

## Basic Principles of FY 2007 Budget Formulation

December 1, 2006  
Cabinet Decision

### I Accelerating and Deepening Reform for a New Growth Economy

#### 1. Toward a New Growth Economy

##### (The current state and outlook for the Japanese economy)

The economy is recovering, despite some weakness in consumption.

Under the condition that the world economy will continue to recover steadily, the domestic corporate and household sectors of the Japanese economy will grow continuously and self-sustainable economic growth under the price stability, led by accelerating and deepening reforms and united efforts of the government and the Bank of Japan, is expected to be realized.

On the other hand, attention should be given to the effect which developments in oil prices in particular have on both domestic and overseas economies.

##### (Enhancing growth potential)

The results of the various reforms have begun to manifest themselves, and the Japanese economic system is leaving a long tunnel of stagnation with bright prospects opening before it. But it still shows mismatches with the times, failing to take advantage of its high growth potential and meet the consumers' needs. In order to tackle those structural problems and make the people's life more affluent, we are now required to create a whole new regime and put the economy on a new growth over the medium to long term.

For departure from the postwar regime under the idea "no future without growth," the Government will take advantage of innovation and openness to complete a "transition to a new growth economy" in about five years from now and boldly tackle reforms to enhance the Japanese economy's growth potential under the appropriate macroeconomic policy.

##### (Vitalization of regional economies and Challenge-Again Support)

A nation will not be vitalized unless its regions are vitalized. A Japanese economy full of vitality can be realized with support from vigorous regional economies. But economic recovery gaps are seen between regions. While promoting decentralization reform, the Government will be united to promote the vitalization of regional economies through regional vitalization and other measures. The Government will also implement a "Helping Striving Regions to Help Themselves Program" for regions that are highly motivated to develop their own measures freely to be reborn as "attractive regions".

As to addressing the concern over the stratification of society into winners and losers and other problems to be overcome, the Government will take measures such as supporting challenge-again efforts.

#### 2. Administrative and Fiscal Reforms Are Inseparable

##### (Fiscal consolidation)

Toward advancing fiscal consolidation, the Government will unflinchingly work on the Integrated Reforms of Expenditures and Revenues and take the first step forward with responsibility in the FY2007 budget in line with Basic Policies for Economic and Fiscal Management and Structural Reforms 2006 (the cabinet decision on July 7, 2006, hereinafter referred to as "Basic Policies 2006"). While maintaining economic growth, the Government will systematically carry out expenditure cuts during the next five years with a primary goal of the minimization of the increase in burden on citizens and definitely achieve a surplus in the primary balance of the

central and local governments combined by FY2011. In this regard, the Government will prevent automatic tax revenue increases from being easily spent on expenditure expansion.

In making these efforts, the Government will consistently and continuously conduct well-balanced economic and fiscal management that regards both enhancing the growth potential and advancing fiscal consolidation under the principle that “there can be no fiscal consolidation without growth”.

#### **(Accelerating and deepening reforms)**

Thanks to the structural reforms covering the entire fabric of Japan's economy and society, and to the self-supporting efforts of the people, the results of the reforms have begun to manifest themselves. But Japan is facing an extremely severe fiscal situation. It is clear that if the population decline continues with the ageing population and the declining birthrate, an even heavier burden will be placed on future generations than on the present generations. The Government cannot ask the people to bear an increased burden while doing nothing to cut waste and inefficiency at central and local governments. The Government must steadily promote fundamental administrative reform and create systems suitable for the 21st century.

To this end, based on the Administrative Reform Promotion Law, the Government will promote the policy-based finance reform, the review of incorporated administrative agencies, the special accounts reform, the overall personnel expenditure reform and the Government asset and debt reform, while sorting and reviewing its operations with a view to expanding the scope for private sector activities and to consolidating and streamlining the administrative system. At the same time, the Government will tackle the secure implementation of postal privatization, the active implementation of market testing, the regulatory reform, the civil servant system reform and the public-interest corporation system to organize a simple yet efficient, lean Government.

The Government will also accelerate its study of a regional government system (doshu-sei).

## **II Basic Concepts of Fiscal Consolidation in FY2007**

#### **(Enhancing expenditure reform)**

In order to definitely achieve a surplus in the primary budget balance of the central and local governments combined by FY2011 and organize a simple yet efficient Government, the Government will continue fiscal consolidation efforts and enhance its expenditure reform in formulating the FY2007 budget. Therefore, based on the Administrative Reform Promotion Law, the Government will streamline and improve the efficiency of administration more exhaustively and appropriately reflect the overall personnel expenditure, special accounts, asset and debt, and other reforms in the budget. The Government will also thoroughly review overall expenditures and strictly curb the general expenditures and general account expenditures. Based on the present economic situation and tax revenue trend, the Government will reduce new government bond issues substantially from the previous year's level of 29.973 trillion yen.

In allocating expenditures, the Government will strictly curb “public works related expenditures” and “other expenditures”. Basically, both expenditures will be limited to the aggregate of the amount of “public works related expenditures” decreased by 3% from the level in the previous year's budget, “other expenditures” decreased by 3% in principle from the level in the previous year's budget and additional expenditures for promotion of priority projects. “Non-discretionary expenditures” must not be left to automatically increase. But non-discretionary expenditure systems and measures should be fundamentally reviewed to curb expenditures. In continuous terms, the budget must be based accurately on actual budget implementation.

In prioritizing the budget allocation and increasing the efficiency of the allocation, the Government will concentrate measures in “Constructing an Open Economy Full of Vitality” and “Realizing a Healthy and Safe Society” in the third chapter. Each government agency will set goals for its measures and conduct strict ex post facto evaluations of these measures. Policy evaluations will be utilized for increasing the efficiency of

expenditures and streamlining spending. Furthermore, the Government will endeavor to increase the efficiency of its operations with the vigor of the private sector. It will also lower unit service costs and overall expenses on the basis of the rationalization and increased efficiency of public services.

#### **(Area-by-area expenditure reforms)**

In the first year of the five-year expenditure reform program, the Government will review systems and measures in the following three areas in line with the “Basic Policies 2006”. Similarly, the Government will tackle expenditure reforms in other areas as well.

#### **(1) Social security**

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 continue to make reform efforts from a medium to long term perspective, while verifying the effects of institutional reforms to date, and make constant reviews so that this system will be kept within a scope bearable by citizens.

Under the FY2007 budget, the Government will carry out an employment insurance system reform including the elimination of state contributions to unemployment benefits and the like, and the fundamental realignment of the three employment insurance programs. Regarding public assistance, the Government will review welfare benefits for mother-child families and implement property-backed loans and the like that are preferred to the public assistance system.

As for medical and nursing care services, it is extremely important to maintain and improve the service quality and curb service supply costs through rationalization efforts in order to lead the people to accept their contributions supporting medical and nursing care insurance systems. Comprehensive measures to this end will be promoted systematically.

#### **(2) Public investment**

The Government will continue public investment reforms while advancing expenditure reforms. In order to implement truly essential social capital development, the Government must prioritize public investment projects based on social capital development levels and utilization of facilities with a view to promoting the independence and vitality of regional communities, enhancing the nation’s growth potential and ensuring safety and security through disaster prevention and reduction measures. The Government will also advance cost reduction measures in consideration of gaps between public and private sectors in all areas and bidding reforms to further promote the prioritization and rationalization of public investment.

Specifically, the Government will support efforts to promote the independence and vitality of regional communities while respecting their independence and discretion and considering role sharing between central and local governments. As infrastructure to enhance Japan’s international competitiveness, the Government will promote ring roads in the three metropolitan regions, super hub ports and airports located in major metropolitan areas. Furthermore, the Government will promote disaster prevention and reduction measures while continuing efforts to link these measures to utilization of regulatory methods and soft measures. The Government will continue reviewing projects for water supply and sewerage systems, large dams, urban parks, local roads, rural ports, rural airports and living environments for rural communities, while considering regional needs and development levels based on the past basic principles of budget formation.

The Government will flexibly allocate the budget to regions in consideration of development conditions.

Furthermore, the Government will efficiently implement public works through the effective utilization of existing stock, the promotion of efficient and systematic maintenance management and renewals, the enhanced utilization of private sector resources through private finance initiatives (PFIs) and the reform of standards in order

to powerfully promote cost structure reform of public works projects aimed at reduction in overall costs by 15% in five years.

Particularly, the Government will thoroughly eliminate bid-rigging and expand open and competitive biddings and overall greatest value methodology to further enhance the competitiveness, transparency and fairness of biddings and contracts. At the same time, the Government will strictly implement ex ante and ex post facto evaluations of public works projects and thoroughly reflect evaluation results in the budget.

The Government will also consider how best to spread these cost-reducing and bidding reforms to local governments.

The Government will review tax revenues earmarked for road projects on a premise of shifting these funds to general revenues while maintaining the current tax rates and intends to compile a solid plan within the current year while soliciting the understanding of taxpayers.

### **(3) Local public finance**

While maintaining relations of mutual trust between central government and local governments, local government expenditures including personnel costs, construction and general administrative expenditures will be strictly reduced at the same reduction pace as that of the central government in the FY2007 budget in line with the "Basic Policies 2006".

Based on the law for the promotion of decentralization reform, the Government will deliberate to submit a "new decentralization package law" (as tentatively named) to the Diet within three years.

Considering financial conditions of central and local government, the Government will comprehensively deliberate for example the review of allocation of tax revenues including a transfer of tax revenue sources, along with reforms of local allocation tax and subsidies.

Considering existing financial power gaps between local governments, the aim will be to narrow such gaps.

The Government will aim at promptly increasing the number of municipalities that do not need to depend on local allocation tax.

In FY2007 the Government will start a "Helping Striving Regions to Help Themselves Program," under which assistance in the form of local allocation tax will be newly provided to local governments that develop original regional projects and work proactively. A method to calculate local allocation tax under new simple standards will be introduced in FY2007.

Efforts to develop a new fiscal rehabilitation system will be advanced to encourage local governments to implement voluntary fiscal consolidation. Local governments will tackle administrative reform more proactively in line with the guideline for further promotion of administrative reform at local governments (August 31, 2006).

### **(Tax reform)**

The Government is required to promote comprehensive tax reform from a medium-to long-term viewpoint to meet social and economic structure changes in Japan in the 21st century.

An urgent challenge regarding the tax reform is to enhance the Japanese economy's international competitiveness and contribute to its invigoration as well as to avoid shifting a burden onto future generations by securing a stable supply of revenue to cover an increase in burden caused by social security services and the declining birthrate that cannot be covered by thorough expenditure cuts. The tax reform should also meet policy objectives such as the expansion of support for child-raising efforts and the promotion of decentralization and give consideration to the so-called inequality problem.

With the above viewpoints in mind, based on expenditure reductions under the FY2007 budget, the settlement of government accounts for FY2006 and social security benefit payments after the healthcare system

reform, the Government will conduct full-fledged and specific discussions on tax reform from the autumn next year, thereby working to implement a fundamental tax reform around FY2007 in line with the reform timetable as given in the past “Outlines of Tax Reform of the Ruling Parties”.

For FY2007, the Government will consider measures, including a review of the tax system aimed at developing infrastructure for Japan’s economic growth with a view to taking advantage of economic growth to promote fiscal consolidation and minimize the financial burden on taxpayers under the principle that “there can be no fiscal consolidation without growth.”

#### **(Budget system reform)**

In order to firmly establish the budget system reform to realize the Plan-Do-Check-Action (PDCA) Cycle, the Government will continue to promote “Performance-based Projects” and “Policy Packages”. The Government will endeavor to improve and expand policy evaluations and will further enhance the link between policy evaluations and the budget. With a view to checking and following up expenditures over multiple years to ensure the effectiveness of the Integrated Reform of Expenditures and Revenues during a “transition to a new growth economy,” the Government will also enhance the policy-making process based on the formulation at the Council on Economic and Fiscal Policy of “the Structural Reform and Medium-Term Economic and Fiscal Perspectives”, “the Basic Policies for Economic and Fiscal Management and Structural Reform”, “the Overall Picture of the Budget” and “the Basic Principles of Budget Formulation”.

### **III Promotion of Prioritization and Efficiency of Budget for “Innovative Growth”**

With a view to realizing sustainable “Innovative Growth,” the Government will give priority to and efficiently promote measures that have conspicuous policy effects for 1. “Constructing an Open Economy Full of Vitality” and 2. “Realizing a Healthy and Safe Society.” For the promotion of these measures, the Government will specify goals and policy tools and steadily implement the PDCA Cycle.

#### **1 Constructing an Open Economy Full of Vitality**

##### **(1) Enhancing growth potential**

Under the basic concept and strategic objectives of the “Economic Growth Initiative,” the Government will steadily enhance Japan’s growth potential by thoroughly and efficiently prioritizing budget allocations to areas that contribute to the improvement of productivity, technological innovation and utilization of Asian vitality, and by basing an additional 2% of baseline requests as “Requests to Promote the Strategies for Economic Growth”.

The Government will promote the Asian Gateway Vision, which will make Japan a conduit between Asia and the rest of the world in terms of the flows of human resources, equipment, money, culture and information.

##### **(Enhancing international competitiveness)**

Under the “The 3rd Science and Technology Basic Plan”(adopted by the Cabinet on March 28, 2006) and the “Comprehensive Strategy for Creating Innovation,” the Government will strategically promote such measures as an innovation superhighway initiative and try to create new industries leading the world and advance basic national technologies. The Government will work out an “Innovation 25” strategic guideline for the long term to 2025. In order to promote successive creation of innovation, the Government will advance innovative research and development through industry-academia-government collaboration and develop the world’s most advanced patent examination system and other measures to further enhance protection of intellectual property rights. Based on the “Comprehensive Logistics Policy 2005-2009” (adopted by the Cabinet on November 15, 2005), the government will tackle the strategic and prioritized development of hard and soft logistics infrastructure and realize an efficient logistics system invulnerable to the impact of oil price hikes. Based on the “New

Agricultural Administration for the 21<sup>st</sup> Century-2006,” the Government will concentrate and prioritize policy measures in principal farmers. It will also advance “Aggressive” agriculture policy such as the promotion of agricultural, forestry and fishery product and food exports, the revival of forestry and timber industries, and structural reforms to develop an internationally competitive fisheries industry. The Government will promote various measures toward making Japan a nation built on tourism. The Government will also promote measures to enhance the international competitiveness of pharmaceutical and medical equipment industries and to globally expand industries for domestic demand and export products for such demand.

In order to take advantage of Asian and other overseas growth and vitality for Japan’s growth, the Government will accelerate negotiations on economic partnership agreements including a pact between ASEAN (Association of Southeast Asian Nations) and Japan. In the Asia-Pacific region including East Asia, the Government will try to create an international system like the Organization for Economic Cooperation and Development to develop statistics, make policy recommendations and undertake coordination. To make the Doha development round successful, the Government will promote assistance through the “Development Initiative” and implement strategic and effective diplomatic measures. The government will enhance the international competitiveness of Japanese culture and Japan’s capacity for transmitting information overseas. By developing comprehensive measures to support foreign residents in Japan, the Government will build a society where multiple cultures coexist.

The Government will try to strategically develop natural resources and energy policies including the realization of the most advanced energy supply-demand structure in the world and comprehensive measures to secure resources for Japan. At the same time, it will advance Asian environmental and energy cooperation.

In order to develop a global strategy contributing to the enhancement of national interest, the Government will strengthen its comprehensive diplomatic capacity and expand the diplomatic operation system including overseas diplomatic establishments.

#### **(Innovation in the IT and services industries)**

The Government will endeavor to improve productivity and create markets through the steady implementation of the “New IT Reform Strategy,” the expansion of the contents market, the development of next-generation IT technologies and the utilization of teleworking. The Government will also try to innovate the services industry through a services industry productivity improvement campaign and the adoption of measures for realizing high-quality and efficient services.

#### **(Revitalizing regional communities)**

In order to allow highly motivated regions to be reborn as attractive regions full of wisdom and ingenuity by developing their own measures, the Government will further develop and continue such efforts as urban renaissance, revitalization of central urban districts, promotion of special zones for structural reform and regional revitalization. The Government will also provide information and know-how to highly motivated regional communities through interactive cooperation between central and local governments, train and support various people undertaking regional development efforts and integrally support efforts to utilize local products and develop regional brands for the advancement of local industries. In this respect, the Government will expand and enhance measures and consider organizing menus of measures that are easy to be implemented by communities, based on five viewpoints – (1) drawing out and utilizing regional ideas, (2) advancing the development of regional leaders and other human resources, (3) utilizing tangible and intangible unique resources in the region, (4) promoting international and interregional exchanges, and (5) providing conditions for sustainable and independent development of regional communities. Furthermore, central government officials will proactively visit various regions for consulting services utilizing know-how accumulated through past support measures. The Government will also consider developing a program for cooperation between central government agencies to create a new

network in which various players from regional residents' associations, NPOs, industries, academic institutions and government agencies would participate and cooperate to develop regional communities and solve regional problems.

**(Supporting SMEs)**

In order to invigorate small and medium sized enterprises (SMEs) as the original source of Japan's economic vitality, the Government will try to facilitate fund supply to SMEs and will support new SME business launches, and research and development, foster small and medium sized retailers and small companies, and revitalize shopping areas.

**(Realizing a nation built on human resources)**

The Government will seek to improve the quality of education by conducting nationwide academic ability surveys, to promote practical education and training through industry-academia collaboration and science and career education utilizing engineers at local companies, to boost young people's interest in manufacturing, to expand sound scholarship programs, to enhance graduate school education fundamentally, to secure education and research funds for higher education and to implement investment in priority areas identified through third party evaluations. The Government will also improve the foreign student system while securing high-quality foreign students and promote interchange between young people in Japan and foreign countries including Asian nations.

**(2) Challenge Again support**

The Government will seek to realize a society in which every citizen can fully demonstrate abilities and personality, a society in which the efforts of people are rewarded, a society in which there is no stratification into winners and losers, and a society in which ways of working, learning and living are diverse and multi-tracked -- in other words, a society of opportunities where everyone has a chance to challenge again. Under a "Comprehensive "Challenge Again" Support Plan" (as tentatively named) to be compiled within the year, the Government will comprehensively support the following support measures. The Government will also establish new Prime Ministerial awards for contributors to the "Challenge Again" initiative.

**(Overcoming jobless status or economic hardship due to prolonged deflation)**

The Government will promote the permanent worker status of "freeters" (job-hopping part-timers) and the vocational self-support of young people not in education, employment or training (NEET) through comprehensive employment support measures such as career consulting and capability development, the revision of the current system of employing new graduates en masse, and the development of employment opportunities. The Government will also implement the expansion of application of social insurance coverage to part-time workers and other measures to pursue equal treatment of regular and non-regular workers.

The Government will prevent people from becoming heavily indebted and provide consulting services and other relief measures for people faced with economic hardship. For challenge-again entrepreneurs and turnaround-seeking SMEs, the Government will support fundraising operations and promote loans that do not heavily depend on real estate collateralized or personal guarantees.

**(Equalizing opportunities)**

In order to allow people facing various difficulties such as child-raising, long separation from jobs, physical or mental disabilities, economic hardship for guardians, crime victimization and criminal records to proactively seek jobs or learning opportunities, the Government will provide consulting, recommendation, training, guidance and information services as well as learning opportunities, promote teleworking and enhance cooperation between relevant organizations.

### **(Realizing multi-tracked society)**

In order to diversify ways of working, learning and living in each lifetime phase, the Government will promote the expansion of working opportunities for elderly people and baby-boomers and relearning opportunities for working adults and the support for people having residences in both urban and rural areas as well as people pursuing a “UJI-turn” (returning to their hometown and moving from large cities to rural regions), including those seeking agricultural, forestry or fishery jobs in rural regions (“Jinsei Nimousaku”).

## **2 Realizing a Healthy and Safe Society**

### **(Constructing an easy-to-understand, reliable social security system)**

The social security system with pensions, medical care and nursing at its core provides a safety net against the risks of life. In order to construct a social security system that places value on the spirit of self-reliance and is easy to understand as well as compassionate, reliable and sustainable toward the future, the Government will promote a comprehensive reform of the current system.

As for pensions, the Government will promote the unification of employee pension schemes under the “Basic Policy on the Unification of Employee Pension Schemes” (as adopted by the Cabinet on April 28, 2006). The Government will front-load the "Pension Regular Notification Service" system that will periodically inform people of how long and how much they have paid in pension premium contributions and how much they will receive in the future. The Social Insurance Agency will be reorganized from scratch.

### **(Constructing a child-raising friendly society)**

As the population-decreasing society is approaching, the Government will powerfully promote measures against the birthrate decline as its basic policy and construct a “child-raising friendly society” in order to reverse the downward trend of the birthrate. Based on the Child-raising Supporting Plan and the New Measures against Birthrate Declines, the Government will provide extensive support measures to child-raising families, including support to reduce the economic burden before and after childbirth, and during child-raising periods. The Government will promote the development of an environment where parents can raise children securely and will support regional child-raising supporting measures such as after-school plans and childcare services. Comprehensive support will thus be provided to meet growth of children. The Government will also promote reform of working habits and styles to allow people to balance working and child-raising responsibilities. Furthermore, the Government will seek to reform the social consciousness to allow people to share wonderful child-raising experiences and family values.

### **(Coping with the risks in daily life)**

Recognizing that ensuring national safety and security is a basic responsibility of government and a basis for stable economic growth, the Government will implement the following measures:

While developing national movements to prepare for natural disaster crises, the Government will strategically and selectively implement disaster prevention and reduction measures including the promotion of earthquake-resistant public facilities and houses, the urgent redevelopment of heavily populated urban regions, measures against large earthquakes such as epicentral quakes hitting Tokyo, and measures against large-scale floods and landslides. Furthermore, the Government will enhance the prompt provision of accurate disaster prevention information, the development of contingency planning arrangements, and firefighting and other anti-disaster measures.

By advancing measures against malicious incidents in which children are victims, organized crime and international crime, the Government will promote efforts to restore Japan to being the safest country in the world. The Government will advance justice system reform including the expansion of comprehensive legal support, and

the enlightenment of the people and other measures for the planned introduction of the Saiban-in System. Furthermore, the Government will promote measures for crime victims and enhance information security measures. For constructing a society where various world cultures can coexist safely and securely, the Government will promote terrorism prevention and other measures.

In order to ensure peace and safety of Japan, and peace and stability of international society, the Government will promote the build-up of efficient defense systems while taking effective measures against diverse situations as well as new threats including ballistic missiles.

The Government will advance measures to ensure safety of houses and other familiar facilities from the viewpoint of consumer protection, prevent railway and aviation accidents, secure traffic safety and realize a barrier-free society. The Government will seek to ensure food safety and gain consumer confidence, promote Food Education as a national movement, and maintain and improve the food supply capability. It will also advance measures against new infectious diseases.

As Japan's commitments under the Kyoto Protocol are to begin in 2008, the Government will steadily advance the Kyoto Protocol Target Achievement- Plan (as adopted by the Cabinet on April 28, 2005) by stepping up energy conservation measures, the utilization of biomass and other new energy sources, the promotion of nuclear energy, the management and conservation of forests and the exploitation of the Kyoto Mechanism with a view to accelerating measures against global warming. The Government will also build a Sound Material-Cycle Society through the "3Rs"(reduce, reuse and recycle) and measures against illegal waste dumping and promote the harmonious coexistence with nature. To work toward compatibility between the environment and the economy, the Government will promote environmental considerations to from financial aspects and advance the development of environmental technologies.

Toward the deadline for the submission of information about continental shelf limits in 2009, the Government will steadily promote marine surveys and appropriately prepare information on continental shelf limits.

#### **(Developing an environment in which citizens can live a well-off life)**

In order to build an education system suitable for Japan in the 21st century and revitalize education, the Government will promote fundamental education reforms.

The Government will enhance educational functions of kindergartens and child-care centers and promote early childhood education by enhancing measures to reduce the preschool education-related burden on parents and guardians while comprehensively considering financial, institutional and other problems with early childhood education free of charge in the future in step with the revenue reform.

The Government will promote experiential activities for fostering rich humanity and social skills, strengthen the educational functions of school, home and community, address bullying, violence, school refusal, child abuse and other problems, and expand educational support for children with disabilities including developmental disorders. The Government will also seek to promote culture and arts by creating new culture and arts and conserving and utilizing cultural assets. Furthermore, the Government will make efforts to achieve a lifelong sports society and improve Japan's ability to compete in international sporting events through the development of national-level training bases.