

**Minister's Summary by Minister Ota**



**12th Meeting (May 20, 2008)**

- (1) On Integrated Reform of Expenditures and Revenues
  1. General statement
  2. Tax reform
- (2) Foreign direct investment in Japan
- (3) Aviation liberalization

Hiroko Ota here. Today, the Council on Economic and Fiscal Policy (CEFP) held its 12th meeting of the year and conducted discussions on Integrated Reform of Expenditures and Revenues (General statement and tax reform), foreign direct investment in Japan and aviation liberalization.

The expert members presented their papers titled “On Integrated Reform of Expenditures and Revenues (General Statement)” and “Tax Reform”. First, regarding “General Statement,” the following comments were voiced:

Member Nukaga (Minister of Finance): The expert members’ paper states that, in accordance with “ ‘Basic Policies 2006’ the Government should make its utmost efforts to carry out maximum reductions of expenditures,” and I think the phrase “make its utmost efforts” conveys only a weak message. Instead, the Government itself must express its strong will.

Expert member: With the reallocation of earmarked revenues for road construction to general revenues, some media speculate that the government seems to loosen their efforts to cut spending. However, the Government must not lose its momentum in its expenditure reform, and has to completely eliminate wasteful expenditures and duplicative administration. In addition, the Government has to maintain the “pay-as-you-go” practice where every new expenditure increase is financed in principle, by an expenditure cut in other areas. The CEFP also has to make a careful check of the progress of the special account reform.

Member Amari (Minister of Economy, Trade and Industry): The Government has to make efforts toward a “zero waste” government and, at the same time, improve the budgetary efficiency. The Government earmarked 300 billion yen as the budget for “Economic Growth Strategy Promotion Request” in fiscal 2007 and another 600 billion yen as the budget for fiscal 2008 for “Priority Measures Promotion Request (Priority items)” which was requested in last year. It is important for the Government to set up a scheme like the above requests, so as to narrow down priorities and focus their efforts for achieving economic growth. The Government is required to adopt zero-base budgeting in principle as its budgeting method. The Government should create more mechanisms, such as the above requests, to uniformly reduce the budget for each component and reallocate the resulting savings to priority issues.

Regarding the tax reform, expert member explained their papers on the issue and in response, the following comments were voiced:

Mr. Kosai, Chairman of the Tax Commission: I read the expert members' paper on the tax reform with much respect. We, the Tax Commission, would like to carefully consider the proposal and bring together opinions. It is necessary to link individual tax items to the taxation system as a whole. Last year the Tax Commission discussed mainly grand themes such as the safety and security of people's livelihoods, economic vitality and respect for personal and corporate free choice, for compiling its report. On the contrary, this year, detailed problems have already surfaced and we should discuss individual tax items and the system as a whole, so as to consistently resolve issues in a consistent way. Accordingly, we are determined to engage in more careful discussion than ever. We will make further effort to fully explain our discussion to the public. In addition, it is important how the Government interprets economic conditions. We would like to make key decisions in line with decisions of the entire Government.

Expert Member: A long-term increase in social security spending cannot be avoided. At the same time, economic growth is weakening to a certain degree. Accordingly, for ensuring security and safety of daily livelihoods as well as economic growth, conventional measures which focus solely on cutting expenditures can work only to a very limited extent. Of course, the Government must not relax fiscal disciplines and needs to carry out expenditure reform in accordance with "Basic Policies 2006," but it is necessary to discuss annual government revenues and the allocation of revenue sources accordingly. The Government has to carry out the fundamental reform of the taxation system, including the review of the consumption tax and the reallocation of the earmarked revenues for roads to general revenues.

Expert Member: The introduction of the taxpayer identification number system is essential to maintaining taxpayers' confidence and to ensuring the fairness of the taxation. The Government is now starting to develop a schedule for realizing e-Government, and it should also start developing a schedule for the introduction of the taxpayer identification number system.

Expert Member: The tax reform this time is intended to fundamentally reform the taxation, including the social security system reform and the reallocation of the earmarked revenues for road construction. Accordingly, the Government should be flexible enough to start discussion on the matter ahead of the regular schedule. It is important that the Government should start deliberating earlier in this year than usual. The CEF and the Tax Commission need to work together to address these issues. Regardless of its past background, the taxpayer identification number system should be put in place.

Member Amari: The taxation reform needs to focus on the following three issues: first, review of the corporate tax rate which is the highest in major counties; second, tax reduction which has significant

effect on investment for encouraging investment in research and development, information technology and human resources; third, a simple international tax system effective in fund recycling. In recent years, other countries are promoting tax incentives, such as a corporate tax rate reduction and tax incentives for research and development as above mentioned, simultaneously. The combination of these tax reductions is essential to vitalizing economy. In addition, a tax affecting fund recycling needs to be positioned as a part of growth strategy. Accordingly, I will point out the need of such tax system when discussing the growth strategy at a later date.

The Prime Minister made the following statements:

The cut in expenditures is extremely difficult, but the Government must not abandon its reform efforts so as not to pass the financial burden on future generations. We, the Government, will further made efforts for realizing the Integrated Reform of Expenditures and Revenues based on the “Basic Policies 2006” to achieve a surplus of primary balance by fiscal year 2011 without fail. For that purpose, the Government is determined to make efforts more than ever to realize a “zero waste” government and make an inventory of policy measures for eliminating wasteful expenditures, including those in general accounts, special accounts, independent administrative agencies and public interest corporations, without allowing a sanctuary. I ask for your cooperation. Regarding the taxation system, the Government will carry out the fundamental reform of the taxation this fall in the light of today’s discussion. Authorities concerned within the Government, including the CFP, the Tax Commission, and the National Commission on Social Security, need to work together to promote the discussion.

I summed up the discussion as follows:

The CFP will continue discussion on the tax reform.

We are determined to carry out the Integrated Reform of Expenditures and Revenues in accordance with the “Basic Policies 2006.”

Regarding foreign direct investment in Japan, Mr. Haruo Shimada, the chair of “Expert Committee on FDI Promotion” presented the committee’s proposals, and the expert members made presentation based on their papers. Then, Mr. Atsushi Saito, President and CEO of Tokyo Stock Exchange Group Inc. voiced the following comments:

Expanding FDI in Japan is essential to revitalizing Japanese economy, and we need to define and clarify how M&A should be.

Corporate M&A transactions serve as a business model which enhances corporate values. I am afraid that the way corporate M&A should be is not, in essence, something that the Government should determine. I have a sense of uncomfot that the Government itself is presenting guidelines

on how to defend a company against takeovers. Basically, such guidelines should be presented by businesses themselves. When the management adopts “poison pills” based on the Government’s guidelines, it will seem that the management has tried to protect its own interests. What is misleading is to discuss M&A between domestic corporations or those that Japanese corporations carry out overseas, and those in Japan conducted by foreign companies, from totally different viewpoints. It is problematic that authorities should impose constraints only on M&A carried out by foreign investors.

In the past, creditors such as financial institutions closely monitored and exert corporate governance over activities of businesses, their debtors. At present, with the development of financial technologies, a company is more likely to finance itself through issuance of equity transactions in the company’s own stocks, and as a result, shareholders now play key roles in corporate governance. For this reason, easily initiating defensive measures will work against shareholders’ interests.

Then who is responsible for evaluating shareholders’ activities? Their activities must be monitored, too. We need to create so called “the monitoring cycle” where a company’s activities are monitored by its shareholders and their activities are monitored by someone else. We also need to check to see who invested in funds.

Tokyo Stock Exchange will also discuss the way M&A transactions should function from a viewpoint of a market establisher for protecting the rights and interests of shareholders.

The discussion proceeded as follows:

Expert Member: Reducing business cost is important to encourage FDI in Japan. In other countries, local and regional governments offer drastic tax breaks at their own discretion to attract investment. In Japan too, local governments should be given more freedom in levying taxes. Friendly M&A is welcome in Japan, however, hostile takeovers and greenmailers must be properly regulated regardless of whether they are indigenous or foreign businesses.

Expert Member: Considering that Japanese businesses have already generated 30% to 40% of their revenues from overseas, if they activate too much defensive measures against M&A, then in turn, Japanese businesses seeking M&A overseas will surely face backlash there. Any generalization claiming that “foreign businesses seeking M&A are all evil-minded while Japanese counterparts are not” is an oversimplification. I believe that the restriction on foreign investment in some particular sectors, for example, military and nuclear energy sectors, is acceptable, but such restriction should be sufficiently accountable. In other sectors, every party concerned must respect and comply with the non-discrimination principle that ensures equal treatment for all investors. To how much degree Japanese corporate taxation has discouraged FDI in Japan? Some overseas studies indicate that direct investment will increase by 3% for every 1% drop in the corporate taxation rate. However,

some argue that is not the case in Japan. Accordingly, we cannot clearly demonstrate whether the corporate tax rate directly affects foreign investment, and I believe it is rather premature to conclude that the Government should immediately cut the corporate tax rate.

Expert Member: The restriction on foreign investment intended to keep an industry out of foreign control should be sector-specific, and its application should be kept to the minimum necessary to guard sectors concerning national security and other crucial matters. For controlling foreign investors in sectors concerning industrial foundations, basic infrastructures and the maintenance of public order, authorities should draw up measures other than the restriction of foreign investment, such as economic behavior regulation including the non-discrimination principle and restriction of shareholding to a certain level, or the contingency legislation.

Member Nukaga: Japan's restriction on foreign investment is in good agreement with the provisions of the OECD Code of Liberalization of Capital Movement. Regarding predictability, some countries actually restrict foreign investment not in a sector-specific manner. Japan's restriction on foreign investment, on the other hand, clearly defines which sector is off-limits to foreign investors and Japan has indeed adopted clear-cut rules for administering the restriction. In the United States, the administration sometimes intervenes *ex post facto* to bar foreign investments from acquiring U.S. companies under the Exxon-Florio Amendment. On the contrary, in Japan the legal stability is respected, too. What really matters is whether we can deal with some of M&A with measures other than the restriction on foreign investment, such as behavior regulation including the non-discrimination principle and restriction of foreign shareholding to a certain level. In order to secure public interest of businesses, it is better to deal with mergers and acquisitions by foreign investors with the aid of capital control in a non-discriminating manner and economic behavior regulation. Accordingly, the Japanese government should develop something like an economic security act. For example, at present the banking industry is subject to the restriction of shareholding to a certain level because banks are responsible for handling settlement systems. Each ministry should work out how to deal with activities of foreign investors in sectors which may fall under its jurisdiction. In the course of such discussion, general laws on the non-discriminating treatment of investors may be formulated.

Member Amari: (While presenting his papers) In reality, predictability of the restriction process in Japan is higher than those in other countries. We need to focus on priority issues and work out what we should do to boost foreign investment in Japan. In addition, we need to more actively let foreign investors know the effective openness of Japan, to wipe out the notion that Japan is "closed." Regarding rules on M&A, we started discussion on the matter at meetings of the Corporate Value Study Group of the Ministry of Economy, Trade and Industry four years ago, and in addition, the Corporate Governance Study Committee of Liberal Democratic Party has also discussed the issue and made recommendations. However, these recommendations and activities have not always been

correctly understood. It is important to let them be heard and correctly understood.

Mr. Shimada (Chairperson of “Expert Committee on FDI Promotion”): It is necessary to carry out the reform while learning lessons from overseas cases. Extremely important is for what purpose Japan is required to boost foreign direct investment. Japan has so far accepted only a relatively small amount of foreign investment in the country by both developed and developing countries. In addition, the reality is that Japan is aging and accordingly the country’s economic growth requires more Japanese businesses to go overseas. In other words, Japan needs to be open to overseas more than any other countries. Otherwise, the country’s future growth cannot and will not be sustained. Prime Minister and his cabinet ministers should be fully aware of this fact.

The Prime Minister made the following statements:

Last January I attended the World Economic Forum at Davos, Switzerland and made a speech on my intention to expand foreign investment in Japan and make Japan a nation that will grow hand in hand with the rest of the world. Based on the discussion today, I would like the Cabinet Office to lead the revision of the “Program for Acceleration of Foreign Direct Investment in Japan” on this fall, and ministries concerned should take the recommendations from the Expert Committee on FDI Promotion seriously enough and put them in action.

As Mr. Shimada stated, it is important to carry out follow up activities. The CEFPP needs to closely keep track of future developments on this matter.

In addition, it is necessary to address globalization as a whole, by checking on progresses and achievements using “the index to measure the openness of Japan,” which the expert members have proposed, as a benchmark.

The Government should comprehensively discuss how to control foreign investment in Japan, placing focus on what kind of message Japan should convey to the world.

The Cabinet Office will lead to revise the “Program for Acceleration of Foreign Direct Investment in Japan.” President Saito has declared Tokyo Stock Exchange Group will start discussing how M&A transactions should function from a viewpoint of shareholders, and I told him that I am looking forward to the results of the discussion. Regarding restriction on foreign investment in Japan, based on instructions by the Prime Minister, ministries concerned should work together to first, sort out problems on how far and with what methods we should control foreign investors, and should advance discussions within the current fiscal year.

Regarding aviation liberalization, the expert members made proposals based on their papers, and Temporary Member Fuyushiba (Minister of Land, Infrastructure, Transport and Tourism) presented the following proactive proposals, based on his papers:

Both Haneda and Narita airports should offer an increasing number of takeoff/landing slots, and it is necessary to establish “relay time zones” to allow the integrated use of the two airports and also provide Haneda with more international flights during late night hours.

(Though “open skies” is unmentioned in his papers, in his oral presentation) I would like to steadily promote aviation liberalization in accordance with the “Asian Gateway Initiative,” first seeking to negotiate reciprocal “open skies” type agreement with Asian countries.

While expert members proposed the Government to start negotiating “open skies” agreements with European and North American states, first of all, we should work out how to deal with the entrenchment of American carriers’ vested interests in allocating slots at Narita Airport. And concerning European countries, European Commission and EU member states have different opinions on how to seek “open skies” negotiations. Accordingly, I would like to advance negotiations with these countries carefully, keeping track of developments in Europe and North America.

I will also consider the possible introduction of a time-of-day fare system, which expert members have proposed.

Regarding an airport-slot trading system, I am afraid, if such a system is introduced, take-off and landing slots, which are very valuable resources, will be allocated to highly profitable airline services in a concentrated manner, and less profitable routes will be abolished, when the slot allocation is entrusted to the private sector.

I am also not in favor of the special slots available to flight carriers where they are free to choose either domestic or international services, which expert members also proposed, because this system will leave the allocation of valuable slots solely to the discretion of the carriers. Yet I would like to give consideration to the system because it has been recommended by none other than expert members.

In response, the following comments were voiced:

Expert Member: A questionnaire survey of companies in the Tokyo Metropolitan area indicates that many of them want airline services directly flying from Haneda to destinations in ASEAN. ASEAN nations are so important for Japan that, first of all, the Government should work out ways to provide Haneda with flights to ASEAN countries during the day.

Expert Member: I would like to give Mr. Fuyushiba’s proposals full credit for expanding the specific time periods to newly create the relay time zones. However, for flight destinations such as those in the U.S. Eastern Coast, which cannot be conveniently handled during the relay time zones, authorities should allow at least flights returning from overseas destinations during the day at Haneda in 2010 or beyond.

Expert member: Japan is going to conclude “open skies” agreement with four Asian nations. The U.S.-EU aviation liberalization deal already went into effect this March. It may be said that Japan is still closing its door to overseas. The Government has to make further efforts to aviation liberalization.

The Prime Minister made the following statements:

Temporary Member Fuyushiba made very positive proposals to let Haneda airport accept more international flights and to operate both Haneda and Narita in an integrated manner 24 hours a day in order to dramatically enhance the international airport function in the Tokyo Metropolitan area. In this regard, I ask Mr. Fuyushiba to coordinate closely with local governments, including Chiba Prefecture, to significantly enhance the convenience of airport services in the Tokyo Metropolitan area.

In particular, in order to reinvigorate Japanese economic growth with vibrant energy from Asian developing economies, I believe flights to and from Haneda to major Asian cities must be put in place as early as possible.

These issues should be incorporated into the timetable for aviation liberalization that will be drafted by the end of the year.

I have also asked Temporary Member Fuyushiba to revise the timetable for aviation liberalization. Following the completion of the schedule, the CEFPP will further discuss the matter.

(End)