〔Refereed Article〕

The Current State of Japanese Inbound FDI: Deterrents and Initiatives

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Abstract

Japan, a wealthy and sophisticated market, has the potential to be a major destination for foreign direct investment (FDI) due to its local advantages such as market size, an educated workforce and advanced technological capabilities. It is surprising therefore that Japan has a reputation for being averse to inward FDI. In fact Japan was dubbed as the most closed investment market in the developed world by European Union Trade Commissioner Peter Mandelson in his 2008 address to business and government leaders in Tokyo. Japan's trade statistics compared to other developed nations suggest there may be deterrents that are suppressing inbound FDI. As a G7 nation and a member of the Organisation for Economic Co-operation and Development (OECD), Japan is competing against other worthwhile destinations for investment capital, and like its competitors, Japan needs to constantly improve its business climate in order to stay attractive to multi-national corporations. Fortunately, in keeping with successive prime Minister's goal of increasing incoming FDI, Japan has been taking steps to become friendlier to foreign capital over the years.

This paper will assess the current state of Japan's inward FDI and evaluate Japan's performance in relation to its major global and regional competitors particularly other G7 nations and OECD members. It discusses Japan's openness in terms of existing impediments to FDI and look at Japan's international perception based on its ranking on two global indices. As well, there is an overview of the government's goals for increasing FDI and local initiatives to stimulate openness to foreign capital. Finally there are suggestions for areas of opportunities that Japan can explore going forward to increase its inbound FDI.

Keywords : Foreign direct investment, FDI, MNC, M&A

Introduction

A vibrant local economy is a top priority for most countries, and international trade in the form of foreign direct investment (FDI) helps to achieve this. Openness to international trade in general helps nations profit from industries in which they possess a comparative advantage, increases competition in products and labour markets and helps to bring about economies of scale [Beltramello, De Backer, Mercade, 2011].

Benefits specific to FDI often derive from the long term nature of the investments made by multi-national corporations (MNC) in local markets. For example, several studies on FDI have documented the superior performance in productivity, innovation and R&D of foreign affiliates relative to domestic firms in host countries (OECD, 2011a) [Beltramello, De Backer, Mercade, 2011] Furthermore, foreign capital results in unintended benefits that typically spill over from MNCs to the local economy they invest in. Local benefits can potentially arise from FDI when foreign firms demonstrate new technology that diffuse to local companies, train workers who subsequently migrate to other firms, and spur competition which leads to improved efficiency in the local market. When these spillover benefits are assimilated by local suppliers, customers, the workforce, and local firms, FDI contributes additional productivity growth for the host economy [Beltramello, De Backer, Mercade, 2011]).

The long term economic benefits of FDI are compelling enough that economies both large and small find it prudent to improve their investment atmosphere for foreign capital and aggressively market themselves as attractive FDI destinations. On this competitive FDI landscape, where does Japan stand in terms of attracting MNCs to invest within its borders and what issues serve as deterrents to Japan receiving even more cross-border investments? How does Japan currently business climate rank among other competing nations in regards to openness, taxation and other factors that are important to attracting inward FDI? This report will seek to answer these questions by analyzing data from the Organisation for Economic Co-operation and Development (OECD), the World Bank and other world organizations that track international trade.

In particular, emphasis will be placed on the OECD's FDI Restrictiveness Index and the World Bank's Ease of Doing Business ranking as they are two of the most reputable global organizations that track trade and investment data for countries worldwide. Japan's position on both these indices will shed light on its performance individually and in comparison to other nations. More importantly, the well-defined performance criteria tracked by these two indices will be used to gain a better understanding of the reason behind Japan's current inbound FDI status.

Ⅰ　Current State of Japanese Inbound FDI

Japan is the third largest economy in the world based on its gross domestic product (GDP) which stood at USD $4.123 trillion at the end of 2015. It is a major trading partner for most advanced countries and many other developing nations. It accounts for 3.6% of global exports and 4.3% of global imports [WTO, 2015]. Japan ranks 4th worldwide in merchandize exports and imports and ranks 7th and 6th for commercial services export and import respectively. Japan's position as a major economy with many competitive advantages, as well as a sophisticated and wealthy consumer base, makes it a major player in the international trade arena.

Particularly, Japan is an aggressive investor overseas and according to the United Nations Conference on Trade and Development (UNCTAD) in 2014, it ranked 7th worldwide for the

Table 1: Top 10 Industries with Inward FDI Stock as at End of 2014

	Industry	Stock (Billion Yen)	Ratio (%)		Industry	Stock (Billion Yen)	Ratio (%)
1	Finance and insurance	7,738	37.9	6	Service	671	3.3
2	Transportation equipment manufacturing	2,781	13.6	7	Communications	644	3.2
3	Electric machinery manufacturing	2,309	11.3	8	General machinery manufacturing	445	2.2
4	Wholesale and retail	1,646	8.1	9	Glass and ceramics manufacturing	362	1.8
5	Chemical and pharmaceutical manufacturing	1,121	5.5	10	Real estate	355	1.7

Source: Compiled from JETRO Invest Japan Report 2015

Table 2: Inbound FDI Stock (billions of USD)

Location	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Canada	639	707	1,033	6,202	867	984	863	954	962	954	752
China	472	614	704	9,155	13,149	1,570	1,907	2,160	2,331	2,599	2842
France	371	494	624	5,630	648	631	699	680	761	681	660
Germany	648	836	1,013	9,274	965	959	989	863	953	843	792
Italy	237	312	377	3,279	364	328	355	364	365	347	335
Japan	101	108	133	2,034	200	215	226	206	171	172	171
S. Korea	105	116	122	947	121	134	134	156	167	179	175
OECD Total	8,791	10,678	12,901	105,276	12,197	13,124	13,334	14,651	16,106	16,321	16419
U.K.	788	1,035	1,125	9,111	1,026	1,068	1,157	1,441	1,513	1,629	1554
U.S.A	2,818	3,293	3,551	24,864	2,995	13,124	13,334	14,651	16,106	16,321	16419
World	11,327	14,052	17,687	152,163	18,199	20,206	20,952	23,053	25,099	25,641	26216

Source: Compiled from OECD and World Bank online databases
OECD (2016), FDI stocks (indicator). doi: 10.1787/80eca1f9-en

value of its off-shore FDI. FDI outflows from Japan, have shown a relatively stable upward trend increasing from 10.3% of GDP in 2006 to just over 28% in 2015 [OECD, 2016], reflecting the tenacity of Japanese firms to develop their business interests abroad.

Japan's inbound FDI statistics however tells a different story. In 2015, Japan's inward FDI stock represented 3.7% of its GDP, a fraction of the OECD average of 42%. As table 1 shows, Sixty four percent of these investments were concentrated in just three industries namely: finance and insurance (37.9%), transportation equipment manufacturing (13.6%) and electric machinery manufacturing (11.7%) [JETRO, JETRO Invest Japan Report 2015, 2016]. Other areas such as real estate, medical and education attracted very little or no foreign capital.

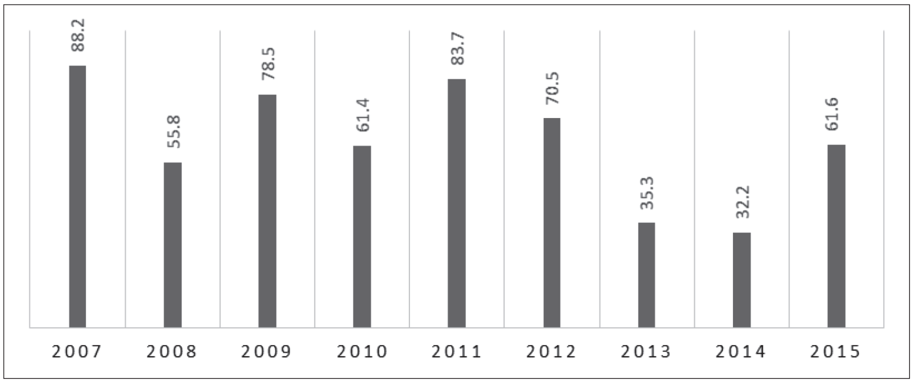
Japan's inward FDI stock had a three-fold increase from USD $29.939 billion to $100.89 billion over the 10 years spanning 1996 to 2005. In 2006 however, Japan had negative inward FDI flows of – $6.5 billion; incoming investments then rebounded until FDI stock reached a peak in 2011 at $225.78 billion (3.82% of GDP) but sagged to USD $170.69 billion (4% of GDP) in 2015, when once again, Japan had negative inbound FDI flows. While inward FDI stock decreased between 2011 and 2015, its percentage of GDP increased suggesting that the Japanese economy had shrunk over the years in question [UNCTD, 2016] (Table 2 and 3).

International merger and acquisition (M&A) is an important component of FDI evidenced

Table 3: Inbound FDI Flows (billions of USD)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Canada	26	60	117	62	23	28	40	43	72	59	43
China	104	124	156	172	131	244	280	241	291	268	250
France	33	25	64	38	31	14	32	16	34	0	40
Germany	47	56	80	8	24	66	66	28	10	−7	13
Italy	20	39	40	−11	20	9	34	0	24	20	15
Japan	3	−7	23	24	12	−1	−2	2	2	11	−2
S. Korea	14	9	9	11	9	9	10	9	13	9	5
OECD Total	621	956	1,319	846	673	716	875	711	764	630	1094
U.K.	183	147	177	92	90	58	42	56	52	45	38
U.S.A	113	243	221	310	150	206	236	204	206	176	353
World	991	1,465	1,970	1,761	1,158	1,500	1,695	1,470	1,551	1,438	1892

Source: Compiled from OECD and World Bank online database
OECD (2016), FDI flows (indicator). doi: 10.1787/99f6e393-en (Accessed on 10 August 2016)



Source: Compiled from OECD data from various years; https://data.oecd.org

Figure 1: M&A Deals in Japan (millions of dollars)

by the fact that it is the strategy most used by multinational corporations (MNC) to enter a foreign market. Before the financial crisis in 2007, M&A accounted for approximately 80% of global FDI but fell to around 60% in 2013 however M&A is expected to return to its pre-crisis levels [OECD, 2014]. As such global M&A has been increasing steadily and has almost doubled over the past five years from USD $3,481 billion in 2010 to USD $6,144 billion in 2015. For the same period however, Japanese inbound M&A was erratic, increasing 20% in 2011, then decreasing 50% in 2013 from 2012 levels. Although M&A rebounded in 2015 to USD $61.6 billion, it was still lower than the USD $63.02 billion average for the prior nine years (Fig. 1).

Ⅱ　Comparing Japan's Inbound FDI Other Economies

1. Return on Inward FDI

Historically, Japan has been a chronic underperforming when it comes to attracting foreign capital compared with other developed, and in some cases, developing countries, suggesting that Japan is rather closed to foreign investment [Beltramello, De Backer, Mercade, 2011]. However, MNCs who do make it within Japan's borders enjoy very good rates of return on

Table 4: Average and Sector Rate of Return on Inward FDI

	Manufacturing	Services excl. Finance and insurance	Finance and insurance	Other	Total	
					Rate of return	Inward FDI position, USD billion
IRL**	24.7%	5.8%		0.0%	14%	378
CZE	16.2%	10.0%	10.7%	17.5%	13%	122
JPN	5.1%	17.8%	10.7%	18.2%	10%	169
POL*	13.3%	10.3%	7.4%	3.5%	10%	206
HUN*	15.2%	8.4%	5.7%	3.9%	9%	99
EST	13.0%	7.9%	9.9%	4.7%	9%	20
AUT*	18.7%	9.1%	3.5%	7.7%	9%	176
SWE	7.6%	8.2%	8.1%	3.0%	7%	312
CHL	18.0%	11.3%	0.2%	7.4%	7%	209
DNK*	4.4%	3.0%	7.4%		7%	94
GBR*	5.1%	4.0%	8.1%	8.0%	6%	1 177
USA	6.2%	4.7%	5.7%	6.6%	6%	2 901

Source: OECD FDI in Figures 2016, pg. 9

their investments. Japan has the third highest rate of return on inward FDI across all sectors (10%) behind Ireland (14%) and the Czech Republic (18%). It places first in the service sector with an 18% return on investment, outranking fellow G7 nations the United Kingdom (4%) and the United States (4.7%) and its Asian neighbor Korea (−0.9%) (Table 4).

2. *Share of World Inbound FDI Stock*

In the 1980's, Japans inbound FDI accounted for less than 1.5% of global accumulated FDI (FDI stock); this was in stark contrast to its 10% share of world GDP [Graham Yoshitomi, 1996]. As of 2015 Japan accounted 4.4% of world GDP and less than 1% (0.6%) of world FDI. Spain and Canada's share of world GDP is 1.45% and 1.48% but accounted for 2.1% and 2.86% of global FDI stock respectively. In 2014 OECD nations held 62% of global inbound FDI stocks, out of this Japan accounted for 1%, while Germany and Italy, the G7 nations with the lowest ratios besides Japan accounted for 4.8% and 2% respectively of the OECD share. Among its neighbours, Korea with a much smaller economy slightly outperformed Japan at .066% of global FDI while China accounted for 10.8%.

3. *Inbound Stock as a Percentage of GDP*

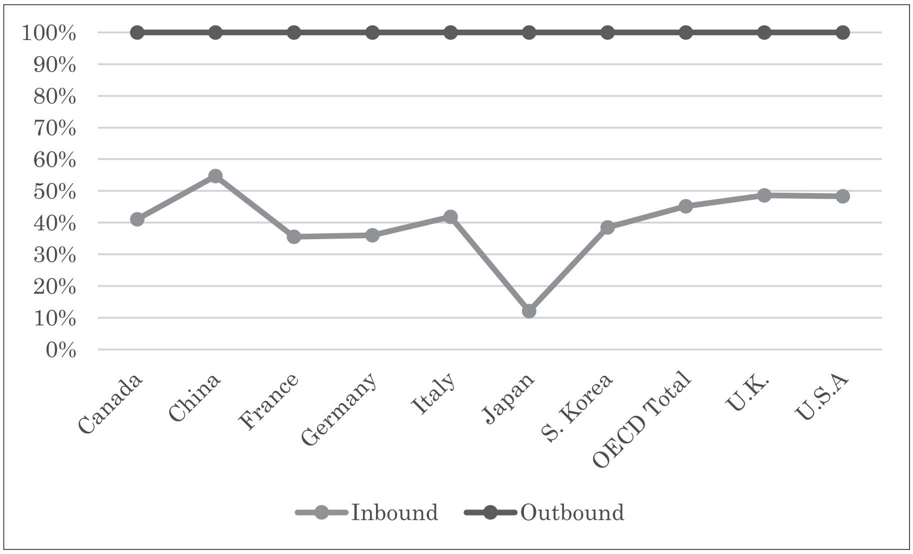
On May 6, 2013 the *Nihon Keizai Shimbun* reported that the ratio of inward FDI to national GDP was 23.2% in the United States and 20.0% in Germany, but only 3.9% in Japan. At that time, the ratio was also far behind that of its neighbours South Korea (11.8%) and China (10.1%). There have been little changes since so these FDI levels remain typical for Japan in 2015. South Korea in particular had a hesitant stance and restrictive policies toward inward FDI until recently, yet their ratios are at a considerably higher level than Japan's.

Since Japan sends far more capital overseas than it welcomes at home, it has created a huge gap between Japan's inbound and outbound FDI stock as a percentage of GDP. As of 2015, Japan's inbound stock is only 4.1% of its GDP while outbound FDI stock represents

Table 5: Inward FDI Stock as a % of GDP

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Canada	54.61	53.73	70.51	40.04	63.27	60.98	48.23	52.27	52.36	53.51	48.46
China	20.79	22.51	19.07	20.08	25.99	25.99	25.45	24.44	24.56	25.11	26.16
France	16.86	21.24	23.42	19.26	24.06	23.83	24.41	25.37	27.09	24.07	27.26
Germany	22.64	27.85	29.44	24.71	28.23	28.07	26.31	24.39	25.44	21.79	23.61
Italy	12.8	16.1	17.1	13.7	16.6	15.4	15.6	18.1	17.13	16.22	18.48
Japan	2.21	2.47	3.05	4.19	3.98	3.91	3.82	3.45	3.48	3.73	4.15
Luxembourg	174.8	202.3	272.6	225.8	340.9	328.5	384.2	298.5	147.9	278.11	357.1
S. Korea	11.78	11.44	10.86	9.45	13.52	12.38	11.24	12.91	13.85	12.71	12.53
OECD Total	23.74	27.34	30.15	23.32	28.82	29.53	27.95	30.87	33.64	33.48	35.85
U.K.	32.58	40	37.87	32.61	44.34	44.44	44.61	54.76	55.77	54.46	54.54
U.S.A	21.52	23.77	24.53	16.89	20.77	22.87	22.55	24.24	29.7	31.37	31.01
Spain	33.2	36.5	39.5	35.8	42.1	43.8	42.2	48.1	44.16	39.2	44.5

Source: Compiled from OECD and World Bank online database
OECD (2016), FDI stocks (indicator). doi: 10.1787/80eca1f9-en (Accessed August 2016)

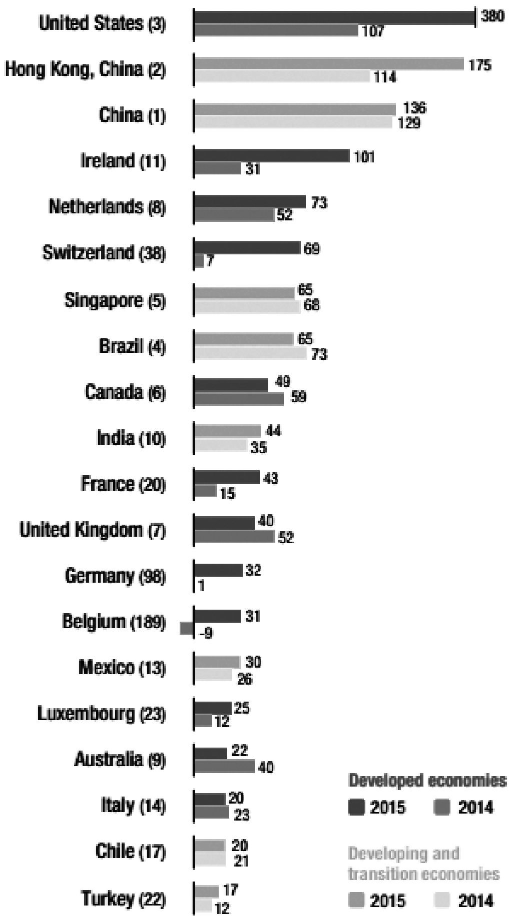


Source: UNCTD World Investment Report 2016: Investor Nationality Policy Challenges

Figure 2: Inward FDI Stock as a Percentage of Outward FDI Stock 2015

29.8%. The OECD average rate of inbound and outbound FDI stock as a percentage of GDP is 35.8% and 42% respectively. Italy has the second lowest inbound FDI/GDP ratio of the G7 nations after Japan, nonetheless Italy maintains an outbound FDI of 25.7% of GDP (compared to Japan's 29.8%) but has an inbound FDI to GDP ratio of 18.5%, more than four times higher than Japan (Fig. 2 and Table 5).

Japan's comparatively low inbound FDI is puzzling considering it has qualities that make it a competitive investment destination. Japan boasts high R&D capabilities, a highly educated work force and cutting edge technology. Japan has well developed rules therefore risks associated with investments in many other countries, such as expropriation, nationalization, and intellectual property infringement, are not a concern in Japan. Additionally, no significant



Source: World Investment Report 2016 pg. 5
(n) signifies 2014 world ranking

Figure 3: Top 20 Nations for Inbound FDI in 2015

restrictions exist for foreign exchange transactions therefore MNCs are at liberty to transfer profits, dividends, royalties, repatriate capital, and repay principal. Japan's civil courts enforce property and contractual rights and do not discriminate against foreign investors [The U.S. State Department, 2014]. Japan is regularly used to test new products since it has a large, wealthy, and sophisticated market of consumers.

If Japan has all the right traits typically sought after by MNCs seeking to enter a foreign market, then why aren't MNCs flocking to invest in Japan? One way of determining a country's attractiveness to FDI is by means of its actual incoming FDI compared to other nations with comparable GDPs or economic status. Figure 2 shows 20 countries that received the highest amounts of global FDI inflow in 2015. Topping the list is the USA, followed by Hong Kong. Singapore was ranked 7th as a host country while Japan failed to make the top 20 list (World Investment report 2016). It seems that despite Japan's positive traits, it is being outperformed by smaller economies such as Hong Kong and Singapore in the race to attract long-term foreign capital. In 2014, Singapore was dubbed by the Asian Pacific Investment Index as the most attractive country for FDI within Asia while Japan was ranked 7th. These are signs that there are factors impeding MNCs from entering Japan.

Ⅲ Deterrents to Japanese Inward FDI

1. Overall Determinants

Despite policy changes and efforts by different governments to boost FDI over the years, Japan's inbound FDI stock in 2015 was 83% of 2008 levels, the lowest in that eight year period. Between 2009 and 2012, Japan suffered political instability in that every year a new prime minister was sworn in for the ruling party Minshuu, however it is unknown if this had a measurable effect on policies to attract FDI. Japan's underperformance has spurred many studies to uncover the barriers that prevent MNCs and other sources of foreign capital from investing in Japan. While there is no definitive answer, observers have expressed that the Japanese market is filled with a host of deterrents for foreign firms, many of which relate to government regulations but also to prevailing social practices. These barriers include high tax rates, the remains of a zaibatsu business culture that allow companies to resist even friendly M&A, a lack of independent directors on many company boards, and culturally derived differences [The U.S. State Department, 2014].

Other determinants such as exchange rates and high labor cost have been suggested however, there is research demonstrating that these factors are not significantly relevant in regards to Japan's inward FDI (Kimino, Saal, and Driffield, 2007). Linguistic differences have also been quoted as an obstacle. In a 2015 government report, it was revealed that 52.9% of foreign-affiliated firms cited "Business communication difficulties in English" as an obstacle to doing business in Japan. However, other studies have confirmed that even when language differences are taken into consideration, direct investment by developed nations in Japan is still significantly lower than their investments elsewhere (Sato and Oki, 2012). In other words, improving English ability locally is not sufficient to expand inward FDI.

In addition to foreign firms expressing that they face a hostile environment in Japan, other observers such as the European Union have noted various restrictive social practices that serve to negatively affect the inflow of FDI to Japan. One such practice stems from the remnants of a share swapping system that has been traditionally used to protect Japanese firms from not only takeovers but also from outsider participation. An increase in the level of these inter-shareholdings (intra-keiretsu) between companies, business partners and clients gained momentum in the 1960's. This served to deter foreign acquisitions by reducing the number of publicly traded stocks available for purchase by outsiders (Sugihara, 2008). Even if a foreign investor acquired stocks of a local company, the inter shareholdings made it difficult to acquire shares sufficient enough to ensure participation in management [Nannichi Kaname, 2010].

2. *Protected Sanctuary Industries*

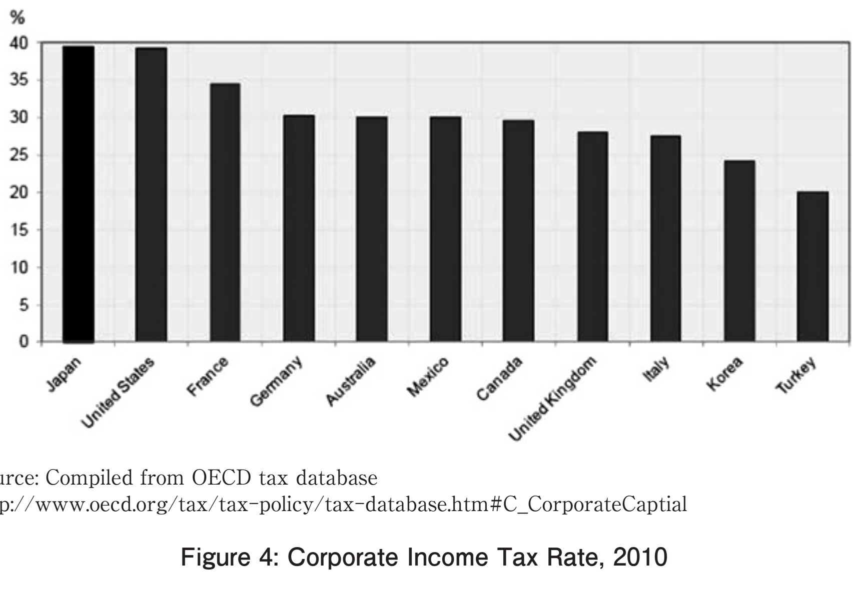
Japanese regulations have resulted in industries that are pervious to new market entrants therefore compared to the U.S., inward FDI in Japan has occurred in a limited number of industries. Historically, the government has liberalized industries that Japan has a competitive advantage in, while employing restrictive policies in industries it considers Japan weak. These "sanctuaries" industries as they are called include areas such as health care, education, electricity, gas, and water supply, and have been safe havens where almost no inward FDI has occurred. Industries that are prime targets for large amounts of FDI in other advanced nations are essentially closed to foreign capital in Japan. In fact, in some industries such as medical services and education, market entry is restricted even for Japanese firms and as an extension foreign capital is miniscule [Ito Fukao, 2003].

A comparison among APEC countries reveals very limited liberalization in Japan in areas such as transportation, health care, posts, temporary labor services, agriculture services, ship repair, electricity and gas (Fukao). In fact employment by foreign firms in these and other sanctuary industries fall below 0.5% of sector employment. This is in stark contrast to the United States where foreign affiliates account for at least 4% in most industries and even as much as 10% in others [Paprzycki Fukao, 2005].

3. *Taxation*

Local taxation and capital are major considerations for MNCs investing overseas. Governments that offer attractive credit and tax packages to MNCs are given more serious consideration even if other conditions are not ideal. In 2010, Japan's 38% tax burden has often been cited as a deterrent to inbound FDI (Fig. 4).

Empirical literature and business perception surveys have consistently shown that taxation is only one of many aspects of the business environment that investors consider when making their location decisions. In fact, government support cannot easily compensate for the negative effects of other factors on investment location decisions (OECD, 2011a). Notwithstanding, other research has suggested that the complexity of the tax system, and the resulting tax compliance costs for businesses, does in fact influence FDI attraction. International investors look for certainty, predictability and consistency in the application of tax rules, and in many cases these considerations are as important as the effective tax paid [Beltramello, De Backer, Mercade, 2011]. Japanese bureaucracy and other complexities create many pitfalls in the tax system for foreign firms. For example, it requires a large investment of time to actually prepare and file the requisite tax paper work (330 hours) with even communist China requiring approximately 70 hours less (Table 7).



Source: Compiled from OECD tax database
http://www.oecd.org/tax/tax-policy/tax-database.htm#C_CorporateCaptial

Figure 4: Corporate Income Tax Rate, 2010

Although a certain degree of complexity in the tax system is to be expected, the added expense incurred in understanding and complying with the tax system would tend to discourage foreign investors and make the Japanese business environment less friendly.

4. Low M&A Activities

Mergers and acquisitions (M&A), is the most common form of FDI, and represents much more than the creation of new businesses or the capacity expansion of existing firms [Beltramello, De Backer, Mercade, 2011]. As is the case for most developed nations, Japan's inward FDI comes primarily in the form of M&A or is the result of earlier M&A [Paprzycki Fukao, 2008]. However Japan differs from its G7 counterparts in that its inbound M&A is very small compared to its GDP. Since M&A comprise up to 80% of global FDI Japan's low M&A activity is one of the primary reason for its overall low levels of inbound FDI.

Between 2005 and 2014 Japanese inward M&A stayed consistently between 1-2% of the number of global M&A transactions, even though developed economies as a whole accounted for approximately 67% of global transactions. Even Germany who had its 2007 numbers reduced by half in 2010 and 2011 recovered at a rate faster than Japan's growth. France and Italy with much lower GDPs than Japan have maintained an average of 4% and 2.3% of global M&A cases respectively (Table 6). Looking at the percentage of M&A it may seem that Italy and France are not performing much better than Japan, however according to UNCTAD M&A data, the dollar value of their M&A portfolio far exceeds Japan's. In 2012 both Japan and Italy had 1.7% share of global M&A cases, however Italy's share was worth $52.86 billion while Japan's share totaled only $17.9 billion. In 2014, Italy's 2.5% totaled $153 billion approximately a little over twice Japan's share of global M&A.

Before the 1990's, Japan had less than 50 inbound M&A deals per year [Usami, 2016], and has absorbed little over 100 acquisitions per year since 2007. In contrast, the U.S. market absorbed about 1000 inward M&A a year until the beginning of the Lehman shock [Bebenbroth, 2015]. For example in 2010, Japan welcomed only 195 cross-border M&A cases, which is considerably lower than the U.S. 1,372, the U.K. 792, and Germany 469. There has been little change since 2010. Even on a dollar basis Japan's performance in the M&A market

Table 6: Number of Inward Cross-border M&A (%)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
World	100	100	100	100	100	100	100	100	100	100
Developed Economies	76	75	74	72	69	67	67	84	69	72
France	5.1	4.8	4.4	4.1	3.7	4.1	4.2	4	4	4.3
Germany	7	7	6	5	5.4	3	3	5.8	5.5	6.3
Italy	2.8	2.2	2.5	2.7	2.5	2.4	2.4	1.7	2.1	2.5
United Kingdom	10	9.1	9	8.9	7	9	6	8.3	9	9
United States	19	18	18	17	17	16	15	14.85	15	16
Japan	1.7	1.6	1.9	2	2.05	1.96	1.1	1.7	1.2	1.8

Source: Compiled from World Bank's World Investment Report, various years
Knoema database at https://knoema.com

is weak. Specifically global M&A stood at USD $6,144 billion in 2015 and Japan's share was USD $61.6 billion or approximately 1%. In 2015 Japan absorbed 162 inbound M&A cases worth $25.4 billion [Usami, 2016] or .4% of world M&A. Even compared with non-developed nations Japans level of inbound M&A is low. UNCTAD M&A data shows that, Luxemburg a minuscule economy with a GDP that is 11% that of Japan, attracted $317 billion of inbound M&A capital exceeding Japan's $294 billion between 2008 and 2015.

Japan understands the value of M&A and this is reflected in its aggressive pursuit of M&A opportunities overseas. However this dedication to M&A has not carried over to its local market, suggesting that Japan has a deliberately unfriendly attitude towards foreign capital aimed at purchasing Japanese firms. This helps explain the limited role of foreign affiliates in Japan. Both in the manufacturing (3.1% in 2007) and the service sector (1.4% in 2006), the foreign share in Japan is far below the share in other OECD countries.

Since 2006, the OECD has been pushing the Japanese government to commit to creating an investment environment where the market for M&A is fully open to all firms, as well as reduce foreign ownership restrictions that are based on national security and strategic reasons (OECD, 2010d) [Beltramello, De Backer, Mercade, 2011]. However, even in 2007 Japanese industry associations endorsed "poison pills" to discourage foreign mergers and acquisition of Japanese firms [Farrell, 2008].

A series of revisions to Japan's legal code over the past decade have served to encourage inbound foreign investment through M&A activity, however overall levels still remain chronically low by OECD standards. Significant measures include the 2005 revisions to the Companies Act, which significantly expanded the types of corporate structures available in Japan as well as the variety of M&A transactions available for corporate consolidation and restructuring. Resulting from the initiative was the repeal of the law banning triangular mergers (*sankaku gappei*) which set the groundwork for Japan's first three-way merger when American Citi bank used its local subsidiary to acquired Nikko Cordial Japan in 2008. Additionally; the 2007 Financial Instruments and Exchange Act (amended in 2008), established a flexible regulatory system for financial markets and applied a uniform set of rules for similar financial instruments to make M&A transactions easier to conduct [The U.S. State Department, 2014].

Ⅳ Measuring a Nation's Attractiveness as an FDI Destination

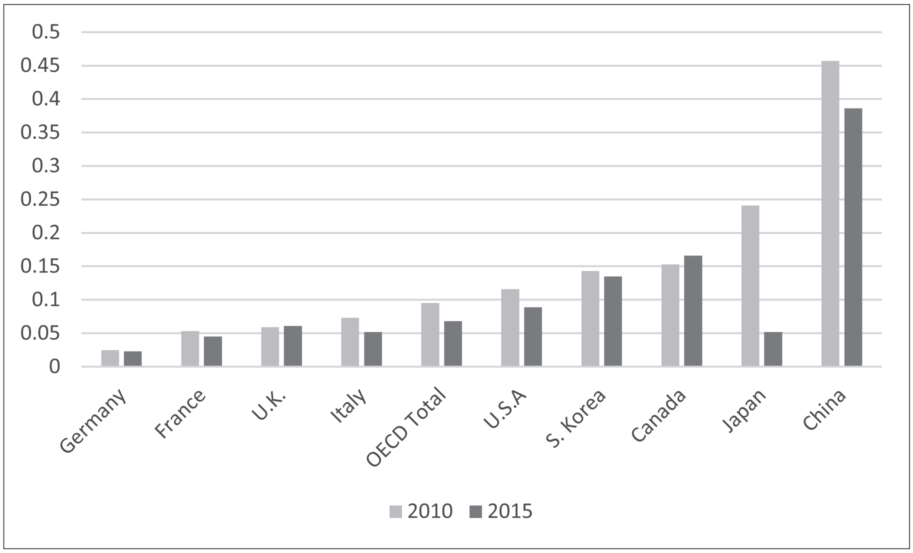
There are indices that assess the business and investing atmosphere in countries worldwide and this data gives an indication of how attractive countries are for companies looking to invest. Many of these indices were created by nonprofit international organizations that seek to foster better social and economic conditions globally. Essentially countries are given scores for selected factors and the composite scores determine a country's global ranking on each index. This section will explore two indices related to investment and trade to determine Japan's perception overseas and its competitiveness as a host country for FDI.

1. *The OECD FDI Restrictiveness Index (the FDI Index)*

The FDI Index is a tool that gauges how liberal a country's foreign direct investment rules are by looking at four main factors: foreign equity restrictions; discriminatory screening or approval mechanisms; restrictions on key foreign personnel and operational restrictions. The FDI index covers 22 business sectors and focuses on overt regulatory restrictions to FDI. The index does not assess the actual enforcement of restrictions nor does it consider perceptions of the business climate or the implementation of trade related issues. Irrespective, the FDI Index still offers a great assessment of how a country's policies towards FDI affect their attractiveness to foreign investors and helps to explain variations in different countries ability to attract FDI [Kalinova, Palerm, Thomsen, 2010].

The FDI Index scores nations on a scale of 0 (completely opened) to 1 (closed). Japan's score between 1997 and 2010 averaged 0.241, more than double the world average of 0.12.; It scored significantly higher than the OECD average of 0.09 in being relatively closed to foreign investment, and had the second most restrictive foreign equity regime among all G20 countries, after Indonesia [Beltramello, De Backer, Mercade, 2011]. This high level of restrictiveness is partly driven by the persistence of significant foreign equity limits placed on MNCs.

Japan has managed to significantly improve its score on the FDI Index since 2010 even though it is still lagging in attracting incoming FDI. As of 2014, Japan (.052) has received a more favourable score than the United Kingdom (.061), the United States (.089) and has



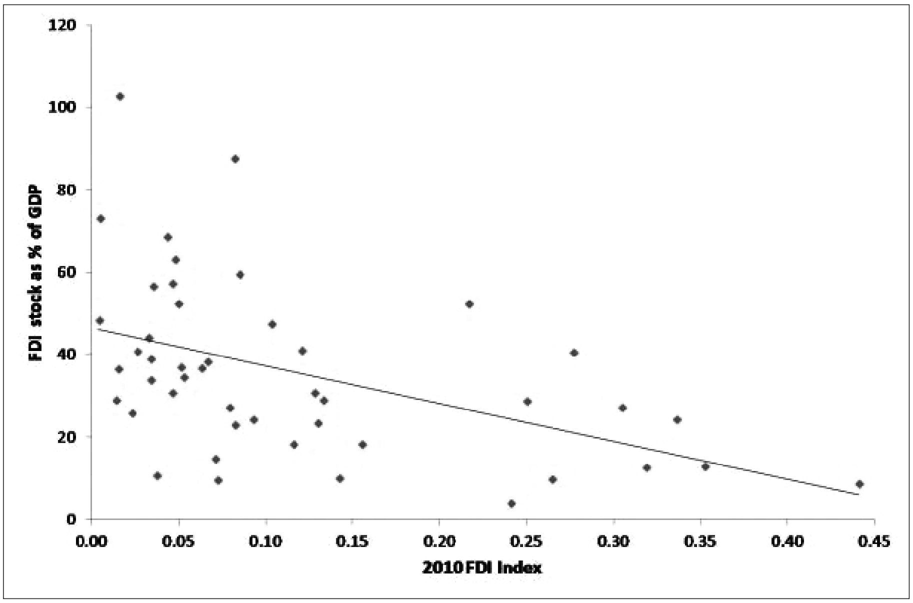
Source: Compiled from OECD's FDI Restrictiveness Index 2010 UPDATE
http://dx.doi.org/10.1787/5km91p02zj7g-en
OECD (2016), FDI restrictiveness (indicator). doi: 10.1787/c176b7fa-en

Figure 5: OECD FDI Restrictiveness: Total Index 2010 & 2015

even beaten the average for OECD member countries (.068) (Fig. 5). This improvement in Japan's score does not reflect fewer restrictions across the board and Japan still remains more restrictive in some industries more than others. While the manufacturing and service industries tend to be more accessible, other industries seem impossible to penetrate. Japan's agriculture, forestry, fishing, and mining industries scored the maximum on the FDI Index, indicating that these industries are completely off limits to foreign capital.

Ensuring the free flow of inbound and outbound capital is an important aspect of economic openness that can yield significant benefits to an economy. This type of liberal investment atmosphere is only one of many elements that shape a country's overall investment climate however based on data collected over the years, it can be concluded that the higher a country's restrictiveness score the lower its levels of accumulated FDI.

For example, as can be seen in Figure 6, the higher a country scores towards the left in terms of its restrictiveness to trade the lower is accumulated FDI stock tends to be. Conversely countries that fall close to zero i.e. they have close to no restrictions and benefit from higher GDP to FDI stock ratios. If a countries scores .45 on the FDI index it can expect to have a FDI stock/GDP ratio of approximately 15%. This holds true for Japan and China, with a FDI Index score of .241 and .457 their FDI stock to GDP ratio falls at 3.9% and 9.8% respectively. The USA and Germany on the other hand score .116 and .02 and boasts FDI stock to GDP ratios of 22.9% and 27.9% respectively. A low level of restrictions to foreign



Source: Kalinova, Palerm and Thomson (2010) ; OECD's FDI Restrictiveness Index: 2010 Update pg. 7

Figure 6: Relationship between FDI Stocks and FDI Index

investment does appear to be positively correlated with investment attraction, and more restrictive countries tend to receive less FDI relative to the size of their economy.

2. Ease of Business Ranking

The Ease of Doing Business Index was created by the World Bank Group and ranks 189 countries (between 1, the best and 189, the worst) on how easy it is to conduct business within their borders. The study assigns numerical values measures to regulations that relate to starting and conducting a business, such as employing workers, registering property, getting credit, tax filing procedures, protecting investors, taxes, trading across borders and enforcing contracts [The World Bank, 2015].

Table 7 shows the "Ease of doing business" ranking for 2015 [The World Bank, 2015]. Japan's current overall ranking is 34th among 189 countries. It is ranked well below other major economies such as United Kingdom (6th), United States (7th), and Germany (15th). Regionally, although Japan is ranked higher than China (84th) it is lagging far behind in much smaller Asian economies such as Singapore (1) and South Korea (4th) on the ease of doing business scale. In other words, from the point of view of an MNC seeking international expansion it is challenging to do business in Japan and its neighbours seem to have more attractive investment climates. It is interesting to note that although China is perceived to be a more difficult country to do business in, it still has a GDP/FDI ratio that is over six times higher than Japan (26.16 versus 4.15).

The ease of doing business index is limited in scope. It does not account for a country's proximity to large markets, quality of infrastructure services (other than services related to trading across borders). However, a high ranking on the ease of doing business does mean that the government has created a regulatory environment conducive to business operations. Often, improvements in the indicators measured on the Ease of Doing Business ranking are a

Table 7: Ease of Doing Business Ranking 2015

	Japan	Korea	China	U.S.	UK	Germany	Singapore
Ease of Doing Business rank	34	4	84	7	5	15	1
Sarting a business	81	23	136	49	17	107	10
Dealing with construction permits	68	28	176	33	23	13	1
Getting Electricity	14	1	92	44	15	3	6
Registering Property	48	40	43	34	45	62	17
Getting credit	79	42	79	2	19	28	19
Protecting minority investors	36	8	134	35	4	49	1
Paying taxes	121	29	132	53	155	72	5
No. of payments per year	14	12	9	11	8	9	6
Hours per year to file	33	188	261	175	110	218	84
Total tax rate (% of profit)	51.3	33.2	67.8	43.9	32	48.8	18.4
Trading across borders	52	2	7	21	33	12	1
Enforcing contracts	51	31	96	34	38	35	41
Resolving insolvency	2	4	55	5	13	3	27

Source: Compiled from World Bank Doing Business: http://www.doingbusiness.org/Custom-Query

Note: Rankings are based on 189 countries. Payments, hours per year, and total tax rate under "Paying taxes" are actual values and not country ranking.

result of broader policy reforms. These reforms affect the procedures, time and cost to comply with business regulations and affects the ease with which MNCs can access credit. Such improvements are directly associated with simpler and less burdensome rules that may entice MNCs to consider investing in a host country.

Japan's performance for most factors listed on the Ease of Doing Business Ranking have actually worsened over the past ten years with a token few showing real or marginal improvements. Particularly in the area of getting credit Japan has dropped from a five year average of 25.6 in 2013 to its 2014 position of 79. Other criteria in which Japan is performing worse on the Ease of Business index are cross border trade and enforcing contracts. Japan has dropped from an average ranking of 20 and 29% respectively to 51% for both criteria in 2014 and 2015. Other reasons for the decrease in Japan's ranking can be attributed to the difficulties MNCs face to obtain construction permits (it takes 193 days to arrange construction permits) and the time and procedures required to register a business, almost double the OECD country average for both factors.

One of the other most challenging areas for Japan is in regard to its high corporate tax rate and bureaucratic tax filing system which has caused Japan to rank 122nd while other developed nations such as Germany, the U.K., and the USA rank 72, 53 and 15 respectively. While China ranks lower than Japan other neighbours such as Korea and Singapore rank substantially higher at 29 and 5 respectively. Japan's overall ranking dropped from 10th in 2006 to 15th in 2010 and plummeted to 34th as of the end of 2015. The continuous drop in Japan's ranking suggests that either the investment environment in other countries has improved to a great extent or that the investment environment in Japan has worsened considerably (Table 8). Either way Japan is at a competitive disadvantage.

Table 8: Changes in Japan's Ease of Doing Business Rank

	2009	2010	2011	2012	2013	2014	2015
Ease of Doing Business rank	15	18	20	24	27	29	34
Starting a business	91	98	107	114	120	83	81
Dealing with construction permits	45	44	63	72	91	83	68
Getting Electricity	N/A	N/A	26	27	26	28	14
Registering Property	54	59	58	64	66	73	48
Getting credit	15	15	24	23	28	71	79
Protecting minority investors	16	16	17	19	16	35	36
Paying taxes	123	112	120	133	140	122	121
No. of payments per year	13	14	14	14	14	14	14
Hours per year to file	355	355	330	330	330	330	330
Total tax rate (% of profit)	55.7	48.6	49.1	50	49.7	51.3	51.3
Trading across borders	17	24	16	19	23	51	52
Enforcing contracts	20	19	34	35	36	51	51
Resolving insolvency	1	1	1	1	1	2	2

Source: Compiled from World Bank Doing Business Database: http://www.doingbusiness.org
Note: Rankings are based on 189 countries. Payments, hours per year, and total tax rate under "Paying taxes" are actual values and not Japan's ranking.

The World Bank's "Ease of Doing Business" ranking and the OECD FDI Restrictiveness Index do not take into account all aspects of a country's investment environment, however, they consider the most critical factors and are reliable resources that offers MNCs a clear, even though not precise, overview of what it would be like to do business in a particular country. A move up the ranks of these widely used indexes suggests to MNCs that a nation is becoming more foreign capital friendly compared to other nations and may be worth considering for future investments.

V　Current Initiatives to Increase Inward FDI

While FDI outflows can lead to a hollowing-out of industry, inward FDI boosts the domestic economy. Japan's negligible inward FDI is unable to offset the hollowing-out of industry brought about by its high levels of outward FDI.

In January 2003, Prime Minister Koizumi made public his ambitious plan to double Japan's inbound FDI over 5 years from $50 billion in 2001 to $100 billion in 2006 as a part of a comprehensive political and economic overhaul. [Paprzycki Fukao, 2005]. An increase in FDI was seen as an important step toward revitalizing the sluggish Japanese economy. The primary initiative at that time was to change the government's policy on stock swaps for M&A including the introduction of a tax deferral on cross-border stock swaps. In March 2003, the Japan Investment Council was established and introduced its FDI promotion program that focused on five specific areas: providing investment information at home and overseas; creating a favorable business environment; revising administrative procedures; improving employment and living conditions for expatriates; and improving the national and local government regulatory frameworks [Tselichtchev Debroux, 2009].

In 2006 the year of the deadline, FDI inflows to Japan fell to minus USD $6.5 billion turning negative for the first time since 1989 due to divestments by large transnational companies. FDI stock stood at $107.63 billion reflecting an increase of 103% over 2001. In September 2006 Prime Minister Shinzo Abe promised to aim for an inward FDI stock that was 5% of GDP by 2010 [Paprzycki Fukao, 2008]. The government fell short of its goal since Japan's stock of FDI as a percentage of GDP stood at 3.91% at the end of 2010, compared with the OECD average of 29.53% [The U.S. State Department, 2014]. In fact, 2010 saw Japan's inbound FDI in the middle of a four year slump that started in 2009 and continued until 2014 when FDI/GDP ratio rose for the first time in four years to 3.73% (Table 4). Although the government did not reach its specific goal, the dollar amount of FDI stock increased a dramatic 198% between 2006 and 2010 registering $214.89 billion. FDI stock continued to increase until 2011 (225.7 billion), and then started a downward trend from 2012 (Table 1)

Between 2009 and 2012, Japan underwent political instability in that it had a new prime minister each year under the former Democratic Party of Japan (Minshuto). If it is presumed that there was a lack of continuity in the government's effort to increase FDI during this period then it stands to reason that this would have negative effects on future inward FDI figures. Moving forward ten years after Koizumi's original initiative, Prime Minister Abe announced yet another ambitious goal to double Japans inbound FDI stock by 2020 ($340 billion). In 2013, the same year Prime Minister Abe set his new goal, FDI stock dipped 17 % to $170.710 billion and at the end of 2015 it was still at $170 billion. The prime minister's intention was to back his resolution to double FDI by policy changes and reforms that favour and support MNCs, as well investment promotion activities. In April 2014, the government constituted a new "FDI Promotion Council" comprised of ministers with major economic portfolios and augmented by private sector advisers. Other initiatives ensued which resulted in important legal changes that were advantageous for MNCs seeking to invest in Japan.

1. *Initiative to Make Japan an Asian Business Center*

Under this initiative the government is seeking to increase its profile among its regional competitors and get noticed as a potential host for FDI. Japan is being overlooked for FDI partly due to the sharp appreciation of the yen but mostly due to its neighbours strengthening their competitiveness as hosts for foreign capital and thus luring foreign businesses. This was the impetuous for a host of incentives that were designed for government-approved MNCs that created new R&D and headquarters operations in Japan.

As a part of this program MNCs would be eligible for (1) Income tax breaks in the form of preferential tax treatment for stock options transferred to their Japanese subsidiary (2) assistance with raising capital through the Small and Medium Business Investment & Consultation Co., Ltd.) (3) accelerated approval process for patent applications as well as a 50% reduction in patent fees (4) quicker decisions in regards to prior notification of foreign investment applications in regulated industries and (5) quicker decisions for residence and work permit applications by foreign nationals [JETRO, 2015].

The overarching goal of the Asian Business Center program is three fold: increase the number regional headquarters and R&D facilities established locally by MNC, double the number of employees of foreign affiliates in Japan (from 750,000 to 2 million by 2020) and double direct investment in Japan. The hope is that through this program Japan will attract higher quality foreign investments that will add new intellectual capital while taking advantage of Japan's strengths.

2. *Ease of Establishing Subsidiaries*

One of the legal changes under Prime Minister's Abe initiative was the 2014 revision of the corporate law. The government made it less burdensome for foreign companies to set up local affiliates by abolishing the minimum capital required to establish a new subsidiary as well as addressed a system that prevented foreigners from registering companies. Under the former system, a foreign firm wanting to set up a local subsidiary was required to have at least one representative residing in Japan. To obtain residence status however, a foreigner required a certificate of employment from a local entity. Seeing that the subsidiary was not yet created, a foreigner sent from the head office could not legally register a subsidiary alone. After considering recommendations put forward by JETRO, the government abolished the requirements and foreign representative can now establish subsidiaries in Japan on their own [JETRO, 2015].

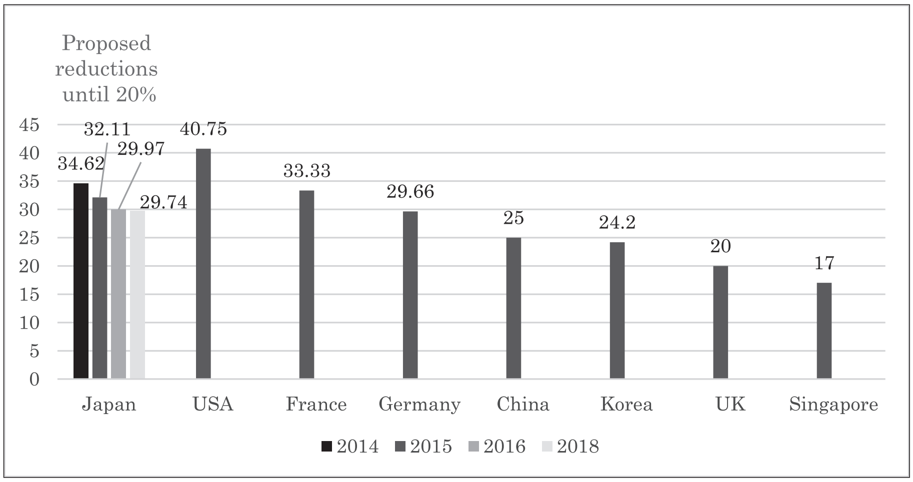
3. Making More Opportunities for M&A

Any initiative to increase FDI will not be successful without addressing issues that prevent M&A. Bearing this is mind, the government cleared the way for triangular mergers and cash out mergers. Triangular or three way merges occurs when a foreign subsidiary in Japan acquires a target and uses the shares of its parent foreign company as payment. In the cash out merger shareholders of the target firm are paid in cash. Additionally, other deregulation measures have opened up access to a few utility and welfare related sectors, and this may offer MNCs more opportunities for M&A in Japan.

4. Reducing Corporate Tax

In recognition of Japan's high tax burden which may deter inbound FDI, the government announced in 2014 future plans to once again cut the corporate tax rate to get closer to levels common in many European and Asian economies [The Japan Times, 2014]. The government kept true to its promise and on December 3, 2015 the *Nihon Keizai Shimbun* reported a reduction in the effective corporation tax rate from 32.11% to 29.97% (Fig. 7). By April 2017 the government is seeking to reduce the national corporate tax rate to 23.4%, followed by further reductions from April 1 2018 to 23.2% [PwC Tax Japan, 2016].

Corporate taxation may have a negative effect on investment by reducing its after-tax return; this affects both domestic and foreign investments. In addition to domestic tax



Note: The rates for countries except Japan are as of April 2015
Source: JETRO Invest Japan Report 2015

Figure 7: Effective and Proposed Corporate Tax Rate

rates, the tax treatment of cross-border income may also have an impact on FDI. Hajkova et al. found that a one percent increase in the effective corporate tax rate of a host country reduced its FDI stocks by 1% to 2% [Hajkova, Nicoletti, Yoo, 2006]. The influence of tax on inbound FDI is complex and depends on a number of factors which are difficult to measure. Accordingly, it may be difficult to see how a lowering of the corporation tax rate will result in a surge in inward FDI. However, a 2% reduction may be incentive enough to prevent or at least reduce high volumes of equity divestments such as those seen in 2006, and may perhaps encourage MNCs to reinvest the earnings of their local affiliates back into Japan.

5. National Strategic Special Zones

A law passed in late 2013, has set the way for the creation of "National Strategic Special Zones" (NSSZ) intended to attract new foreign investment to Japan. NSSZ are an initiative set up by the Abe government to establish new economic zones with business-friendly conditions for MNCs. Within these geographical zones, the government intends to implement selected deregulation measures and relax the rules regarding new corporation procedures, labour, medical care, agriculture and city planning so that these area are friendlier towards foreign capital and their operations. As taxation is always an issue for MNCs, the government will provide tax breaks within these NSSZs. Foreign firms who choose to establish a presence in these NSSZ will find it easier to set-up affiliate, hire staff, and provide their local expatriates with proper housing, insurance and other benefits.

As of March 2014, six initial locations for the new Zones were selected including the metropolitan areas of Tokyo, Kansai area, Niigata city, Yabu city, Fukuoka and Okinawa prefecture. At first, deregulation will be specific to each area. For example, the Kansai area NSSZ will promote deregulations mainly in the medical field such as more effective use of iPS cells (induced pluripotent stem cells). Deregulations planned in the other zones are agricultural reforms in Niigata city and Yabu city, employment reform to support business foundation in Fukuoka city, and tourism promotion in Okinawa prefecture. Deregulations that prove effective in these areas will be implemented nation-wide in the future [Foster, 2005].

Other special zones created under past governments have failed and therefore to show his commitment to the success of the new NSSZ, Prime Minister Abe is heading the program himself. According to JETRO, these special zones are a part of an initiative to make Japan number 3 or higher among developed nations on the Ease of Doing Business ranking by 2020, and to make Tokyo rank third or higher on the Global Power City Index also by 2020.

6. Local Level Initiatives

Beyond the national level, local governments too have become convinced of the benefits of attracting foreign capital to boost their local economy. Prefectures in Japan are vying to attract MNCs away from popular areas such as Tokyo and Osaka. Unlike before, local governments are become more aggressive at promoting themselves and are working to attract foreign capital. Many have been creating their own incentives and policy changes to encourage foreign firms to give them a closer look as potential investment sites. These incentives include making direct contact with prospective foreign investors, offering business start-up support services, and limited financial incentives [The U.S. State Department, 2014].

7. OECD Recommendations

Japan's chronic low inward FDI has not gone unnoticed. The OECD in a 2012 report purported that regulatory reforms should be accelerated; focusing on reducing entry barriers, as international comparisons indicate that starting a business in Japan is relatively complicated, costly and time-consuming. It recommended that international competition should be enhanced by reducing barriers to service imports and encouraging inward foreign direct investment. In addition the OECD advised that competition in key service industries, such as retail, energy, transport and business services, needs to be strengthened through wide-ranging reforms [OECD, 2012]. One way for Japan to increase competition is for the government to implement policies that attract foreign firms into these sectors.

Historically, the Japanese government's has been inconsistent in its efforts to implement policies to improve the climate for foreign investment or tend to deliver very little real net positive change [The U.S. State Department, 2014]. A case in point was the 2005 change in the Corporate Law that allowed foreign companies to use triangular mergers. Before the law came into effect the Japanese government afforded local businesses one year to implement anti-takeover strategies thereby dramatically reducing the intended effect of the change. While the current initiatives may indeed be excellent ones to attract more incoming FDI, they will only be effective if the government implements them without taking side steps to erode their net benefits.

Ⅵ　Global Trends and Local Opportunities to Consider Going Forward

Since Japan is being out-performed by other developed countries and developing countries within its region Japan needs to aggressively explore avenues to stimulate its incoming FDI. One promising way to create new opportunities is by opening Japan's sanctuary industries to foreign capital. However, since entry into these industries is sometimes limited even for domestic firms it is worthwhile to also look at other areas that can contribute to growth in inward FDI.

1. FDI Related Cross Border Corporative R&D

In recent years momentum has been increasing towards shared and open innovation. As a result, having policies that foster global corporation in innovation and R&D activities is now an indispensable competitive factor for companies. MNCs in particular are now consistently seeking new opportunities for international cooperation, such as cross-border strategic alliances [Dunning Narula, 2004].

Government policies need to increasingly take into account these new forms of global R&D as they can potentially lead to increasing trade and allow the national economy to benefit from participating in international R&D and innovation networks as well as in global value chains. According to the OECD (2006b), a nation's economic and trade systems are important to inbound R&D investment, since the later depends heavily on policies that influence a country's attractiveness for FDI in general [OECD, 2006b]. As with other forms of FDI, factors such as political stability, public infrastructure, market size and development, tax rates and labour market conditions are key in an MNC's decision regarding where to locate R&D activities.

Japan has many characteristics that make it a viable candidate for R&D related FDI. It boasts a strong and vibrant academic and industrial research base, strict protection of intellectual property rights and a well-trained workforce; all of which are major determinants of MNC seeking international cooperation or to invest in R&D overseas.

Taking measures to create an investment climate that is friendly towards overseas firms engaged in innovation and R&D activities will allow Japan to tap into foreign sources of knowledge, increase its already competitive scientific and technological capacities and promote the growth of local enterprises.

2. Increase FDI Offspring

Although the government has set the entry of new foreign firms into Japan as a goal, FDI could benefit greatly if the government widened its focus on the home front by assisting existing foreign-affiliated firms to deepen their roots and expand their business in Japan. Further reinvestments by overseas affiliates are not factored into the Ministry of Finance statistical surveys of direct investments [Farrell, 2008]. However, encouraging this form of re-investment and expansion allows Japan to profit more from the incentives offered to attract the original investment and allows the foreign firm to use its existing assets to expand locally. Doing this could play a role in helping the government to meet its goal of doubling Japan's inbound FDI stock by 2020.

Conclusion

Among OECD and G7 member countries, Japan has the lowest ratio of FDI as a proportion of GDP. The limited inbound flows of capital and investments into Japan are characteristics of the closed nature of the Japanese economy. While different political administrations have stated their intention to attract foreign investment, existing policies often fail to make it easy for foreign firms to establish or maintain commercial operations locally. At the same time, these governments have not moved aggressively enough to reduce the time and cost of establishing a business in Japan. The Abe Government is working to change this through its current initiative to create an increasingly open and investor-friendly business environment for foreign capital. This includes the establishment of "National Strategic Special Zones" to promote economic growth in specific areas such as medical, agriculture, and tourism sectors. If these policies and efforts were to materialize they could make a difference in improving Japan's investment climate and over the long term may lead to improvements in Japan's position both on the FDI Index and the Ease of Doing Business Ranking. However, given that other developed nations and smaller economies such as rival Singapore are aggressively improving their investment environments, and already rank higher than Japan on both these indices, the effects from the current administration's initiatives may not be overly profound. More than small incremental improvements, Japan may need to make radical changes to experience an equally significant shift in its inbound FDI status. Overall, consistent policy changes that produce meaningful net results is what matters most in attracting more FDI to Japan.

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