

Basic Policies 2005 Highlights

Half-Complete Structural Reform

By Izumi Masaki

IN June, the government called a meeting of the Council on Economic and Fiscal Policy (CEFP) and an extraordinary cabinet meeting, and officially approved the Basic Policies for Economic and Fiscal Management and Structural Reform 2005 (the Basic Policies 2005), which sets the guidelines for the FY 2006 budget drafting. For Prime Minister Koizumi Junichiro, whose term as president of the Liberal Democratic Party (LDP) will expire in September 2006, these are the final Basic Policies with jurisdiction extending to the actual budget drafting. However, out of caution over the potential effects on postal privatization, the reform's centerpiece, the formulation of specific measures was deferred until the autumn or later on a host of issues, in order to avoid clashes within the ruling parties.

Policy Targets Aiming at Results

These are the 5th Basic Policies to be finalized by the CEFP. The inception of the Council goes back to the reorganization of central government ministries, an attempt made in 2001 to enhance efficiency in administration. Fashioned after the US National Economic Council (NEC) established under the Clinton administration, the CEFP is chaired by Prime Minister Koizumi himself. The objective was to bring transparency to a policymaking process thrown into obscurity by the egos at play across a fractured administration and adjustments made at LDP sectional meetings, where diet members representing special interests are a force, making a top-down approach headed by the prime minister.

Logically the Basic Policies have also

been used as a weapon to force a shift toward greater flexibility led by the prime minister's office. Specifically, this concerns fending off rigid budget drafting by the Ministry of Finance (MOF), such as the guidelines for budget appropriation requests, the MOF draft proposal, and the government draft proposal. However, with the MOF continuing to wield significant influence, resistance from ministries, agencies and diet members representing special interests are as strong as ever. A breakthrough on the reform path has yet to come. The 2005 edition of the Basic Policies is therefore nowhere near a final mopping-up of structural reform. Koizumi said at the extraordinary cabinet meeting, "Expenditure reform will continue in next year's budget planning. All cabinet members are called upon to do everything necessary for policies to take tangible shape."

The Basic Policies 2005 targets small and efficient government, and expressly demands a policy that establishes a net reduction target for the number of central government employees, taking into consideration staff increases during the four years beginning in FY 2006. In addition to calling for a corresponding target to be established for local government employees, it requires that their wage levels reflect those of local private sector, and that allowances be disclosed.

Concerning social security benefits, the Basic Policies stresses that restrictions on medical care expenses, which have been growing strongly, are inevitable to overcome the problems confronting an aging society with a falling birthrate. "Policy targets aiming at results" offers a principle to restrain the growth of medical care expenses.

However, an express preference for target levels linked to economic scope met resistance from LDP members closely linked to the Ministry of Health, Labour and Welfare (MHLW), reflected a wish of the Japan Medical Association, which feared ripple effects on medical treatment fees. As a result, active formulation has been postponed until the end of the year. Policy targets to be finalized within this year will take into account of "how much of a burden the public will find acceptable," as well as a regional approach and individualities of medical care asserted by the MHLW. The question of how to reflect economic magnitude such as national income in the targets will remain a focal point.

Either Small Government or Tax Increase

Concerning a market test for opening the public services to the private sector through competitive bidding involving the public and private sectors, negotiations continue to present a bill for a full-scale introduction to the Diet within the current fiscal year. Although efforts continue to hold down public investment, a change of direction in ODA policy will increase this to 0.7% of the GNI, the actual target called for by the United Nations, to help Japan's bid to become a permanent member of the UN Security Council. Among efforts at integrated reform of revenue and expenditure, policy options including tax hikes beginning in FY 2007 are to be brought up within one year, while a revision of government-related financial institutions following postal privatization, which aims to change the financial flow from public sector to the private sector, are also included.

Slow moving as the structural reform effort is in general, reform surrounding central government employees has been particularly laggard. In order to convince the public to accept a higher consumption tax, it is indispensable to make drastic cuts in the public sector. In early June at the CEFP, Koizumi reasoned:

“Without efforts to achieve small government, substantial tax increases will be unavoidable. Future prime ministers will have to make particularly great efforts.” This remark was made in the presence of Minister of Finance Tanigaki Sadakazu and Minister for Internal Affairs and Communications Aso Taro, whose names are being traded as successor candidates for the post-Koizumi era, and was meant to spur them to hammer out a net reduction target.

The prescribed staff limit for national administrative agencies stood at around 330,000 as of the end of FY 2005. By comparison, the net reduction of prescribed staff during the plan period to FY 2005 stops at a total of 2,500 over five years. This figure relates to the number of targeted staff cuts, and the increases required to accommodate emerging new tasks. However, for FY 2005, 12 out of 20 institutions reported a net increase in the number of staff due to reinforcement of security measures, and the Ministry of Internal Affairs and Communications (MIC) has expressed the view, that “numeric targets for net reductions pose problems as long as future demand for administrative services cannot be assessed.” Toward the end of the year, ministries and agencies will inevitably strengthen their resistance, and formulating of net reduction targets is predicted to be an uphill battle.

While Koizumi was credited with having exercised leadership in the discussion about net reduction targets, reform plans for government-related financial institutions, supposedly a key agenda point following postal privatization, were quickly settled with ambiguous expression about the timetable. LDP executives are reported to be strongly opposed to a consolidation of financial institutions for small and medium-sized businesses. Even ODA, which has been pared back on a general account budget basis for six consecutive years, underwent a change of direction toward a “strategic expansion of project

volume,” amid other evidence highlighting insufficient zeal for expenditure reform.

ODA was down to two-thirds of its peak, and Koizumi, targeting on Japan’s permanent UN Security Council membership, declared in the midst of the Basic Policies discussion that he was contemplating an increase in ODA. This upset the MOF, which managed to add the phrase “project volume” to “strategic expansion” in its final draft, leaving room for further restrictions on the general budget while accepting increases on a project cost basis, such as debt relief. Since the MOF seeks early fiscal rehabilitation, it is concerned that the ODA about-face could have ripple effects in the direction of raising expenditures in other areas, such as public works. The Basic Policies puts forth a favorable assessment of the progress made toward reaching the reduction target set for the government’s medium-term public investment, and the trend of deregulation beginning in FY 2007 is becoming an established fact.

The integrated reform of revenue and expenditures, to be formulated within one year, including optional tax increases beginning in FY 2007, is on a meandering course – despite it being a core element of structural reform. Although it is an unavoidable step for securing financial resources for social security and restoring fiscal integrity, a serious debate over a rise in the consumption tax remains taboo because of concern about the negative effects on the economic recovery, and thorough expenditure cuts are impossible to enforce. With decisions in place for cutting the fixed-rate reduction of income taxes beginning January 2006, the Government Tax Commission published a list of “critical issues concerning personal income taxation” in June, advertising corrections to the tax system’s distortions and inequality as the selling points.

This list calls for a necessary radical review of deductions for dependents, suggesting a tighter tax regime, and also

proposes reviews of employment income deductions and taxation of pensions, with a strong leaning toward tax increases. Much space is given to arguments for reform of tax deductions, which have been criticized as excessively complicated.

The Logic of Tax without Political Sense

Ishi Hiromitsu, Chairman of the Government Tax Commission, emphasized at a press interview: “Dealing with a low birthrate and an aging population is impossible without higher taxes. The focus will have to be on employed workers, who account for 80% of the working population.” Concerning expenditure reductions as a precondition to tax increases, Ishi noted: “I am afraid this is a slogan without substance. Politics must quickly reach a public consensus over how much can be achieved until when.” The list of critical tax issues, putting greater emphasis on the logic of tax, is said to strongly reflect the mindset of the MOF. Even many members of the ruling parties criticize it for lacking political sense, and predicts its failure to find acceptance with the public because it was raised at an inopportune time.

This situation highlights the turmoil that is returning to the policy debate over fundamental fiscal restoration by the early 2010s, the government’s only fiscal rehabilitation target, since there is no clear priority order of the issues to be dealt with or ways of dealing with them. The conflicts between ministries and agencies and within the LDP over the Basic Policies 2005 and integrated reform of revenue and expenditures tell us that Japan’s structural reform remains only half-complete. **J.S**

Izumi Masaki is an editor in the Economic Division of Jiji Press Co., Ltd. His work focuses on economic policy. At the New York branch of Jiji Press, he specialized in matters of finance and industry.