

Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2002

summary (June 21, 2002)

Section 1: Advance Structural Reforms and Revitalize the Society and Economy

The government has advanced structural reforms, starting from “the Basic Policies for Macroeconomic Management and Structural Reform of the Japanese Economy” (June 26, 2001), and has taken appropriate measures to deal with the economy and employment. These measures were successful in putting a hold to the downward trend in the economy and public finance.

(Objectives of the new Basic Policies)

- 1. Steadily advance tax reform, local administrative and fiscal reforms, and the reform of the social security system, thereby enhancing vitality of the Japanese society and economy, and building an equitable society in which all members share the burden.
- 2. Accelerate the reform of government expenditures to realize “a small government of high quality worthy of burden required .”
- 3. Overcome deflation by comprehensive measures vigorously implemented by the government and the Bank of Japan; advance the “Economic Revitalization Strategies,” including the establishment of the “special structural reform areas ,” thereby pushing the economy onto a “full-scale private demand driven recovery path.”

Section 2: The Economic Revitalization Strategies

1. Basics of the Economic Revitalization Strategies

(1) Objectives

- Enhance Japan’s industrial competitiveness via greater “selection and concentration”
- Create markets by expanding private sector businesses via regulatory reform

(2) *Basic Principles*

- Transfer activities from public sector to the private sector
- Shift from ex ante to ex post monitoring-based regulations
- Reinforce Japan's technological foundations
- Prepare attractive business conditions
- Form linkages with many foreign countries and regions

2. *Six Strategies and Thirty Action Programs*

(1) *Human Resource Strategy*

- Improve international competitiveness of national universities by restructuring them into independent administrative corporations (where staff are under smaller control of the government)
- Provide IT training to all Japanese people.

(2) *Technology Strategy*

- Reinforce the nation's technological foundations through concentrating resources on life sciences and other key fields.
- Promote research and development on a project basis as a bridge to span the "Valley of Death" (that is, to overcome financial difficulties at a stage between basic R&D and commercialization).

(3) *Management Strategy*

- Review the legal system for bankruptcies, and facilitate business and industrial restructuring by strengthening the Industrial Revitalization Law.
- Encourage entrepreneurial activities and eliminate barriers to discontinuing businesses.

(4) *New Industry Development Strategy*

- Promote the development and commercialization of environmental technologies, biotechnology, nanotechnology, and other new technologies.
- Create life industries, such as "Anshin houses" (reasonably priced care facilities for the elderly).

(5) *Regional Strengths Strategy*

- Advance regulatory reform via the introduction of special structural reform areas (i.e. special areas which are free from a certain regulations), thereby pursuing distinctive regional development in accordance with local characteristics.

- Revitalize Japan's key cities as internationally competitive metropolises by implementing measures including the expansion of the Haneda Airport.

(6) *Global Strategy*

- Promote free trade agreements (FTAs).
- Reinforce competitiveness by encouraging inward direct investment and influx of brains.

Section 3: Basic Principles of Tax Reform

1. Necessity of Tax Reform

- Rebuild strengths of the Japanese economy.
- Support the vitality of individuals and enterprises.
- Respect characteristics and ability of each individual in line with greater diversification of lifestyles.
- Respect characteristics and autonomy of each local community.
- Establish fiscal structure and social security system meeting long-term sustainability.

2. Socioeconomic Goals and Tax Reform

- The goals of the present tax reform should be the future society and economy envisaged in the Structural Reform and the Medium-term Economic and Fiscal Perspectives (January 18, 2002) ("Reform and Perspectives" hereafter).
- The conditions for a desirable tax system can be summarized by the three principles, "equity, neutrality, and simplicity." To keep up with the times, these are interpreted as "fairness, vitality, and simplicity" under the present tax reform.

3. Viewpoints of Tax Reform

- Put the maximum emphasis on recovering vitality of the economy.
- Facilitate ample manifestation of individuality and ability by each person while allowing him/her to enjoy his/her own way of life.
- Advance the tax reform together with the government expenditure reform.
- Keep consistency with the reform of the social security system.
- Implement the reform in line with the administrative and fiscal reforms in local governments.
- Give consideration to low-income households and other disadvantaged members of society when truly necessary.

4. *Procedures to Implement Tax Reform*

- The tax reform is to be initiated from FY 2003, and it should be a full-scale structural tax reform based on principles such as “broad but light” taxation.
- Financial resources necessary to carry out the tax reform, in principle, will not depend upon the issuance of government bonds.
- Through carefully grasping the necessary level of administrative services and expenditure, while both the national and local governments accelerate their efforts to reduce expenditure, and also through taking account of the progress in economic revitalization and the fiscal situation, the necessary measures on the tax system will be decided within the time frame envisaged in the "Reform and Perspectives."
- A surplus in the primary balance should be achieved early in the 2010s.

5. *Tax Reform and its Related Issues Requiring Further Investigation*

- How to realize sustainable economic growth
- How to support diverse lifestyles
- How to ensure long-term security
- How to promote regional independence and vitality
- How to gain public understanding for the burden .

Section 4: Structural Reforms in Major Government Expenditures

1. *Upgrading Public Infrastructure*

Make public works more prioritized and efficient, as stipulated in “Basic Policy” last year and “Reform and Perspectives.”

- Shift from the central to the local governments, and from the public to the private sector.
- Realize effective prioritization: top-down decision making and bottom-up selection; Specify and narrow down priority areas in respect of economic revitalization effects.
- Improve efficiencies: conduct strict project evaluations and use the results in the budget compilation; utilize private finance initiative (PFI); make more use of competitive bidding in public procurements, thereby improving competitive conditions.
- Review the existing projects and long-term public works plans.

2. *Social Security System*

Reform the social security system so as to make it secure and sustainable into the future, while exerting every possible effort to minimize the rise in the national burden ratio (i.e.

the sum of tax and contributions relative to nation income).

- Reinforce measures to reverse a declining trend of birthrate.
- Start debate early regarding the basic direction for reform of pension system to make it sustainable and trusted by the people, in preparation for the pension reform scheduled for 2004.
- Continue with the reforms of the healthcare system, the medical service fee system, and the medical insurance system.

3. *Central and Local Governments*

Promote administrative and fiscal reforms in local governments strongly and in an integrated manner.

- Reduce the involvement of central government and expand the authority and responsibility of local governments. Reach conclusions on abolishing or cutting back state-subsidized projects within this year.
- Examine the issues of state subsidy, local allocation tax, and the transfer of tax resources to local governments in trinity; prepare a reform plan within one year; eliminate 14 trillion funds shortages faced by the local governments; and thereafter establish local governments' fiscal independence.
- Promote municipal mergers and reallocate works and responsibilities in accordance with the size of the municipalities.

4. *Other Items*

(Reform of the Food Industry)

Advance the revitalization of the food industry and the structural reform of agriculture that can fulfill people's expectation under increasing concerns over future food supply and mistrust towards food safety and security.

- Redirect administration from producer-oriented to that consumer-oriented .
- Switch to policies that stimulate farmers' entrepreneurial spirit and their individual characteristics .
- Introduce competitive conditions to the distribution stage, and promote radical reform of agricultural cooperatives.
- Foster biomass industry that utilizes agricultural, forestry, and fishery resources.

(Review Earmarked Fiscal Resources)

- Review all earmarked fiscal resources together with long-term public works plans and the tax reform, and where ever possible, implement concrete revisions from FY 2003.

(Improve Efficiency in Public Sector)

- Introduce outsourcing and PFI; improve public procurement by central and local governments; upgrade functions of E-government, etc..

Section 5: Overview of Economic and Fiscal Situation and Outline of FY 2003 Economic and Fiscal Policies

1. Basics of Economic and Fiscal Policy Management

- Accelerate the medium term government expenditure reforms stipulated in “Reform and Perspectives”.
- Promote the “accelerated government expenditures reform”, the Economic Revitalization Strategies, and the tax reform in trinity, thereby achieving the growth shown in “Reform and Perspectives.”

2. The Japanese Economy in FY 2002 and FY 2003

(1) Present Business Trends, and the Economic Outlook for FY 2002 and FY 2003

- The Japanese economy has entered the bottom stage in its cyclical changes .
- Business investment remains weak, employment and income conditions continue to be severe, and recovery in household consumption delayed and hovering.
- The non-performing loans problem at financial institutions and excessive corporate debt continue to be addressed. Deflation tendency persists.
- Although likely recovery of corporate earnings in the second half of FY 2002 is expected to stimulate business investment, the overall pace of the recovery is moderate and real GDP growth in FY 2002 is expected to remain flat.
- The economy is expected to be on the general recovery phase during FY 2003, but this recovery may be fragile as the improvement of the employment and income environment might be mild if eliminating anxiety regarding the financial system is delayed. Prices are expected to begin to stabilize.
- It is important to reinforce this cyclical recovery with structural reforms, thereby ensuring that the economy achieves sustainable growth over the medium term.

(2) Current Economic Management including Anti-deflation Measures

- The disposal of non-performing loans should be advanced further under market discipline and strict asset evaluations in accordance with successive government policies: specific targets should be set for removing non-performing loans from balance sheets; the RCC functions, including trust, should be aggressively utilized. At the same time, the securitization and liquidification of these claims and other

assets should be promoted, and the non-performing loan problem should be normalized in FY 2004.

- Advance structural reforms from the industry side via enterprise reconstruction and liquidation, and industry restructuring.
- Upgrade market infrastructure to enhance individual investors' confidence in securities markets.
- Compile swiftly a medium-term vision for the financial system toward establishing a vitalized financial system.
- Promote mergers among regional financial institutions to improve their competitiveness and profitability. Take all necessary measures to ensure the stability of the financial system.
- Expect an effective monetary policy by the Bank of Japan.
- Encourage corporations to divert their improved profits on expanding their equipment or establishing new businesses.
- Implement the "Economic Revitalization Strategies", the tax reform, and the structural reform of government expenditure. Study those items that can be quickly put into practice, and implement them as soon as possible.

3. *Fiscal Policy Management in FY 2003*

(Basics)

- Review non-discretionary (i.e. intuitional or obligatory) expenditures, which account for more than a half of the total expenditure, in addition to discretionary expenditures. Implement administrative reform in both central and local governments.
- Step up reform of government expenditure in order to realize "a small government of high quality worthy of the burden required."
- Advance reform of budget complication process and method so as to reinforce the decision making system lead by the Prime Minister's initiative.

(Speed up expenditure reform)

- Reform non-discretionary budget drastically and undertake fundamental reform of discretionary one.
- Keep general expenditures and general account expenditures equal to or below the level of FY 2002 budget (once an increase in non-discretionary expenditures is adjusted).
- Minimize the divergence of actual government bond issuance from 30 trillion yen, the promise of the FY 2002 budget.

(Four New Priority Areas Based on the “Economic Revitalization Strategies”)

- Expand growth frontiers—science and technology, education, and IT.
- Build attractive cities and create local communities with their own characteristics.
- Take necessary measures to build a fair and secure society despite a progress in aging and a declining birthrate.
- Construct an environment-friendly society and economy to deal with global environmental problems.

(Other Government Expenditures)

- Public works, social security, transfers to local governments, agriculture, forestry, and fisheries, ODA, defense and police.
- State subsidies, and total personnel costs.

(Improve Process to Compile the Budget)

- Reinforce decision-making system so that Prime Minister fully exercise his leadership (Prime Minister will put forward a basic guideline based on the deliberation at the Council on Economic and Fiscal Policy, and thereby each minister shall fulfill his/her responsibility in undertaking fundamental reforms in the policies and expenditures of each Ministry and Agency.)
- Conduct strict policy and project evaluations so as to make objectives and effects of the policy more transparent to the public. Organize the budget by minister and by priority area (i.e. matrix-type budget).