribution, say, in 1980, and look at it in 1990, and say supposing in every age gender group people would have gotten the same per capita utilization throughout the 1980s that they got in 1980, how much more would we have spent in 1990, and it was a trivial amount more. That is one data point.

The other is that Germany today has an age distribution that we will reach only in the year 2020, I believe, and yet they spend less than 10 percent of their GNP on health care and we are at 14 percent.

What drives, technology drives, no question. The new marvels that come out, very expensive, often help very few patients drive.

A third driver is that the demand side of American health care really has so far had no ability to resist any price that they were charged, and that is how you can explain that our hospitals have a 61 percent occupancy ratio, 40 percent of the beds empty. We have four times as many mammography machines as we need.

The *Wall Street Journal* had an article on gamma knives, two hospitals in Miami have them, when one would be more than enough. The private insurance side is so splintered that no individual insurer has the market power to resist whatever price is charged.

Representative Hamilton. Is technology the single largest factor driving health-care cost?

Dr. Reinhardt. Economists think it is.

Representative Hamilton. Let's go back to demographics. Ordinarily, we think that the largest health-care expenditures come in the final year of life. We are constantly pushing up the age of longevity. Why doesn't that increase your costs? I don't understand that.

Dr. Reinhardt. I didn't quite believe my son's paper either, but I think when you look at it, you begin with a distribution of health spending, per capita, by age, and you do find that 85-year-olds, on average, are $10,000 a year and younger people less than a $1,000. So you say, as we slide into that older age group, we must be spending more.

The demographic change is very, very gradual, so we are sliding into that higher age group at such a slow rate that year-to-year or even decade-to-decade increases are not driven by that.

REPRESENTATIVE HAMILTON. On the technology side, if you put limits on increases in costs, you are talking here about cost-containment, but if you put limits on these increases in costs, does that mean we are going to have less innovation in technology?

DR. REINHARDT. I don't think it means that necessarily, and this is one of those wishy-washy answers. The system we have now has been such that almost any "beep beep" machine could somehow find a customer, whether it did something or not. If you put some brakes on health spending, I think it will focus the mind of the producers of new technology to focus strictly on technology that is breakthrough, and not me, too.

REPRESENTATIVE HAMILTON. And what works?

DR. REINHARDT. What works and what has clinical efficacy, but also makes some economic sense. You might have a machine that does, on average, benefit 1 percent of the cases, but the costs are too enormous to justify it, but now all of that gets used.

REPRESENTATIVE HAMILTON. The fact that we are putting more and more of our GNP or GDP into health care, and so on, is that good or bad?

DR. REINHARDT. One might say that you have to worry what does it displaces. If it displaces the education of our young, if it displaces safety in the street, then I think it is a bad trade off. If it displaced firecrackers and balloons, I would say personally that it is a tolerable trade off. And we really don't know what it displaces. But given that 42 percent of health spending is through the public sector that is also largely responsible for education, I have a strong suspicion that eventually education will be the trade off.

REPRESENTATIVE HAMILTON. Forty-two percent of all health-care expenditure is by government?

DR. REINHARDT. Yes.

REPRESENTATIVE HAMILTON. Well, that is what, Medicare, Medicaid?

DR. REINHARDT. Medicare, Medicaid, CHAMPUS, the VA and the public health service. It is actually now 44 percent and rising. More and more chronically ill people are spewed out by the private insurer and dumped into the lap of government.

REPRESENTATIVE HAMILTON. Let me ask you, one of the things hospital administrators talk to you about all the time is this business of the Federal Government reimbursing for less than full cost, and boy, they really make that point, as I am sure you very well know. Is that accurate or not?

DR. REINHARDT. I think it is inaccurate. There is an exchange of letters that is just going through the *Wall Street Journal*. It started with an opening salvo by Carl Schramm, who used to be head of the Health Insurance of America, but also a professor of economics, who argued that government pays only 88 cents on the dollar and therefore the private sector had to make up the difference.

My letter to the *Wall Street Journal* argued that that would be believable were it not for the fact that hospitals are 40 percent empty; they are only 60 percent occupied. So I asked my friend Carl, how is it then that you pay not only for the shortfall, you pay for all these empty beds and the profit margin on top. Name me another industry that has that much excess capacity that is profitable.

Hotels are not, office buildings are not, airlines are not; only the hospital industry remains profitable, running at a 60 percent occupancy ratio. The Columbia ACA system runs at less than 50 percent occupancy, is highly profitable, and if government doesn't pay for it, I ask who are the strange creatures who do pay for it. It is the private insurance companies of America that are perpetuated and financing this capacity.

REPRESENTATIVE HAMILTON. So the system we have now, where you have hospitals with 60 percent occupancies, is grossly inefficient?

DR. REINHARDT. It is grossly inefficient and that inefficiency, I argue, is sustained by the private insurance sector. They are paying for it and they are assuring it.

The most graphic example is mammography. The National Cancer Institute had a carefully researched article that showed at current user rates, we have four times the mammography machines in this country that we need.

I serve on the Physician Payment Review Commission, and we said, what should we recommend to the Congress for reimbursement; should we recommend that the U.S. taxpayer pay for that excess capacity? And we said no. We should recommend to Congress to pay a rate that would amortize a fully used mammography machine with a profit margin, and that rate came to $55, five years ago. That is what Congress did.

The private sector pays $120. The extra they pay is enough to pay for unused mammography machines. The damage is uninsured working women who want mammography, they have to pay $120. So, by having too many machines, we actually ration these women out of mammography.

REPRESENTATIVE HAMILTON. Why do you have too many machines?

DR. REINHARDT. Everyone wants to have it and the private insurance industry shovels the money out in such abundance that even if I have a machine that is used only one-quarter of the time, I can make money off it.

I invited Carl to my freshman class at Princeton to explain to 300 bright Americans why does the insurance industry do that, and I hope he accepts my invitation.

REPRESENTATIVE HAMILTON. One of the things that is impressing me more and more as I talk to people is the number of decisions now being made in the labor force based on health care. It has really become a major factor in whether or not people accept jobs or don't transfer, or whatever. Health-care costs are driving more and more labor market decisions, I think.

DR. REINHARDT. Yes.

REPRESENTATIVE HAMILTON. I believe that is the case.

And at the same time, you have this phenomenon of stagnation in wages over a long, long period of time. What is the impact of the increase in health-care costs on wages?

DR. REINHARDT. Well, economists believe that in the long run those fringe benefits are taken out of the paycheck of the take-home pay of the workers. If you look at the data, you will find that take-home pay has increased much less rapidly than total compensation, and health care has displaced cash take-home pay and other benefits such as pensions.

REPRESENTATIVE HAMILTON. So I can say to the worker then, the reason they are not seeing, in all likelihood, an increase in their wages and their take-home pay is because their health-care costs are going up?

DR. REINHARDT. Yes. You would have almost all economists behind you on that one.

SENATOR BENNETT. Not employers.

DR. REINHARDT. You are right, Senator. They don't believe that.

SENATOR BENNETT. I was an employer until I got into this crazy business, so my perspective on what you are saying is very different. I would be delighted to come to Princeton and talk to your 300 students about what life is like in the real world.

DR. REINHARDT. Okay.

SENATOR BENNETT. I have been taking notes. I have to challenge a lot of the things you are saying because it does not coincide with my experience. Any "beep beep" machine can find a customer.

I have been involved in trying to sell a "beep beep" machine that demonstrably has significant medical benefits. I discovered the medical community to be the most conservative, the least entrepreneurial of any market I have ever tried to crack. They turned it down again and again because it was not invented here.

We finally had to give up. We sold it to Beck and Dickinson, who was able to put a million dollar marketing effort behind it, and they finally got it into the marketplace.

I think you are a little glib when you make that comment about technology. Let me take you through a hospital. I raised the same issue you have raised. I said, you guys have a MRI machine and you use it 25 percent of the time—pick a low number. Why do you do that?

I am a businessman; I understand about markets. The market clearly is not there for that machine if it is only used 25 percent of the time. They said, we have the machine because the market demands it. I said this is double-talk, the market is not demanding it. And we yelled back and forth across the table.

I didn't yell that much because I was running for office and needed to make a good impression on them.

Finally, it dawned on me that when I say "market," as a businessman, I mean customers who buy things, the end users. When they say "market," they mean insurance companies.

I said, can't you get together with the other hospitals around town and decide that you will have only one? He said, if we did that, we would get no referrals. The insurance companies demand that we be a full service facility.

It is not the insurance companies pushing money out that does it; this hospital is on the verge of bankruptcy. They would love to refer all their MRI patients to the hospital across town and get out from under those costs.

So I come here convinced that the solution to that problem is doing something about the antitrust laws so that hospitals can talk to each other in intelligent ways.

We have an experience in Utah where we have one of the finest children's hospitals in the world. It is right next door to the University of Utah Medical School, a fine teaching research hospital, one of the 10 best in the country. We have spent as a state some $10 million of the University of Utah's budget.

Do you know how much effort it is for the University of Utah to raise $10 million? They spent $10 million in legal fees because some lawyer discovered that it violated the antitrust laws for the University of Utah to send their kids to primary care and blame the insurance companies for the breakdown of the antitrust laws, which is something that we in Congress can fix, which will bring four times the capacity of mammographies, and it will get to the point where the people with mammography machines can talk to each other and refer customers, and that will go away. It is not a matter of the structural problem of the insurance system.

I ought to pause for breath and let you comment.

DR. REINHARDT. There is no question that the antitrust laws often do stand in the way of efficient functions. It is a two-edged sword. If you didn't have antitrust laws, you might get the kind of collusion that would drive up prices and create monopolies, but with any law you can go too far, and there is a general sense among economists that the entire issue of antitrust laws needs to be revisited.

Usually, the private market gets around antitrust laws through mergers and consolidations. That is one way to get around it. And antitrust has not been that vigorous in challenging consolidations that hospitals are doing. That eliminates some of the excess capacity.

But when you said the insurance industry isn't funneling the money out, but they insist that every hospital is full service, to my mind, that is part of the flaw. Why then do you need that many hospitals, each half empty?

SENATOR BENNETT. I agree with you, the problem is the hospitals have been half empty. You talk about Columbia HCA. I had the head of that hospital in my office yesterday afternoon talking about an issue that is very sensitive in Salt Lake City. I don't want to breach any confidence because there hasn't been a press announcement, but we have overcapacity in Salt Lake City, and if they come into the market, they will immediately close the hospital that they are looking to acquire.

As he went through the history of that company, which he described as highly profitable, they have become highly profitable by buying and closing hospitals.

DR. REINHARDT. That is why I call them "bounty hunters." We have concluded that the only way we come to grips with this capacity is to richly reward bounty hunters, and I think it is an honorable activity, to take down this excess capacity and become billionaires in the process.

SENATOR BENNETT. I much prefer it being done by private activity than government fiat.

DR. REINHARDT. There are areas, of course, where they would not venture, and that is inner cities, where we then have to make sure that capacity is there for those citizens. Otherwise, I am totally on their side.

SENATOR BENNETT. You talk about 44 percent of the system being currently under government control and you list the items. I don't have any academically compiled data on this, but the overwhelming assumption on the part of everybody that I have talked to is that the 44 percent that is under government control is the area of least quality and lowest service.

Anecdotal evidence—I had a general in my office talking about veterans benefits and he said, "Senator you are not going to cut our veterans benefits, are you?" And so on.

We got on the subject of VA hospitals, and this general told me that he had just had a heart bypass and that he had gone to LDS Hospital in Salt Lake rather than the VA hospital, because it was his life he was playing with and he was not going to trust himself to the kinds of doctors that you have under government control; this isn't a reassuring kind of attitude when you think of putting 100 percent under government control.

DR. REINHARDT. If I may break down the 42 percent, the government is only the insurer. The delivery system is private. The Medicare and Medicaid, which is delivered in regular community hospitals, is the same quality care. We know this from studies that everyone else gets.

I don't think anyone would argue that America's elderly get low-quality care.

SENATOR BENNETT. That is true, but I know specific instances of a number of physicians who will not provide care for Medicare or Medicaid patients. They say the hassle is not worth it.

The paperwork and bureaucracy is so overwhelming that if you walk into one of their offices, they will not provide care.

REPRESENTATIVE HAMILTON. Is that a growing number of physicians?

DR. REINHARDT. The Physician Payment Review Commission keeps track of that and it is quite small.

REPRESENTATIVE HAMILTON. Ten percent or less?

DR. REINHARDT. It does occur, but we are in charge of monitoring access and so far we have not discovered any major problem.

REPRESENTATIVE HAMILTON. I hear that all the time, too. I have never really known how many physicians——

DR. REINHARDT. The Commission issues a report every June and the latest one, monitoring, is just out.

REPRESENTATIVE HAMILTON. A lot of physicians threaten.

SENATOR BENNETT. Maybe, you and I get that because the constituents——

DR. REINHARDT. We actually survey, and so does the Secretary. She also publishes the monitoring of access reports and we monitor hers, so there is a fair amount of hands-on monitoring in that, but there are anecdotes of course, and physicians threaten more frequently than they do it, which I would too. It is a good posture.

SENATOR BENNETT. You responded to the Chairman's, "What does it displace," with an answer that implied that you believe this whole circumstance is a sum zero game; that is, a dollar spent on health care can't be spent on anything else.

Rather than, as I believe, it is a true limitless kind of circumstance, and that if the dollar is not spent on health care, that doesn't mean education is necessarily deprived. That just means the dollar isn't spent. Respond to that.

DR. REINHARDT. Actually, I could submit a paper that I wrote on this very issue because it is very, very tricky. In fact, I belong to the school that has said health-care spending *per se* is not an issue; the percent of GNP going to health care is not really an issue, if that is what the people prefer.

SENATOR BENNETT. I am delighted to have you say that because the implication of your statement to the Chairman as I came in was to the contrary.

DR. REINHARDT. Only the piece thrust into it is not a zero sum game. At the state level, for instance, like in New Jersey, health care is growing apace, but the budget, we have a new governor committed to cutting taxes. Then you are artificially creating a zero sum game, and I was talking strictly about the 44 percent that is coming under that.

In the private sector, I think whatever it displaces ... in fact, until recently we spent more on tobacco. We certainly spend more on tobacco and alcohol than on all pharmaceutical products research.

SENATOR BENNETT. Let's talk about overcapacity for a minute. I have to go to an anecdote because I am not in the business of conducting studies. My wife has had 2 knee operations, the first one 10 years ago, and she spent 10 days in the hospital. The second one on the other knee, arthroscoptic surgery; I drove her in in the morning and took her home at noon.

Somebody raised a lot of money and went to a lot of effort to build Good Samaritan Hospital in Los Angeles on the assumption that it would be 10 years for knee surgery for everybody who comes along, and then somebody invents a technology where it is literally done in a doctor's office. And the overcapacity circumstance, I don't think, once again, you can say that it is because the insurance companies are shoveling out money to keep those hospitals alive. I think the overcapacity is a function of the technology that has come along and rendered what used to be viewed as a great benevolent community benefit suddenly obsolete, because nobody needs to stay in hospitals anymore.

I am not sure of these figures, but I have been told and would like your response; that the average length of stay in a German hospital is much longer than in the United States, and sometimes can be as much as twice as long as in the United States. There is a suspicion that the German system keeps these beds full simply to demonstrate that somehow they are utilizing them properly. In other words, the desire to make the system as designed in the 1960s, or whenever it was put together, still works in the 1990s; they are preventing the kind of quality care that would say, sorry guys, all those hospitals you built in the 1950s, 1960s, suddenly we don't need anymore and your system isn't flexible enough to recognize that. Would you comment on that?

Dr. Reinhardt. There is something to what you say. If you look at per capita utilization of hospital beds, it plummeted in the 1980s, which was in part a creator of some of the excess capacity, an overhang. Yet, in spite of that, new capacity was still brought on line and you read stories like the gamma knife or the Kalamazoo helicopter war, where one hospital bought a helicopter and competitively the other had to have it, and so on. It is this competitive game that exacerbates it.

If we had not had the new technology, our hospitals probably would be 75 percent occupied. On average, for the same thing, Germans stay twice as long in the bed than we do.

Senator Bennett. Isn't that bad medicine?

Dr. Reinhardt. Not necessarily. That would depend on how that works out for them. In many instances, I think we might discharge too soon in our country for the comfort of the patients. In our case, and I don't like to use anecdotes, but we had our second baby in Boston and my wife was, I thought and she thought, absolutely not ready for discharge. We pleaded for one extra day. I thought it was too soon, that it would have been better to stay.

Representative Hamilton. We hear a lot of complaints from constituents who think they are kicked out of the hospital too soon.

DR. REINHARDT. I think, in general, the Senator is right; too long a stay, hospitals are dangerous places. There is some happy medium. I think the Germans have too long; I think we push them out too soon.

SENATOR BENNETT. I don't mean to be deliberately argumentative with you, but I am convinced that, based on my study of this thing, the German system is on the verge, if indeed has not passed over the verge, and is in the process of coming unraveled. It is a wonderful system designed for a decade or two ago.

Our system clearly has serious, serious flaws. I would be the first to admit that. I argue with Republican colleagues who say everything is fine and all you need do is fine-tune around the changes. Everything is not fine and we need structural change. But I am very disturbed at suggestions that I hear coming out of some supporters of this Administration that say the German system is the one we should emulate, that is the one we should go in the direction of.

I think it is anti-technology; I think it is anti-quality in terms of the future. But there are some aspects of it, the idea that the individual owns his own policy, it is not owned by the employer, I applaud 100 percent. I think tying this to the employer is structurally the single most damaging thing we do in our present system.

But I get very distressed at suggestions that we ought to be moving in the European general direction, generally, and to the German system, particularly. You see, Senator, the problem, when people say the German system, it has many different facets. Some of them, for example, the way they collect the money, is actually quite clever.

You could call it an individual mandate, but it is convenient to collect it at the nexus of the payroll, so you take "X" percent of every individual, you never tie anything to the size of the firm, which I think is a horrible approach. That one is good.

I think the idea of an all-payer system is ultimately what people in America seem to be screaming for, because I hear two messages and people don't want to put them together. I hear on the one hand, the government isn't paying its fair share of hospital bills, but if you want the government to pay its fair share, basically that means government and private payers should sit on one side of the table, hospitals on the other, and you figure out a fair rate that every one pays. That is the all-payer system; that is what Germany uses.

On the other hand, Germany now has used a very unseemly budgeting system, and it won't hold. It was a temporary measure to take them to 1995. The idea is that they budget every sector—so much for drugs, so much for hospital, so much for doctors. That freezes technology.

They have a commission to study how to unlock the budget because the legislation goes only to 1995. I am going there to explain that managed competition is something they should at least look at. So I think the system is not unraveling, but is in the throes of a major change.

SENATOR BENNETT. One last comment. Speaking theoretically now—I don't want to be pinned down by a potential opponent in the primary with what I am about to say—I could be enticed by the single-payer concept if we could tie to it absolutely, irrevocably requiring a constitutional amendment to change the notion that applies to catastrophic only.

I believe that one of the major, major problems that we have in health care is that we now have in the mind of every American that health care isn't any good unless it provides first-dollar coverage. I have lived, anecdotal, under that system.

I used to work for Howard Hughes, and Howard Hughes provided first-dollar coverage for anything. My kids teeth, no problem. Orthodontia, no problem. I could have sent him the vet bills for the dog and they would have paid. I didn't, but I could have.

Looking back on that experience, it was a wonderful benefit to have. There is no question that I overused the system. No question that I abused it. I didn't deliberately do it. I didn't set out maliciously like Phil Gramm would suggest, but it happened. When we got from under the Hughes circumstance and suddenly were faced with a more realistic circumstance, then we started to make some intelligent decisions as to whether we really needed to call the doctor, or whether we could do something ourselves. Catastrophic events like the birth of a child with major birth defects, mental retardation, that is going to cost $50,000 a year for the rest of that child's life, shouldn't ruin a family's life the way it does now. But a government-supported single-payer system that provides first-dollar coverage for aches and pains, insurance will bankrupt the Nation.

I will close with this analogy. Homeowners insurance. Every homeowner in America has homeowners insurance. There is no government mandate that you must have homeowners insurance. The market forces it and people are smart enough to buy it.

If my home burns down, my homeowners insurance will not only replace the home, it will replace the dishes on the shelves, the carpet on the floors, the pictures on the walls, and give me some spending money for new clothes, everything in the home, 100 percent coverage for a catastrophic event. The premium for that homeowners insurance is relatively low considering the benefit that I would get. But the premium does not cover the cost of mowing the lawn, does not cover the cost of painting the front door, does not cover the cost of replacing a light bulb. But somehow we are saying that our health insurance isn't universal coverage if it doesn't take care of everything that goes wrong with us.

If you could somehow wave a magic wand and say that the single-payer, universal coverage, government-controlled insurance that is going to take care of everybody has a level below which it will never go, as I say, with the constitutional amendment, I would say, then, I will talk to you about it. I won't be ideological; I won't plant my feet in cement and say never, never. But if we can't break the paradigm of the American that says my insurance has to cover the cost of mowing the lawn or somehow it isn't universal coverage, then I say we can't ever let the government do this.

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DR. REINHARDT. I couldn't disagree with you, because I wrote somewhat the same speech in a paper at a Princeton conference reacting to the Clinton plan. There, I made the point there are two dimensions to universality. One is how many people are covered, and the second is how many services are covered.

For some reason, we have gone from covering every service in the package and phasing in very slowly the people. I would have gone the other way. The model is the Medicare program, which pays for, on average, less than half of the health care of the elderly.

It is not a generous program. If you want to see something close to first-dollar coverage, look at what the *Wall Street Journal* gives its employees. It is astounding that a conservative newspaper like that would actually give its employees something that is beyond belief and contradicts their own editorials.

SENATOR BENNETT. Not necessarily, because, again, having been an employer, you want to acquire a certain kind of employee and you do things to acquire the employee, and you realize that if you are smart, very quickly that the employee is not attracted to you solely by salary.

Sometimes you paint everything green or blue, or whatever, because the employee is more likely to work for you if there are pleasant surroundings. I put a lot of money into landscaping and a lot of people say, why are you spending this much money out of this piece of property? I say, because it holds down my turnover rate. Employees eat their lunch under the trees and they are less likely to go work for somebody else.

This isn't my ego speaking; this is an intelligent employee decision. The *Wall Street Journal* may have decided that in order to get the kinds of employees they want, this is the kind of benefit we are going to give them, and it is a competitive edge on their part. I know that was a deliberate decision on the part of the Hughes organization; this is the kind of people we want and this is what we are going to do to hang on to them. It is an employee cost, and an employer is free to make the decision.

DR. REINHARDT. It would be good if this were a taxable item to the employee like all other forms of compensation. That is a problem economists have with this scheme. We believe all employer-provided fringes are shifted into wages. This means that a corporate executive effectively gets dental and vision care at half the price, because for every dollar of insurance he or she loses, only 50 cents comes out of income, while the janitor pays 85 cents of income because the marginal tax rate is lower.

Why not add this to taxable income, that way all compensation is taxable. Then you would get an economically correct choice. You tell the employees, would you like to have your wages in this blue box cash, or would you like it in the green box fringes, but it will be taxable income to you one way or the other.

SENATOR BENNETT. I ran a cafeteria plan for my employees and said you get so many benefit dollars, flex bucks and you decide, you want them spent for health care, for your 401-K plan, for day care—we are willing to spend $300 a month for you and you get to decide. You would be surprised how many of them did not take health care.

But why does it have to be taxable? It never has been. Why not say, look, I am paying you $20,000 a year in taxable dollars and $10,000 a year, right now, in nontaxable dollars, which is roughly what it runs. It is about a third of your employee costs, which are nontaxable dollars, that I am spending on you.

Why do they have to be taxable? Why can't you say to the employee that you get to choose how those tax-free dollars are spent? If you want to take $300 a month out of that and spend it on the health-care plan, blessings on you. The Federal Government is not taxing you on it now because I am spending it; it won't tax you because you spend it.

I don't see why we have to say that it always has to be taxed. It isn't taxed now and the economy survives.

DR. REINHARDT. What you then do as the Congress is, you are saying that you favor some sort of consumption over others.

Maybe we ought to visit on that again.

SENATOR BENNETT. I will come to Princeton and talk to you. I apologize for having to leave.

REPRESENTATIVE HAMILTON. I wanted to talk about the growth in health-care costs. Is the market solving that problem of growth in health-care costs?

We have seen a lot of articles suggesting that in the last year or two, this rapid increase has come down.

DR. REINHARDT. It has, but it also did in 1984 to 1985. Every once in while you get breathing spells. From 1984 to 1985, it seemed like health-care costs were under control. Secretary Heckler, I think, went on TV and announced that we have slain the monster, and some of us said that you need a longer run to be sure.

At the moment, we are in single digit increases in premiums, although they still proceed often at twice the rate of general price inflation. So you always have to look at this in real dollar terms.

REPRESENTATIVE HAMILTON. What is your judgment? Are we going to repeat the 1984 to 1985 experience and see this thing take off again?

DR. REINHARDT. I wrote an article and predicted that it will take off. I am cautious because managed competition could for awhile wring out a awful lost of prices and excess capacity out of the system. This may be a longer run.

I personally am convinced that from 1996 on, we will again see fairly stiff price increases relative to general consumer prices, because there is only so much fat in the system and that fat is now being wrung out by making specialist unemployed, cutting their fees, closing hospitals. But once that fat is out, ultimately technology will drive the system.

REPRESENTATIVE HAMILTON. Why is universal coverage desirable? Obviously, it is desirable in terms of people; everybody has medical care.

But from a systemic point of view, why is universal coverage important; or is it?

DR. REINHARDT. I think ultimately it is a political and value call. You could certainly run with a society that has, say, 90 percent of the people covered.

REPRESENTATIVE HAMILTON. What percentage are covered today?

DR. REINHARDT. Eighty-three. If you went to 90 percent, then you would have, say, 20 million uninsured people. Most of them would probably be fairly young.

In an editorial that was in yesterday's *New York Times*, I said that it really is a society that has features of a Russian roulette. Imagine having a revolver with 10 chambers, one bullet. Would you want to play with this thing?

And what I would tell the middle class, you are then living in a country where at any time 20 million people are in the hole, not insured. If they get sick, they will get care, but maybe late, and they will be broke. Whatever their savings was, it will be gone.

But the people near the hole are not secure either. They may fall into it. You may lose your job, lose your insurance; so you live with insecurities and that is a political question.

One of the handouts that I gave out reads that 50 percent of America's corporate executives in a recent survey said that they don't want to give the uninsured insurance. I say that is a respectable view, because you are rich and you will be paying for that, and you tell us that you don't want to pay for that. I respect that. You could live with a society that has that. So I don't think it is as much an economic view as an ideological view.

REPRESENTATIVE HAMILTON. How do you get to universal coverage? What are the options. You talked about employer mandate, individual mandates, a single-payer system; any other options?

DR. REINHARDT. Ultimately, to get universal coverage, you have to have compulsory coverage for at least a solidly catastrophic.

REPRESENTATIVE HAMILTON. Are there any options other than the three I mentioned, individual employer, single-payer?

DR. REINHARDT. Not really. That is it.

REPRESENTATIVE HAMILTON. Now, you are not too strong on the employer mandates. Why not?

DR. REINHARDT. Well, actually, if the employer mandate is played out the way the social insurance systems do it in Europe, where you essentially say everyone must be insured, and to make it easy we collect that at the nexus of the payroll for anyone connected to the workplace, I don't call that an employer mandate, because the only thing the employer is mandated to do is put a little code in the computer that siphons off the money from the paycheck and puts it in the insurance pot. That kind of employer mandate I am not opposed to.

But the employer mandates that we have, which essentially puts a premium that is a head tax on the employee, put a heavy burden on a low-wage industry. Then you say, well, we can fix it by giving subsidies to small business firms with low-wage employees, but now you have brought the size of the firm into the game and you get all kinds of gaming. If you make under the magic number, then the 99th employee was the last cheap one you had and you get all these notches. So most economists would argue let's not put the size of the firm in as a legislative parameter, otherwise, you get bad economic decisions.

REPRESENTATIVE HAMILTON. So you basically agree with the small business people who say that if you put an employer mandate on us, we are going to let people go from the payroll, we can't afford it?

DR. REINHARDT. I don't quite agree with them. They usually come and I sympathize. The usual image is, I run a Burger King or a restaurant and my employees get $15,000 dollars a year. Somebody tells me I have to buy a $5,000 product and give it to them on top of this, how can I compete. They always think the other hamburger stand won't have that problem.

But if every hamburger stand in New Jersey had to pay $5,000 more, what you would find initially is that the price of hamburger would go up somewhat and people would eat them anyhow. Because the minimum wage was raised, it did not displace these workers.

The problem comes when you make that a premium that hits a low-wage worker at $5,000 and an engineer at $5,000, rather than "X" percent of the payroll the way the Europeans do it, where a 10 percent hit on the payroll wouldn't be nearly as bad as laying $5,000 on top of someone who makes only $15,000.

The President's employer mandate had this premium, but for small low wage they converted it more and more into the European-style payroll tax, but in a very complicated way that requires you to have benefit managers and lawyers.

In Germany, companies don't have huge benefit departments. They don't need it. It is so simple. Every American company has a huge employee benefit department that hires high-priced consultants who tell them about benefits.

REPRESENTATIVE HAMILTON. How would you get to universal coverage if you were designing the system?

DR. REINHARDT. The proposal I would have and I did last year put in, is to say, don't touch the whole system; it touches too many people.

Simply say that whoever is not insured will fall into a federal fail-safe system. You have to put on your income tax form evidence that you are privately insured, certainly not with the first dollar, but a good catastrophic policy, and if you do not have that evidence, you must pay an extra surcharge into a federal fail-safe pool of your adjustable gross income if you don't have private insurance. That goes into a federal pot.

There would be a tobacco tax going into that and other such taxes, and I would say let us convert to taxable income the fringe benefits of people making $35,000 or more, phase that in. If you make $50,000, maybe 30 percent of your fringes will be added to your W-2 form so that a corporate executive would buy dental care with his or her own money, not tax money. That would give you $30 or $40 billion and those pots would be enough to have folded the uninsured into the federal employee benefit program, or through them give them a policy or Medicare. It could have been done. I think we could have had universal coverage that way last year. Not now.

REPRESENTATIVE HAMILTON. If you look at the plans that are floating around here, Jim Cooper's plan, the Gramm plan, which do not have the employer mandate, is it possible under their plans to get to universal coverage?

DR. REINHARDT. I don't think so.

REPRESENTATIVE HAMILTON. You have to have an element of compulsion, you said a moment ago.

DR. REINHARDT. Yes. The reason I think you have to have it is that they reformed the insurance industry by saying that there has to be community rates. The question is, what do you mean by a community? They haven't even begun to think about this, and I think we are running out of time to think about it. Is Westchester County and Harlem one community or are they two?

Second, if you exclude preexisting conditions those two mandates on the insurance industry allow anyone to walk in and say, look at me, I am going to cost you $100,000, here is my $3,000, insure me. That will drive up the community-rated premiums and many young people—at age 25 everyone is immortal—they will argue, I am going to luck it out. If I hit a tree, there is the emergency room and if I don't, I save this money. So I think you will create a lot of uninsured.

REPRESENTATIVE HAMILTON. One of the areas where you get a lot of figures thrown around is this area of savings that you get from the Medicare program, and the President thinks he can get $118 billion worth of savings out of Medicare. Now, as you know, the older people are very nervous about that, very skeptical about it, fearful about it. Is the President's figure of $118 billion, or whatever the figure is, is that a soundly based figure, do you think? Can you get that much savings out of Medicare?

DR. REINHARDT. Actually, I think, if it were skillfully done, you could. First of all, that is off a fairly steep trend line. I forget the numbers, but it is sometimes better to look at not the savings but what the President proposes to spend, and I think when I looked at this, it was a sizable amount of money in the President's budget for Medicare in the future. So I think that is much less alarming than looking at the savings.

But I didn't, I think, bring my irreverent Christmas card—I had a display from an Urban Institute study that shows spending per elderly, age, sex, adjusted for doctors in various cities in the United States, and you will find that according to the study in Miami, we paid doctors, that is Part B Medicare, $1,800 per elderly, and in Minnesota, only

$822. That difference is larger than the difference between Canadian per capita spending and America; it is almost the same as England and America.

In the Christmas card, of course, I called Minnesota "brutal rationing" to tweak the nose of my friend Senator Durenberger. Minnesota has some of the finest health care in the world.

So you should ask when doctors come before you, explain the chart to us, what is going on, age, sex and price differentials have been taken out, what are Miami doctors doing with patients that Minnesota doctors are not doing. Even New York, which is usually so pricey, spends only $954 per elderly. If you want to go after Medicare spending, perhaps you ought to use a database like this and go after Miami. If you took 20 percent——

REPRESENTATIVE HAMILTON. Why is it that high?

DR. REINHARDT. We do not know. That is why in my other guise, I never lobby, but I do lobby for health services research, because that is what gives you such numbers that allow you to ask what is actually going on in Miami. We did get the Agency of Policy Research funded in order to look at clinical outcome studies to see if what they do is justified and what works.

REPRESENTATIVE HAMILTON. If we look at the sources of money, financing up here, you are looking at the savings we are talking about out of Medicare, Medicaid, we are talking about a tobacco tax, an employer mandate—are there other sources from which we could get revenue for health care that you think would be good?

DR. REINHARDT. The one source where you would literally get the entire American Economic Association on your side would be to begin to tax employer-provided health insurance. We consider that tax preference highly inequitable but also inefficient. And I couldn't get a response to the Senator. It is the inefficiency of it that troubles us. The notion is that I am subsidizing the purchase of first-dollar health insurance coverage, which the Senator thought was a problem. Well, that is why the *Wall Street Journal* has it. The reason they give their employees this lush policy is that it is out of pretax dollars.

I sat on the board of a company and it was proposed to put in dental care, and the natural juices began to flow and I protested. I said dental care is not an insurable item, you should pay that out of your own pocket. I was told by these executives, but we are getting this for half price; how can you resist it? And I voted for it. That is how it goes in every board meeting.

There is no reason why the *Wall Street Journal* should give its people dental care other than they can get it for half price.

REPRESENTATIVE HAMILTON. I would like you to comment a little bit about the benefit package. How much should you put into a benefit package and what kind of things should you exclude? Should you cover mental health?

DR. REINHARDT. This is a thorny issue driven by two parameters. On the one hand, there are definite health needs—

REPRESENTATIVE HAMILTON. I am talking about the benefit package.

DR. REINHARDT. On the one hand, there are definite medical needs that as conscientious legislators, you would like to include, but on the other hand, you are besieged by people who derive income from delivering these services. And this happened, I think, in the House Ways and Means just yesterday, that the benefits package was—

REPRESENTATIVE HAMILTON. It is awfully hard to draw a line.

DR. REINHARDT. It is extremely difficult, and therefore I think this will always be a contentious and political issue call. My approach would be start lean. You can always add or give people riders where they can get additional benefits, but start lean rather than too generous, because when it is too generous, you can't afford it.

REPRESENTATIVE HAMILTON. If you have a lean package, you will have a lot of Americans who are going to buy more.

DR. REINHARDT. Yes.

REPRESENTATIVE HAMILTON. Then you end up with a two-tier system; in other words, the well-to-do people are always going to put themselves in a position where their families are well covered for almost all contingencies.

DR. REINHARDT. Yes.

REPRESENTATIVE HAMILTON. If you have a benefit package that is fairly lean, that benefit package is the only package available for people on a lower-wage scale, so you end up with a two-tier system.

DR. REINHARDT. Absolutely. I think it is a dream to think that we won't have a three-tier system, because the elite will always have health care of a sort that clinicians wouldn't even defend. There will be a fairly lean regime for public-financed patients, and eventually the elderly will have to come to terms with that as well. There will be whatever the middle class wants to afford, and there will be boutique medicine for the elite.

REPRESENTATIVE HAMILTON. You mentioned some of the problems with the community rating system. Can you go into that a little more? What does it mean? What are the problems with it?

DR. REINHARDT. First of all, technically how would you get a community rate.

REPRESENTATIVE HAMILTON. What is a community?

DR. REINHARDT. You have to define what is a community, which is a geographic concept, or it could be any definition, it could be that all economics professors are a community, but you have to define that. Once you have defined what the denominator is, you take all the health spending that they will incur, divide one by the other and you get the actuarial community rate for that community. Then you say that everyone who wants to join that pool must pay that rate.

You could have a modified community rate where you say you can do it by age group, so you stratify it by age so that young people don't subsidize old people. Within an age cohort, very sick people will be subsidized by very healthy people if they join that pool. If the joining is voluntary, then you will inevitably get a flight from insurance, because young or healthy people will say that they are not going to pay this. That makes the pool sicker, makes the rate go up and drives out even more—the way we had the flight from the city with the tax code, where each time people left, the tax base shrank; therefore, the rates went up and more people left.

REPRESENTATIVE HAMILTON. If you don't have mandates——

DR. REINHARDT. If you don't have compulsion.

REPRESENTATIVE HAMILTON. If you don't have compulsion, you go to a community-rated system of some kind?

DR. REINHARDT. You could leave it as it is, where it is actuarial fairly priced. That, however, means chronically ill people don't get insurance unless you subsidize them separately.

REPRESENTATIVE HAMILTON. What is New York's experience?

DR. REINHARDT. Flight from insurance of young people.

REPRESENTATIVE HAMILTON. When was that put in?

DR. REINHARDT. Two years ago. It is basically community rated on geographic ... I am not sure if it is all New York, but it is community rated. It was basically to help Blue Cross, frankly, and as I don't think there have been in-depth studies——

REPRESENTATIVE HAMILTON. So the experience in New York has not been good?

DR. REINHARDT. It is disquieting, but still going on.

REPRESENTATIVE HAMILTON. Senator, do you want to go ahead?

SENATOR BENNETT. You are on the same subject as when I had to leave, because I said that somehow universal coverage has to be catastrophic, and we have the rest of the package for the rest of the problem to be addressed. My reaction to this is to define the basic benefit package in terms of dollars rather than services, and let the market work.

Back to what I was saying when I had to leave. In a cafeteria plan, you have so many benefit dollars, you spend them the way you want and you take the consequences, and we have employees who say, I don't want any health-care coverage, I want all those benefit dollars to go for day care.

We were talking earlier, Mr. Chairman, about what is lost with the money spent on health care, what is it not spent on. In these cases, these women said that they wanted money spent on day care. Suppose we say all right, the basic benefit package is going to be in terms of dollars. Picking up the discussion, you somehow complained about these dollars being marketable and wanted to make them taxable. Suppose we say all right, we will leave the present system in place, where an employer can offer benefit dollars that are nontaxable to the employee and still deductible to the employer, a payroll cost.

I would argue that a payroll cost is a payroll cost. If I am a foolish employer who wants to put money into fountains in my workplace, I deduct that and I take the risk as to whether or not that produces a better work product in the workplace.

You want to say, okay, we will put a limit on the amount of benefit dollars that can be deductible to employees and deductible to the employer and tax free to the employee. We could debate that. But what is wrong with the concept of saying that the employee has "X" number of tax fee dollars to spend however he or she wants on health care and let each individual construct his own basic benefits package out of a combination of those dollars and his or her own after-tax dollars.

A hypochondriac buys a policy that covers everything. The person who is convinced that all doctors are witch doctors and the only people who can be trusted are chiropractors can use those benefit dollars to call on a chiropractor. The person who believes in holistic medicine and crushed butterfly wings, can live off butterfly wings, and the government doesn't have to make any of those decisions. What is wrong with that?

DR. REINHARDT. Supposing you had an employee with diabetes and a heart condition and you have this package that is averaged, who would sell such a person an insurance policy knowing how expensive they are going to be? Take someone with AIDS, for that matter. At the amount that the employer might put in there, maybe $4,000 can be spent on either health care or anything else you want, how would you guarantee that your employee with AIDS or with diabetes would in fact get a policy for that?

SENATOR BENNETT. Presumably, he or she would have gotten a policy prior to getting AIDS. Presumably, everybody gets their health coverage at the time when they are healthy and it carries with them when they are unhealthy. If the individual controls the policy rather than the employer, the previous condition circumstance goes away.

When somebody goes to work healthy and then is discovered to have diabetes or a heart problem or AIDS, they are already in the pool because they have bought the thing that says, if I get these, then if it becomes truly catastrophic, then they go up into the catastrophic level and get taken care of, so the pool doesn't have to concern itself with the truly catastrophic circumstances.

DR. REINHARDT. Suppose I want to switch jobs or move to another state.

SENATOR BENNETT. Under my system, you have bought the policy, you own the policy, you take the policy with you. It has no connection with your employer whatsoever. The employer gives you the tax-free dollars and the salary dollars and you spend them however you want.

DR. REINHARDT. That would work if you then had a lifetime, basically, guarantee the company could not cancel your policy essentially.

SENATOR BENNETT. That is right.

DR. REINHARDT. But what if you were chronically ill from the start, you come out of college sick or are likely to get sick, and with genetic testing we can tag people like we have never been able to do before?

SENATOR BENNETT. That crosses the border into the catastrophic area, which I was talking about earlier. I would be willing to talk to you about universal coverage for every person in the country on catastrophic so that somebody who crosses the border into a catastrophic circumstance and is overwhelmed, gets taken care of.

I said to the head of a large insurance company, what if you split the system and dropped off everything but catastrophic? They said about 10 percent of our current premiums could cover everybody in the country for catastrophic, which shows the enormous waste in our present system processing paper for flu shots, or my analogy, mowing the lawn. Why should I file an insurance claim and have three clerks shuffle the paper through the system and write a check and send me back for mowing the lawn?

A flu shot is a $15 office visit and it costs $30 because of the paperwork.

DR. REINHARDT. Why do the *Wall Street Journal* employees put in a claim for flu shoots? Because you give them this tax preference and this commodity is so cheap—first-dollar coverage—that they buy it and thereby most corporate employees are the ones that have the first-dollar coverage.

SENATOR BENNETT. But it is not so cheap anymore. More and more employers are moving away from first-dollar coverage. I came out of my Howard Hughes experience; it was wonderful as an employee, and when I was putting the health-care system in the business as the CEO, I said let's do what we did at Hughes. It was great, employees loved it.

I had wiser heads say to me, you don't want to do that. And we didn't and we put in a system currently self-insured, where we say to the employees every month, this is what it is costing. And we are deducting so much out of your paycheck if you have elected health insurance—under the cafeteria plan, they can opt out entirely—if you elected health insurance, this is what our experience was this month.

If this experience repeats next month, everybody's premium is going to go up. We say this is our experience the next month; you held it down, your premiums go down. Our employees understand. That is a decision I made as an employer. I am getting the results I want out of my employees.

The *Wall Street Journal* has made their decision as an employer. Presumably, they are getting what they want in terms of retaining employees. The free market works that way. The management ought to be allowed to make a dumb decision if they want. That is one of your privileges in America.

DR. REINHARDT. I would be the first to shout that from a steeple.

SENATOR BENNETT. The government makes the decisions in the Clinton plan.

DR. REINHARDT. We could argue that the Clinton plan probably wouldn't touch them very much. I would say that it would be fine to make these managerial decisions if they were made on a level playing field without a tax preference. Then I could go for that. The tax preference troubles every economist alive, because it is not only inequitable but inefficient.

Get my ultra-conservative colleague, Martin Feldstein, and discuss it with him. He won't be as calm as I am about it because he has made a religion out of it. Get Allen Enthoven(spelling ???), get any economist, and he will go ballistic on this issue.

REPRESENTATIVE HAMILTON. We will bring that up with him.

My guess is that in my constituency, which is a fairly conservative constituency, 80, 90 percent of the people favor price controls. Why are these doctors charging me so much money? Why do I have to pay so much for 2 days in the hospital? These prescription drugs are driving me nuts. Why don't you fellows in the Congress slap price controls on these people and make them behave themselves?

I hear that all the time, and I think the national polls support what I have said. Ordinary Americans think the way to solve this problem is price controls.

SENATOR BENNETT. Seventy-eight percent.

REPRESENTATIVE HAMILTON. What do you say to that?

DR. REINHARDT. This is somewhat amusing, and I have to laugh—recently, I was in Nashville with some truly rich Princeton alumni and they were in one conversation running down the government, but also complaining what pharmaceuticals cost them. I happen to think that relative to cognac, most pharmaceutical products are cheap. But they were complaining about this.

I personally think that before you go out——

REPRESENTATIVE HAMILTON. We are not going to do it, obviously. I want to be able to respond to that.

DR. REINHARDT. I have lived here for 30 years and the longer I live in the United States the more I now know I will never understand this country. I recently had the privilege to testify before Senator Rockefeller on the Veterans Administration, and I asked an impertinent question: Why do we have a VA? Why do so many conservative Senators go to the mat to defend purely socialized medicine that even the Russians don't run anymore? Canada doesn't have socialized medicine. Why are American veterans so fond of socialized medicine?

I don't know the answer. I am trying to study it. I actually brought and I gave Dr. Ruggles a paper I had submitted to the Wall Street Journal last year, because I didn't think price controls were necessary on doctors.

You could have done something and we should have done that with Medicare in the hospitals the following: The government has developed a relative value scale for doctors and for hospitals. For hospitals, we call it DRG, where you basically could express for 500 cases the fee of each, relative to a base fee that is given a unit of 1. For physicians, the unit is a routine follow-up visit that has a value of 1 and Medicare now pays $35 for that. And then another procedure has a value of 2; Medicare would pay $70. So you can explain the entire fee schedule with one number.

I propose that Congress pass a law that every doctor must use for pricing that relative value scale, but they can put their own money value on the base unit, which then defines the entire schedule, and post it so that the newspapers can print it, that there would be an 800 number I could dial that says Dr. Jones charges a $5.00 conversion factor. Then I know every fee would be that much higher and advertise those.

Also, for hospitals, you would have hospitals post the base price instead of having government set these fees, which is what we now do. Each hospital would say, for the base unit, which is an appendectomy, we charge $100 and all the other hospital charges would be known.

REPRESENTATIVE HAMILTON. Let me go to my question.

What do I say to the person that comes to me and says set the prices? Why is that not a good thing to do?

DR. REINHARDT. It is very difficult to do this right. To not hit it either too low or too high is very, very difficult.

REPRESENTATIVE HAMILTON. What happens if you don't set it correctly?

DR. REINHARDT. If you set it too low, you might get shortages, unless you have it for absolutely everyone, doctors not accepting patients with price control fees. Most countries use that of course.

REPRESENTATIVE HAMILTON. Price controls?

DR. REINHARDT. Canada does, Germany, France, Japan does. Every country I know does. What typically happens is, if you set those prices too low, they just do more or unbundle what they do. This is what we find in Germany, Japan——

REPRESENTATIVE HAMILTON. Massive bureaucracy?

DR. REINHARDT. You do get into a bureaucracy, which I think, with my system, you could avoid and then you could negotiate as a HMO with doctors around one number. To some extent, I think that is something we should have tried. You could still put a trigger on.

REPRESENTATIVE HAMILTON. Do you think doctors, hospitals or pharmaceutical companies today are ripping the public off?

DR. REINHARDT. No. I don't use that language.

REPRESENTATIVE HAMILTON. I am using the language my constituents use. I am not arguing it. I hear it all the time: They are ripping me off, Congressman.

DR. REINHARDT. I would disagree. They are charging what they can get away with. Somebody is paying it and why is that ripping off? Do I rip off? Everyone tries in our economy to get the best deal they can get, and why should they voluntarily hold back? The lawyers are not doing that, architects are not.

REPRESENTATIVE HAMILTON. Professors are not.

DR. REINHARDT. We do. We are underpaid.

SENATOR BENNETT. Depends on the university.

DR. REINHARDT. That is the point. When we are consulted, we are not diffident. I think it is not the right approach——

REPRESENTATIVE HAMILTON. Let me ask you one other thing. I wanted to ask you about this trigger business, how you feel about that. The approach that I think is being taken in the Senate, in some of the plans and certainly in the House as well, is that you try to get as close as you can to universal coverage. You may hit 90 percent, but you don't get there all the way and then you have a trigger. You have the soft trigger and the hard trigger.

How do you respond to the whole concept of trigger?

DR. REINHARDT. Basically, we have three, we have those plans, Senator Gramm's, that basically have no trigger and then you have the other extreme, the very definite timetable that the President proposes, and in between you have soft and hard triggers.

I would say, if that is the best you can get, take it. Basically, I call a soft trigger a "Scarlett O'Hara technique." Wasn't there a last line, "I'll worry about it tomorrow; tomorrow is another day." It basically says that we have this goal, and it is certainly worth keeping an eye on that goal rather than saying we have reform and we won't look at it for 20 years.

Here you have reform, and we will monitor what it does and if it doesn't do it, some earlier Congress said we should look at this, but every Congress can do what it likes, so therefore a soft trigger is just that. A hard trigger is also a soft trigger. I view every hard trigger as a soft trigger because Congress can always undo it.

They have been known to repeal laws before. They require more action, but a hard trigger doesn't bind a future Congress to maintain it, I don't think.

REPRESENTATIVE HAMILTON. Do you think we can contain costs with managed competition? And if we can, what do you mean by managed competition?

DR. REINHARDT. By managed competition, I understand the pitting against one another of capitated managed care systems. Managed care, means somebody monitors what doctors and hospitals do and also bargains over prices with them. That is managed care. Managed competition is pitting these systems that do that against one another in the competition over a premium for that.

I think such a system, if played out properly can, at least, for awhile, dampen costs, and it seems to me that we are seeing that. You would have to be bigoted not to say that at the moment these managed care systems seem to be doing that.

My colleague Joseph Newhouse has done literature on HMOs and found that while their costs may be lower than that of the fee-for-service system, in the past the growth rates from year to year have been the same. He attributes that to, new technology that comes gets used. I believe there is a real sleeper that managed competition is inimical to technical innovation and that has to do with the fact that if you have large systems like the Columbia HDA system, they can go to a pharmaceutical company and say, we want your product, your antibiotic, but at a discount off full cost. The company will say, but we have to recover our R&D, and they will say, we understand this, but we are competing against some other system. Private competitors cannot worry about other people's R&D. This is one of those speeches I gave health reform through bounty hunting. I think at some point the Congress has to keep a eye on what managed competition will do to R&D, device manufacturing, pharmaceutical and biotechnology.

REPRESENTATIVE HAMILTON. But, in general, you feel that the managed competition concept would be effective in containing health-care costs?

DR. REINHARDT. In containing costs, it has a side effect that you may or may not like. There may be underservicing of patients. There will be rationing. The whole idea of managed competition is to ration. Economists are not opposed to rationing.

You will be shocked to hear that any economist would have to tell you that any system that doesn't ration is inefficient. That is what we teach. We don't apply that when we are personally sick, but nevertheless that is what we teach. So, therefore, the rationing doesn't disturb us, and if it goes too far, how do we catch it?

There has to be monitoring; there has to be a data system that follows this. You have to have information on patient satisfaction that is objective. Somebody other than the HMO has to produce that. You want something on clinical outcomes I think, but not to give to people, because I think they will be confused by it, but savvy buyers who can say this doctor is really not good or this product doesn't work. If you had this, I think it is worth a try, and we are trying it.

SENATOR BENNETT. I just want to compliment you and thank you for your presentation. It has been very useful.

If I could close with my speech, this is enormously complex. The stakes are enormously high. Life being what it is, there is a 100 percent probability that if we try to do it all, in a single bill, in a single Congress, we will get it wrong and probably make it worse. This is, I hope, not a partisan note, but I love what Bill Saffire said in this morning's *New York Times*.

> Bill Clinton deserves credit for getting us started, and Bob Dole deserves credit for stopping us at the right place. I think we should stop there, see what happens, discover.

There are all kinds of things wrong. Revisit this in the next Congress, make some changes based on the data that comes in, revisit it in the next Congress, make the changes. Again, in the context from which I come, if I were the CEO of a corporation and someone came to me and said that we have a division in our corporation that is in real trouble; it is not delivering what it needs to deliver to the customer, the costs are out of control, the bureaucracy stifling—and by the way, it is losing $800 billion a year—I would say let's fix the division very carefully. If it is doing $800 billion a year, let's not call IRA Magaziner and have him give us one of his 60-day wonders. Let's do this very carefully.

DR. REINHARDT. You may ask why are people pushing for doing this all at once. My plan is a far more conservative plan; it leaves the private sector alone. There is a view that many policy "wonks" have, and I am not sure if it is true, but the religion is that Congress makes major health policy every 20 or 30 years, so we will do it again in 2015. That is why people say, let's load up this train, because the next train takes 30 years.

If one had some assurance that the Congress would consider this like the budget—an annual review of the health care. And maybe you need some commission like the Physician Payment Review Commission, that the Congress says we will do this; see how that works and then we will fix it according to the wishes of the people, I think a lot of people would sleep much easier with Senator Dole's approach.

The big fear is that their train came, that is what we loaded on it and we will have to wait another 30 years. I hope Senator Dole could also assure us that he will revisit it next year.

SENATOR BENNETT. I can't speak for Senator Dole.

DR. REINHARDT. That is very reassuring.

REPRESENTATIVE HAMILTON. We stand adjourned.

[Whereupon, at 11:40 a.m., the Committee adjourned, subject to the call of the Chair.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF UWE E. REINHARDT

Every so often these days, word leaks from the White House that the Administration will impose a price freeze upon the health sector or, alternatively, extend the Medicare fee schedules for hospitals and doctors to the entire health sector. Alas, the first option would be difficult to police and probably lead to a bureaucratic nightmare. The second option would be easy to implement, but it would subject many a hospital and physician to a severe financial shock, because Medicare rates are much lower than the fees providers charge private patients. Is there a third alternative?

There may be, if one is willing to gamble that mere *price transparency* would serve to constraint health-care prices. Thus, one might impose upon the entire health sector the *relative value scales* developed by the Medicare program during the 1 980s, but allow doctors and hospitals to set, for non-Medicare patients, their own monetary conversion factors for these schedules, at least in a transition towards more uniform, negotiated fee schedules.

A *relative value scale* expresses the fees of all procedures in a fee schedule in terms of relative value points. Suppose one selected a routine office visit as the base procedure and assigned it a point value of 1. Then an echocardiogram might have a point value of 6, a normal appendectomy a value of 12 and a gall bladder operation a value of 20. These relative value points would reflect estimated differences in the cost of performing the procedures. Now, if all physicians used a common *relative value scale* and Dr. Jones charged, say, $50 for a routine office visit, then he or she would charge $300 for an echocardiogram, $600 for an appendectomy and $1,000 for a gall bladder operation. If Dr. Chen charged only $40 for a routine office visit (i.e., 20 percent less than Dr. Jones), then all of his or her fees would be 20 percent lower than Dr. Jones'. In short, one could easily compare the fees charged by different physicians in the community by a single number: their fee for the base procedure, in our case the routine office visit. That fee would be called the physician's "conversion factor."

Under the proposal recommended here, physicians would be mandated to use the *relative value scale* that the Medicare program has developed for some 7,000 procedures performed by physicians. But physicians would be allowed to apply to that relative value scale their own monetary conversion factors for privately insured or self-paying patients. That factor would apply to all private patients; extra billing on a patient-by-patient basis—i.e., price discrimination—would not be permitted. If physicians were made to announce their conversion factor at the beginning of each year, then these factors could be published in the local newspapers and routinely made available to patients via an 800 telephone number to facilitate price comparisons without having to pry loose that price information directly from one's doctor.

A similar mandate could be imposed upon hospitals, with the *relative value scale* based upon the federal case payments, although only if cost sharing by patients were negligible or confined to a simple deductible. The all inclusive federal fee per medical case is in effect an average for relatively simple and complicated cases within the same diagnostic category. If patients were forced to pay, say, 20 percent of each hospital bill out of pocket, then patients with a relatively simple case within a diagnostic category would be forced to subsidize, through their share of the *average* fee for that case category, patients with relatively complicated cases. That might cause considerable social tension. For that reason, an extension of the idea proposed here to the hospital sector would require that any cost sharing by patients take the form of a flat sum per admission, where that flat sum would vary directly with the hospital's announced conversion factor.

The approach recommended here could be implemented swiftly, even this year. All the hardware and software for the federal schedules are fully developed and are well known to the providers of health care. The policy would not constitute rate regulation, because it leaves the conversion factors for private patients fully to the individual providers' discretion. The policy merely mandates doctors and hospitals to reveal their prices in a manner patients and their insurance carriers can easily understand. Surely neither doctors nor hospitals can legitimately object to that transparency. In fact, the American Society of Internal Medicine has already endorsed this approach.

This high price-transparency alone probably would serve to drive health-care prices towards greater uniformity and acceptable levels, even without explicit rate regulation. It would be fairly easy to simulate, for example, what income levels the typical physician could achieve at various levels of the conversion factor and to publish those estimates along with the conversion factors themselves. Patients could then decide for themselves whether their doctors really "needs" the higher income implied in a high conversion factor and whether they wish to underwrite that need with their own money. Furthermore, private employers who provide their employees with health insurance could then insist that employees confine their choices to physicians with stipulated maximum conversion factor of $X or less, or pay 100 percent of the portion of a physician's fee that exceeds an implied conversion factor of $X (and likewise for hospitals). Chances are that such a stricture would quickly drive the fees of higher-priced providers down towards the stipulated maxima.

The policy would have one major additional advantage: it would greatly facilitate the spread of electronic billing on the basis of common claims forms. While electronic billing has by now become the dominant form of reimbursement under the Medicare program, it is still in its infancy in the private insurance sector, precisely because fees have been so chaotic there. If all doctors used the same list of procedures and all hospitals did likewise, many billions of dollars now spent on paper pushing could be saved, a wasteful effort that makes our current health system probably the most administratively cumbersome system in the world. The time has come to cut that waste.

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