Provisional Translation

Structural Reform and Medium-Term Economic and Fiscal Perspectives – FY2005 Revision

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Cabinet Decision

Structural Reform and Medium-Term Economic and Fiscal Perspectives – FY2005 Revision

1. Introduction – Concerning the FY2005 Revision[1] –

By positioning the two years of FY2005 and FY2006 as the "Concentrated Consolidation Period," the government will make further efforts to promote structural reforms more aggressively, ensuring the breakaway from deflation, and focus on consolidating fundamentals for new growth.

This revision is intended to show basic policy for the medium-term economic and fiscal management and perspectives on the economy and fiscal conditions.

Concerning the medium-term policy plans to be dealt with in the future but not mentioned in the "Revision", the "Reform and Perspectives" and its revisions will be the basis for policy management. The "Revision" is closely linked to the "Basic Policies for Economic and Fiscal Management and Structural Reform 2005" (Cabinet Decision of June 21, 2005, hereinafter referred to as the "Basic Policies 2005"), and the government will promote structural reform in combination with these.

The "Revision" targets the next five years, but for the achievement of fiscal soundness, envisages a longer period.

2. Economic and Fiscal Conditions

When "Reform and Perspectives" was compiled, harsh conditions existed in the Japanese economy such as negative economic growth rate both in nominal and real terms (in FY2001), and a huge amount of non-performing loans in the financial sector. Through subsequent efforts toward structural reform, however, the Japanese economy has been continuously shifting from prolonged stagnation to economic growth led by private sector demand, normalizing the non-performing loan problem among major banks[2] and enhancing corporate structures by eliminating three excesses (excesses in employment, capital stock and debt) in the corporate sector which had been hindering growth.

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[1] The "Structural Reform and Medium-Term Economic and Fiscal Perspectives" (Cabinet Decision of January 25, 2002, hereinafter referred to as the "Reform and Perspectives") stipulates that the report should be revised each year to reflect changes in the economic conditions appropriately. The FY2005 Revision is the 4th revision.

[2] The ratio of non-performing loans held by major banks decreased from 8.4% as of the end of FY2001 to 2.9% as of the end of FY2004, which has achieved the goal to halve the ratio based on the "Program for Financial Revival."

Over the nearly four years since the beginning of 2002, the Japanese economy has continued recovery and the growth rate for FY2005 is expected to be about 2.7% in real terms and 1.6% in nominal terms. In employment, the unemployment rate that deteriorated to 5.5% in January 2003, has improved to around 4.5% while wages are rising moderately, signaling that the recovery is improving on a broader basis despite some remaining difficulties. For the meanwhile, the unemployment rate is still high among young people and the level of economic recovery varies greatly from region to region. Besides, it should be noted that the future movements of oil prices and the world economy.

With respect to prices, while the GDP deflator[3] is declining at about 1% on a year-on-year basis, due to the narrowing of supply-demand gaps by the economic recovery and the oil price hike, Domestic Corporate Goods Prices are continuing to rise and Consumer Prices (General, excluding fresh food) are hovering at around 0% year-on-year. Considering these price movements in a comprehensive manner, prices are still in a deflationary situation despite progress toward the breakaway from deflation.

In regard to public finance, both central and local governments have promoted expenditure reforms so that the size of government (ratio of general government expenditure[4] to GDP) does not exceed the level of FY2002 until FY2006, and a surplus in the primary balance[5] should be archived in the early 2010s.

In terms of the size of government, the ratio of general government expenditures to GDP has steadily decreased from 38.0% in FY2002 to around 36.1% in FY2005 and around 35.6% in FY2006. The amount of central government general expenditures (general account budget) has been strictly suppressed from 47.5 trillion yen in FY2002 to 47.3 trillion yen in FY2005 and 46.4 trillion yen in FY2006, and local government general expenditures (Local Financial Plans) from 71.1 trillion yen in FY2002 to 67.3 trillion yen in FY2005 and 66.5 trillion yen in FY2006.

Regarding financial balance, in addition to these policy efforts on the expenditure side, and since tax revenues have been improving, the deficit in the primary balance, after becoming 4.4% of GDP in FY2001, reached a high level

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3 The real growth rate is calculated by reducing the percentage change in the GDP deflator from the nominal growth rate.

4 Different to the system of national accounts (SNA), carrying-over to the next fiscal year is not taken into consideration.

5 The primary balance (on a national income [SNA] basis) refers to the financial balance of the “tax and other revenue excluding borrowing” minus the “expenditure excluding principal and interest payments for existence debts”

with 5.7% in FY2002, but steadily decreased to 3.3% (estimate) in FY2005 and is expected to be around 2.8% for FY2006[6]. On the other hand, the ratio of outstanding debt[7] to GDP is expected to increase from 114.9% as of the end of FY2001 to 143.5% at the end of FY2006.

3. Basic Policy for Medium-Term Economic and Fiscal Management

The government will carry out economic and fiscal management under the basic policies outlined below, aiming the breakaway from deflation and the simultaneous pursuit of sustainable economic growth led by private sector demand and fiscal soundness.

(1) Economic and Fiscal Management and Measures to Overcome Deflation

While, hereinafter described, implementing the “Integrated Reform of Expenditures and Revenues” for the simultaneous pursuit of sustainable economic growth led by private sector and fiscal soundness, the government will make further efforts toward structural reform. The government will also pursue stable economic and fiscal management.

Under the above-mentioned price conditions, measures to overcome deflation are still our key policy issue. In order to ensure the breakaway from deflation during the “Concentrated Consolidation Period,” the government and the Bank of Japan (BOJ) will make joint efforts.

Furthermore, when making a judgment on the breakaway from deflation, it is necessary for the government to make cautious consideration regarding the underlying trends and the backgrounds of prices, comprehensively analyzing price-related statistics including GDP deflator and other indices besides Consumer Prices, and taking into account temporary factors such as hikes in crude oil prices and the characteristics of each statistic.

In the medium-term, maintaining a stable inflation rate compatible with economic growth led by private sector demand so that deflation does not reoccur should be the basis of macroeconomic and fiscal management.

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6 Excluding transfers from special accounts identified as “public corporations” in the SNA. The deficit in the primary balance for FY2006 is the value excluding transfer of the special account for Fiscal Loan Program Funds to the special account for Government Bonds Consolidation Funds (12 trillion yen). The deficit for FY2006 including these transfers is about 0.5% of GDP.

7 The sum of general bonds, local government bonds and the borrowing by the special account for the local allocation and local transfer tax.

For the further improvement of the supply-demand gap, the government will promote the structural reforms aimed at each sector of regulations, financing, tax and public expenditures, focusing on increases in private demand and employment, and will further strengthen and expand policy efforts toward the breakaway from deflation together with the BOJ.

The government expects that BOJ will implement effective monetary policy management, which will be consistent with the government's policy efforts and with the economic outlook outlined in the "Revision", and will promote proper formation of expectations in financial markets.

(2) Economic Outlook[8]

By the medium-term macroeconomic and fiscal management described above , in FY2006 and thereafter, the economy will go on a growth path of around 1.5% or higher in real terms and around 2.0% or higher in nominal terms.

Through continuing the combined efforts of the government and the BOJ mentioned above, Consumer Price Index (General, excluding fresh food) and GDP deflator are expected to turn into slightly positive during FY2006, and to maintain that positive state thereafter.

(3) Restoring Fiscal soundness

Toward fiscal soundness, the government will continue to limit the size of government and, at first, aims to achieve a surplus in the primary balance of the central and local government combined in the early 2010s.

To achieve this goal, beyond FY2007, it is necessary for the government to continue the same level of effort as before to improve the financial balance and to realize sustainable economic growth led by private-sector demand.

Taking into consideration medium and long term issues such as intergenerational equity, and based on the results of past reforms, the government will examine the targets of government expenditures, medium-term goals for the size of government and in the major areas of expenditure both for the central and local governments, and issues related to revenues in an integrated manner. Moreover, the government will then clarify options and the process of the "Integrated Reform of Expenditures and Revenues" by around mid-2006.

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8 The economic and fiscal outlooks mentioned above should be interpreted with considerable range since they are accompanied by various unforeseeable factors. The government will widely deal with such uncertainties on consideration of the "Integrated Reform of Expenditures and Revenues".

In this regard, based on the “Basic Policies 2005”, the government will consider the reform following the three principles mentioned below.

i. The principle of “small and efficient government”: Under the motto “no tax increases without expenditure cuts,” the necessary increase of the tax burdens should be minimized as much as possible by thoroughly implementing expenditure cuts and administrative reforms including the reform of government assets and debts and reform of the total amount of personnel costs for government employees.
ii. The principle of vitality: The compatibility between economic vitality and fiscal soundness should be pursued.
iii. The principle of transparency: Options of reform and future prospects should be presented to the public in the process of deliberation.

In order to make economic vitality and sound fiscal management compatible, the government will thoroughly consider the effects on the economy of the “Integrated Reform of Expenditures and Revenues”. When requesting an increase in burdens, the government will study what form those burdens should take by considering the effects on the economy and society.

Through these steps, the government intends to reach the conclusions of the “Integrated Reform of Expenditures and Revenues” within FY2006.

4. Further Efforts for Structural Reform

Based on the “Basic Policies 2005,” the government will make further efforts to promote structural reform in order to achieve “small and efficient government,” construct foundation for the aging population and declining birthrate and on the path to globalization and to ensure breakaway from deflation and sustainable economic growth led by private-sector.

From this perspective, the government will examine the direction of expenditure reform for further reductions and the comprehensive and drastic tax reform in the process of “Integrated Reform of Expenditures and Revenues” investigating the direction of new growth strategies to reinforce international competitiveness in the global market, to improve productivity and to vitalize local economy and medium and small companies and will encourage further efforts for structural reform.

Besides these initiatives, the following measures will be promoted for issues that have been made concrete through discussions at the Council on Economic and Fiscal Policy subsequent to the “Basic Policies 2005”.

(1) Measures based on the “Important Policy of Administrative Reform”

Based on the “Important Policy of Administrative Reform” (Cabinet Decision December 24, 2005), the following measures will be taken to ensure the path to “small and efficient government” by further categorizing and reviewing projects, as well as downsizing and improving efficiency of administrative systems according to discussions by ruling parties:

(Reform of policy-based finance)

The policy-based finance will be drastically reformed and shifted over to a new system from FY2008 by halving the ratio of the lending outstanding policy-based finance to GDP, classifying the functions of policy-based finance and privatizing, abolishing and integrating policy-based finance institutions.

(Reform of government assets and debts)

The government will streamline the assets keeping in mind the long term goal such as roughly halving the ratio of the amount of government assets to nominal GDP over the course of the next decade[9]. While making efforts to promote the sales of marketable national properties, surplus funds and reserves without any clear necessity will be utilized for such purposes as curbing outstanding of the government bonds, thereby lightening the national burden.

Concerning the issue of government bonds, and together with their stable absorption, the government will endeavor to reduce costs such as interest payments in the consideration of risks from a medium and long term perspective, and further enhance the liability control system by continuing to listen to intellectuals and specialists in the private sector.

(Promotion of regulatory reform and opening up to the private sector)

In concert with the Council for the Promotion of Regulatory Reform and the Headquarters for the Promotion of Regulatory Reform, the government will promote regulatory reform and opening up to the private sector concerning government-controlled markets and public sector’s participation in involvement in people’s lives and industrial activities.

Toward the full-scale introduction of market testing, based on “Basic Policies 2005,” the Government will submit the “Public Services Efficiency Bill (or Market Testing Law) (tentative name)” to the ordinary diet session in the early stages,

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[9] While foreign exchange funds, pension trust funds, and other funds that are owned for the purpose of a certain policy, as well as public properties such as roads and rivers that are difficult to sell will not be the targets for streamlining, they should be rationally managed in line with each policy objective.

aiming to maintain and improve the quality of public services and to reduce the costs of these services.

(Drastic reform of special accounts)

In accordance with the characteristics of each special account, the government will promote the reorganization and streamlining of the special accounts through encouraging their contribution to fiscal soundness and examining drastic reform of the scheme, including a shift to independent administrative institutions, privatization and integration with general account. The Special Funding Source for Road Work will be reviewed in accordance with the “Basic Policies of the Review of the Special Funding Source for Road Work” (Agreement among the Government and Ruling Parties on December 9, 2005), and other special accounts will likewise be reviewed as necessary.

(Reform of the total amount of personnel costs for public employees)

The government will aggressively reform the total personnel expenses. Over the next five years, the government will implement a net reduction in the number of public employees through a net decrease of 5% or more of national public servants (excluding employees of Japan Post), an additional net decrease of 4.6% or more of local public servants, a shift to a salary system based on truly the duties and responsibilities of each position, and reform of the salary system by reviewing the public-private comparison method.

(2) Other measures

(Reform of the “State to the Regions”)

With regard to the “Three-Part Reform Package” concerning the state and regions, the government will securely implement the reform of central government subsidies over four trillion yen, the transfer of tax revenue resources of approximately three trillion yen, and the reform of local allocation taxes in accordance with the “Agreement Between the Government and the Ruling Parties” and the accumulated “Basic Policies” relating to the “Three-Part Reform Package” by FY2006. Based on the results of the reforms until FY2006, the government will take measures to establish the self-reliance and responsibility of regions from the viewpoint of further promoting the decentralization and implementing administrative and fiscal reforms throughout the central and local levels.

(Regional revitalization)

Aiming at vitalization of regional economies by wisdom and device, the government will promote measures to revitalize regions through the development of human resources and construction of human-resource networks, the expansion of local government discretion by subsidy reform, and the promotion of utilization of private funds and expertise. In particular, to support regional voluntary actions in cooperation with universities and other institutions, the government will promote the "Program to Revitalize Bases of Knowledge in Regions," which contains support measures coordinated among ministries and agencies.

(Construction of a sustainable social security system)

In order to create an economically and fiscally well-balanced system that will be sustainable in the future with the ageing population and the declining birthrate, the government will advance an integrated reforms of the entire social security programs including pensions, medical care, nursing care, measures against declining birthrate, public assistance, and reach a conclusion within the Concentrated Consolidation Period.

Concerning the pension system, maintaining a long-term balance between benefits and burdens, the state contribution ratio to the basic pension benefits will be raised to 50% by FY2009, based on the 2004 Revised Law. Furthermore, the government will promote the integration of employee's pension systems.

With respect to the medical care system in order to maintain universal health insurance coverage and to make it sustainable in the future, based on the "Outline of Medical Care System Reform" (on December 1, 2005) formulated by the Meeting of the Government and Ruling Parties on the Reform of Medical Care, the government will promote structural reform under the basic ideas of "securing safe and reliable medical care and valuing of prevention," "comprehensively promoting a proper system of medical expenses," and "realizing a new medical insurance system for the super-aging society."

(Reform of the financial system)

The government will steadily implement measures to realize a "financial services nation," which can satisfy the needs of financial service users, which is highly appreciated internationally, and which contributes to regional economies by promoting the early enactment of the "Investment Service Law (tentative name)" as a universal legislation concerning financial and investment services.

(Comprehensive and drastic reform of the tax system)

In line with the “Basic Policies 2005” and the “Outline of Tax Reform of the Ruling Parties” that has so far been compiled, the government will continue comprehensive and drastic investigations and reach conclusions within the Concentrated Consolidation Period.