

JAPAN STRATEGIST ROUNDTABLE: NICHOLAS SMITH ON TAX POLICIES, ABE'S POPULARITY AND THE OVERALL MARKET ENVIRONMENT

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On a trip to Japan in early September, I had the pleasure of having breakfast with Nicholas Smith, the Japan equity strategist for Credit Lyonnais Securities Asia (CLSA). We discussed Japan's tax policies, Prime Minister Abe's popularity and the overall market environment. Here are the highlights of our conversation. **Question: One of the policy changes investors would like to see is the cut in the corporate tax rate. Please talk about the tax environment that has led to this change in policy.** **Smith:** Japan has one of the highest corporate tax rates in the world, second only to the United States. But one problem is that an ever increasing number of companies don't pay any tax. Back in the early 1950s, only 16% of companies did not pay corporate taxes, but today it is 70% of companies—dominated by smaller companies. Generally speaking, corporate profits have increased over 60% cumulatively over the last 50 years, while corporate tax receipts are down 50% cumulatively over the same period. When I look at that, I have asked people at the Ministry of Finance: How did you mess this up so badly? The desire to lower rates and broaden the base of tax collected upon is much needed. **Question: What is the impact of reducing the tax rate?** **Smith:** I have calculated that if Japan reduces the corporate tax rate from the 39.3% [effective tax rate](#) currently to be in line with the effective tax rate in the United States of 27%, this would lead to a 20% increase in the earnings for the [TOPIX 500 Index](#) (after tax earnings). **Question: One part of the third-arrow growth strategies was reforming some of the public pension funds like the Government Pension Investment Fund (GPIF) to modernize asset allocations away from the low-yielding Japanese government bonds (JGBs). When do you expect this to take place?** **Smith:** There is a big question whether some of the flows to trust banks this year were caused by the GPIF purchases. I have looked at it, and we have talked to asset managers. My sense is the GPIF has not started increasing allocations to equities yet, but it will very soon. We could expect to see the purchases in September and October, if not already. The GPIF may very well be considering making purchases before fully announcing its new policy, as investors will try to buy ahead of the GPIF if they were fully clear on their intentions. **Question: There is some media focus on the declining support for Abe prior to his Cabinet reshuffle. What's your take on how Abe is doing?** **Smith:** I believe Abe really has unprecedented support. Former Prime Minister Koizumi (some might call him "Elvis" for his popularity) was less popular than Abe at this stage of his run as prime minister. Usually there is an initial surge of popularity in the first few months in office, and then it trends downward. The historical average of popularity of Cabinet support ratios I have found as approximately one-third. I see Abe's support over 50% at this stage. Thus far, he's the most popular prime minister in three decades. This also shows in the execution of the bills that were passed that he submitted to parliament: 97.5% of the bills he has submitted were executed, a percentage only matched by Koizumi in 2003. **Question: One of the priorities of the Abe government is to increase women in the workforce due to the shrinking labor supply. What do you think needs to be done here?** **Smith:** The lack of women in the workforce is not because companies are unwilling to hire. It's largely a problem of retention due to a lack in performance-based pay. Women need to be rewarded for working efficiently so they can leave early. Women don't quit because households or childcare needs compel them to; they quit mostly because the employment system rewards hours worked, not performance. You are currently incentivized to work longer but not to work smarter. That is clearly visible in the [labor productivity](#) numbers. Japanese [per capita gross domestic product \(GDP\)](#) used to be substantially higher than the USA, but in 2012, per capita GDP in both Japan and France was broadly 30% below the USA. Lower French per capita GDP was largely explained by their working 24% fewer hours. But the Japanese reported working 9% more hours. The French were economically less rich because they chose to spend more time with their families; the Japanese were less rich despite spending little time with

their families. **Question: What are some of the investment themes relating to Abe's strategy to get more women into the workforce?** **Smith:** The number of women returning to the workforce is likely to remain high for the next several years. While these women are paid substantially less than regular employee men, their income is an incremental positive to household income. Women returning to work will make it look as though wages are falling, whereas what is really happening is a change in the mix. On a like-for-like basis, pay is going up for both regular and non-regular employees, at both big and small companies. That looks like good news for consumption generally. We want to thank Nicholas Smith for spending time with us and for his insights. For more insights from Mr. Smith and some of the other strategists and economists we spoke with in Japan, please see our full roundtable [here](#).

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Effective tax rate : The average tax rate at which a corporation's pre-tax profits are taxed, taking into account all forms of taxation paid by the company.

TOPIX 500 Index : A capitalization-weighted index designed to measure the performance of the 500 most liquid stocks with the largest market capitalization that are members of the TOPIX.

Third arrow policies : The part of Japan's Abenomics process of reform that is focused on structural changes intended to promote economic growth.

Government Pension Investment Fund (GPIF) : Japan's largest public pension fund.

Government bonds : A debt securities issued by a government to support fiscal spending.

Labor productivity : Measure of how much labor is able to accomplish, given the use of a set amount of resources, most often the number of hours worked.

Per capita gross domestic product (GDP) : Gross domestic product of an economy divided by the number of people within that economy. Higher numbers indicate a higher standard of living for that economy.