

# The Allocation of Added Value and Issues Confronting the Corporate Sector

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## 1. Introduction

One of the factors cited in the declining profit margins and other serious problems confronting Japanese companies has been the persistently high cost of labor. In other words, the added value created by production activity is being excessively allocated to workers at the expense of shareholders and others. Under this argument, weak corporate earnings can be attributed to problems with the present allocation of added value.

This paper examines what problems exist in the allocation of added value by making comparisons with the past, and also considers the problems posed to corporate management.

## 2. Present Allocation of Value Added

### (1) Definition of Value Added

Value added refers to value that is newly created through production and sales activities, and is calculated by subtracting the cost of materials and other intermediate inputs from output.

There are two methods of analyzing the allocation of value added: using gross value added including depreciation cost, and using net value added excluding depreciation cost. The net value added method is inadequate for grasping the allocation of value added because it excludes the contribution of production capacity to increases in value added. Thus we use the gross value added method.

### (2) Allocation of Value Added

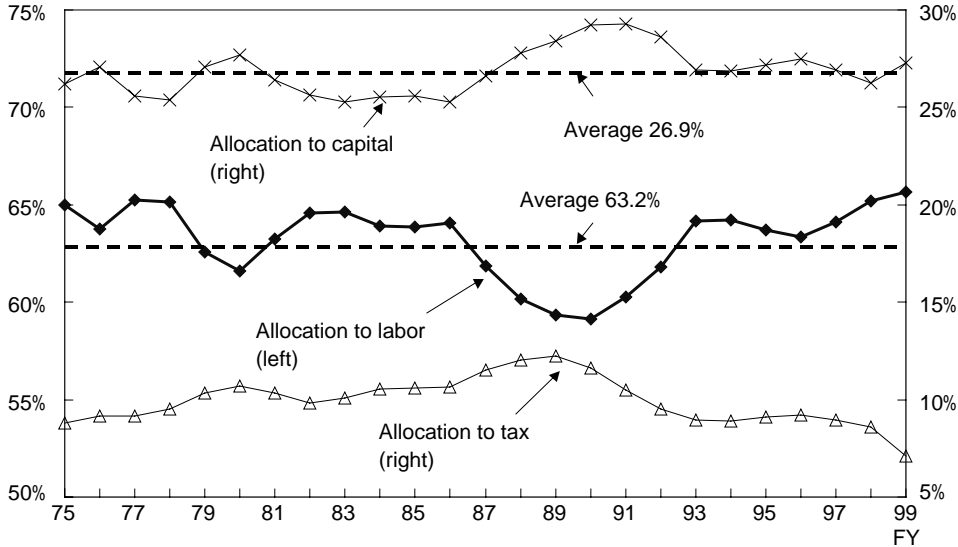
In the corporate sector, value added can be divided into three categories: labor cost (employee welfare cost, employee salaries, and executive salaries), cost of capital with respect to lenders and shareholders (interest and discounts, leasing and rent cost, after-tax operating income, and depreciation expense), and taxes (corporate and resident taxes, and enterprise tax). The respective amounts, divided into total

value added, are the allocations to labor, capital and tax respectively. Trends in the three allocations are shown in Figure 1.

Since bottoming out in fiscal 1990, the allocation to labor has continued to rise moderately, reaching a 25-year high of 65.6 percent in fiscal 1999. Meanwhile, the allocation to capital has hovered near its average historical level since 1993. Thus the increase in allocation to labor has been offset by a significant decline in the allocation to taxes due to corporate tax cuts.

Below we look at the three allocation ratios in more detail.

**Figure 1 Trends in Allocation of Value Added**



Note: Shows aggregate of all industries and company sizes.  
 Source: Ministry of Public Management, Home Affairs, Post and Telecommunications, *Financial Statements Statistics of Corporations by Industry*.

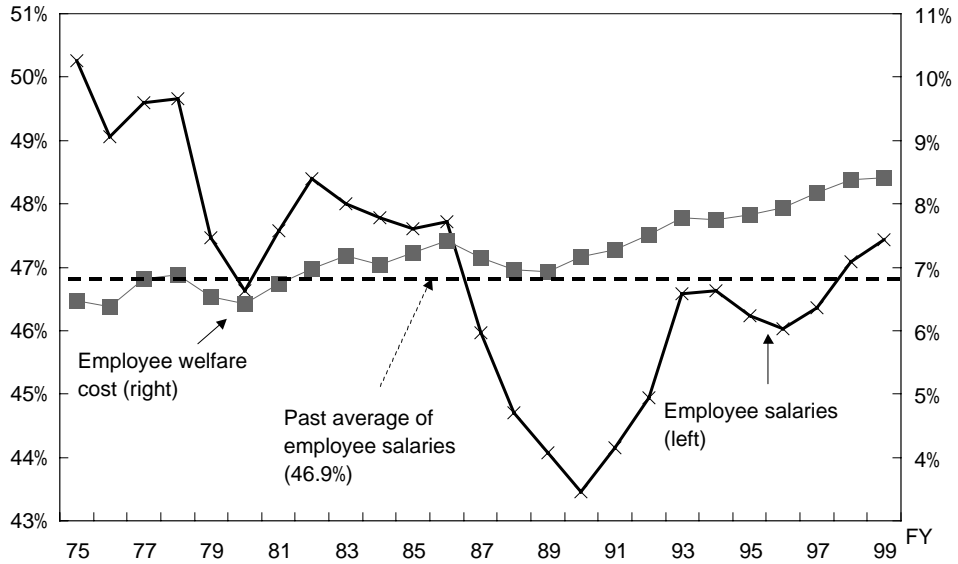
**3. Employee Welfare Cost Boosts Allocation to Labor**

**(1) Status of Employee Welfare Cost and Salaries**

To find the main causes and effects of the rising allocation to labor, we separate the allocation to labor into employee welfare cost and employee salaries (Figure 2).

In the recent past, both employee welfare cost and salaries have pushed up labor cost. However, what stands out in the long term is the effect of the persistent rise in employee welfare cost.

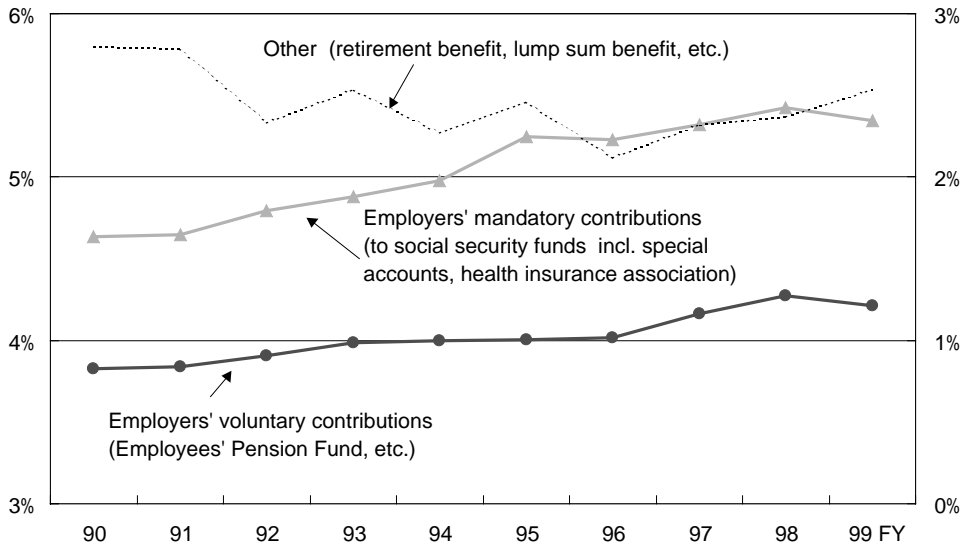
**Figure 2 Composition of the Allocation to Labor**



Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry*. Aggregate for all industries and company sizes.

When employee welfare cost is separated into social security funds (special accounts and health insurance run by private mutual associations), pension fund, and other (including retirement and lump-sum benefits), the increase in contributions to social security and pension funds becomes apparent (Figure 3).

**Figure 3 Composition of Employee Welfare Contributions by Companies**



Source: Cabinet Office, *Annual Report on National Accounts 2001*.

The main cause of the rising contribution to social security and pension funds is aging. While defined

contribution and defined benefit pension laws have been established, only some companies are pursuing pension reform. There is still strong resistance to pension reform on the basis that it shifts the burden to individuals, and also poses problems in implementation. As a result, not many companies are immediately initiating the new pension system. Moreover, judging from the present condition of the economy and financial markets, the difference between expected and actual returns on pension fund assets is likely to burden companies with additional expenses in the future.

With regard to health insurance, contributions are expected to continue growing due to the lack of solutions to critical problems such as rising medical expenses for the elderly.

Based on the above, employee welfare costs are expected to remain high centered around mandatory employee welfare expenditures.

On the other hand, although the allocation to salaries has risen following the post-bubble recession, the level in fiscal 1999 (47.4 percent) only slightly exceeded the 25-year average of 46.9 percent, and remains below that of the 1970s and mid 1980s (Figure 2).

Under these conditions, despite the recovery in corporate performance, wage growth has been sluggish in the past few years because due to the difficulty of reducing mandatory employee welfare costs, companies have tried to control overall labor costs by freezing or cutting salaries.

## **(2) Problems Related to Labor Cost**

We next consider the economic impact of corporate policies regarding labor cost, the growth in employee welfare cost, and containment of salaries.

Many workers believe that if salaries do not rise when business improves, their salaries will surely be cut when business declines. Such expectations cause savings to rise in preparation for the future. Indeed, the excess savings behavior of Japanese has been cited as a contributing factor to the recession. The fact that companies are building up their pension funds (which is equivalent to delayed payment of wages) while containing salaries only aggravates this problem.

From this perspective, if the labor cost issue at the company level is contributing to the demand side weakness afflicting the economy, the government needs to address it as an economic problem.

## **(3) Solution of the Labor Cost Problem**

To solve the labor cost problem, the government needs to make progress in reforming the social security system. This includes issues for which measures have already been taken such as reform of the cor-

porate pension system. However, the critical problems associated with aging — fundamental reform of the pension and health insurance systems — will require more time.

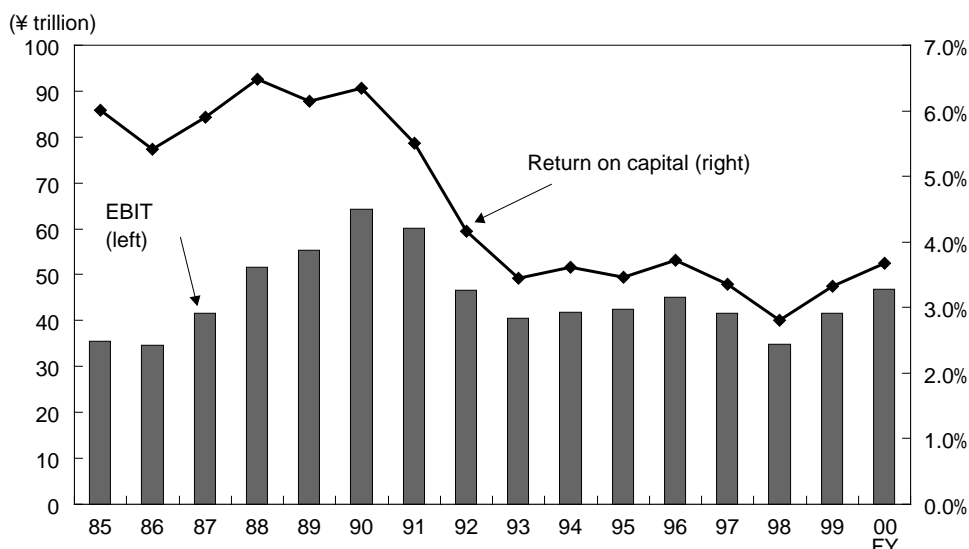
Thus management and labor need to reach a common understanding on basic issues such as the desirable labor cost level and its constitution. Unilateral alterations to the personnel system and salary structure could be construed as unmitigated efforts to contain labor cost, hurting worker morale and causing other unfavorable consequences.

#### 4. Allocation to Capital Suffers from Poor Capital Productivity

##### (1) Poor Earnings are Traced to Sluggish Capital Productivity

Although the allocation to capital has been fairly stable, the corporate sector's return on assets has deteriorated significantly in the 1990s (Figure 4). One major cause has been a shift in the composition of the allocation to capital.

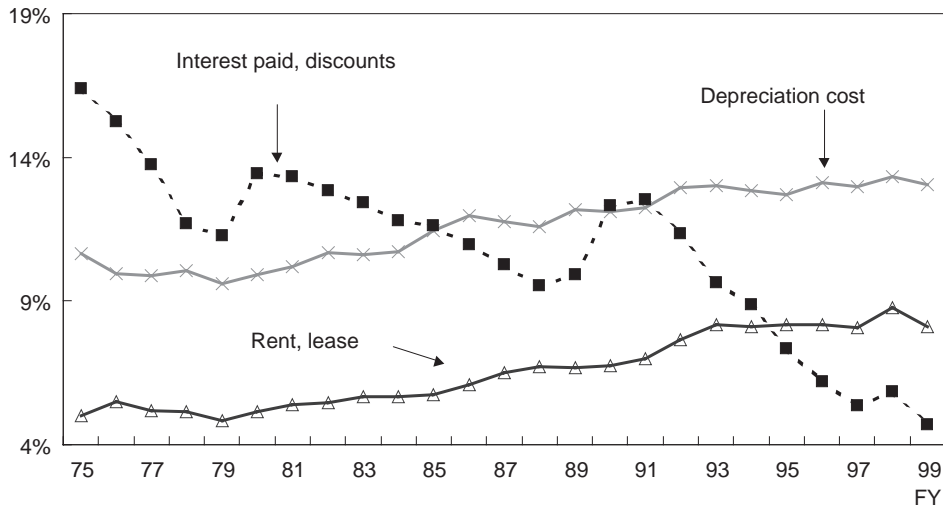
**Figure 4 Trend in Corporate Earnings**



Notes: Includes all industries and company sizes. EBIT is operating profit plus interest earned, etc.  
Source: Ministry of Finance, Quarterly Statistics of Incorporated Enterprises.

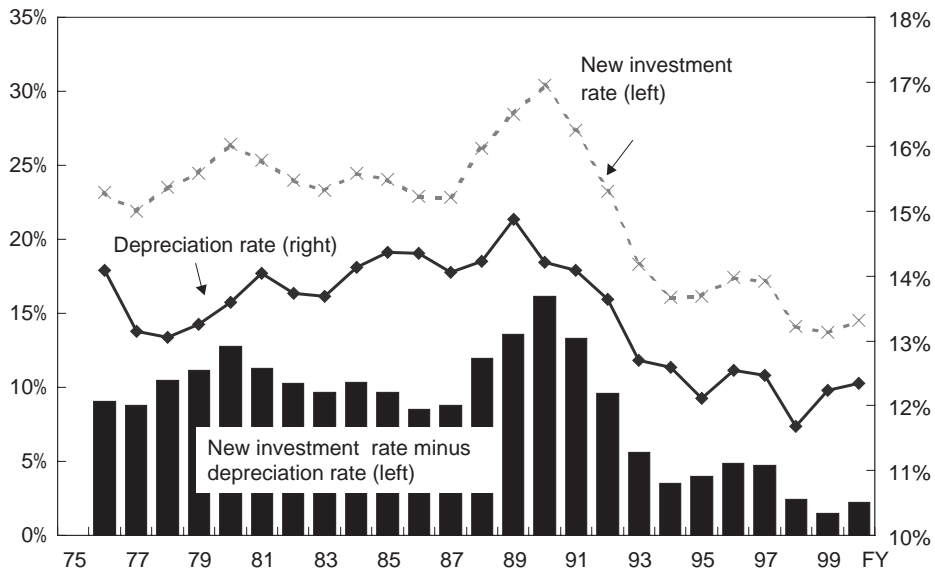
Looking at the makeup of the allocation to capital, what is notable is that while the proportion of interest and discounts has declined due to low interest rates, depreciation costs and leasing and rent costs have continued to grow (Figure 5). Considering the likelihood that depreciation rates have declined in the 1990s due to changes in depreciation accounting methods, the actual depreciation cost burden is thought to be larger than indicated by the data, thereby restraining operating profit after interest (Figure 6).

**Figure 5 Composition of the Allocation to Capital**



Note: Includes all industries and company sizes.  
 Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry*.

**Figure 6 Decline in New Investment Rate Exceeds Decline in Depreciation Rate**



Notes: Denominators for new investment rate and depreciation rate are the same.  

$$\text{Depreciation rate} = \frac{\text{Depreciation cost}}{\text{Other tangible fixed assets} + \text{Non-tangible fixed assets} + \text{Depreciation cost}}$$
  
 Source: Ministry of Finance, *Quarterly Financial Statements Statistics of Corporations by Industry*.

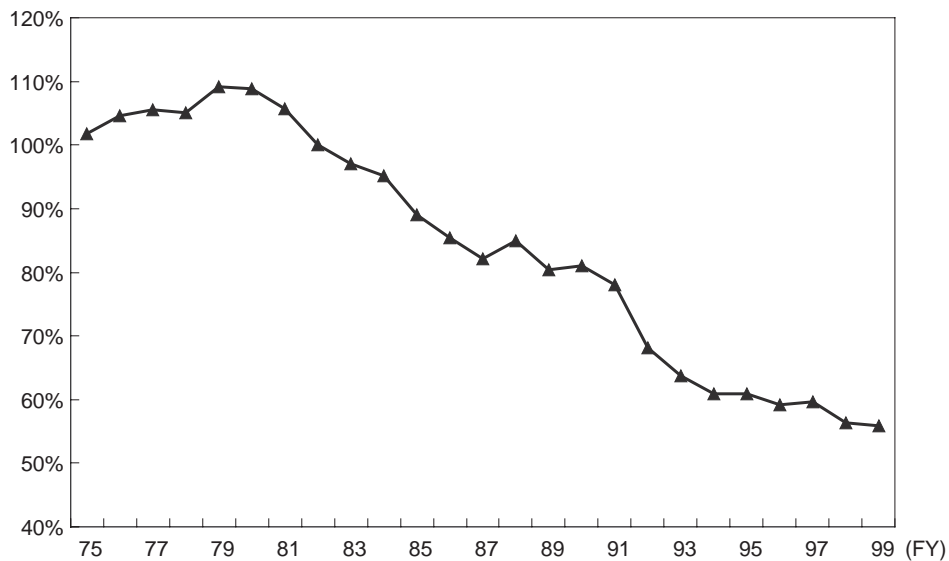
Since low interest rates have reduced the interest rate burden, the anticipated result is either growth in operating profit after interest, or in the case that the lower cost of capital boosts capital investment, revenue growth that exceeds growth in depreciation cost, thereby boosting operating profit after interest. As long as companies make capital investments based on accurate calculations of future costs and

returns, depreciation costs should not continue to rise and constrain operating profit.

The fact that the ratio of depreciation cost to value added has continued to rise indicates that the increase in valued added has not kept pace with the initial investment cost. In other words, capital productivity has declined, and excess capacity has arisen due to the miscalculation of future costs and returns (Figure 7).

With respect to the increase in leasing and rent costs, which can be regarded as a cost of production for the use of facilities, we find once again that the value added has decreased relative to the cost increase, and productivity has deteriorated.

**Figure 7 Long-term Decline in Productivity of Capital**



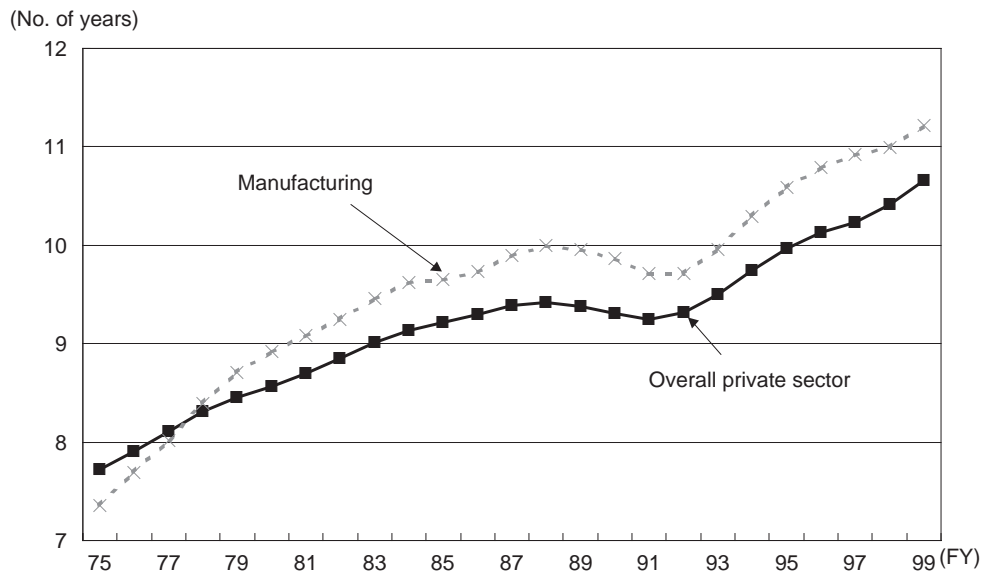
Note: Productivity of capital = Value added / Tangible fixed assets (excl. construction in progress). Includes all industries and company sizes.

Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry*.

## (2) Measures to Improve Capital Productivity, and Their Impediments

As Figure 6 shows, the new investment rate has declined by more than the depreciation rate since fiscal 1990. This suggests that confronted with excess capacity, companies have repeatedly postponed facility writeoffs to avert losses, while restraining new investment due to the lack of opportunities. As a result, while excess capacity has been curtailed, the vintage of facilities has risen since 1990 (Figure 8). Ordinarily, since capital productivity is higher in new facilities, the increasing vintage also suggests that capital productivity has been declining.

**Figure 8 Vintage of Capital**



Note: For manufacturing in fiscal 1999, shows average of nine-month period to December 1999.  
Source: Cabinet Office, *Quarterly Estimates of Private Capital Stock*; EPA, *1970 Survey of National Wealth*.

The only way to improve capital productivity is to eliminate excess capacity and increase the capacity utilization rate. This requires abolishing and writing off excess capacity as well as an increase in demand. Thus new investment must be encouraged to promote capital productivity growth, while the earnings growth must be channeled toward writing off unnecessary capacity.

The above argument suggests the need not only for the special measures law to rejuvenate production activity, but for additional tax incentives to reduce the burden of depreciation. However, the excess capacity was originally caused by companies repeatedly making investments that led to low productivity, and corporate management is also responsible for the present difficulty in reducing capacity. Rather than simply relying on policy measures, companies must make organizational changes to alter their decision making methods, and carry out new investment to improve capital productivity.