

How to Improve Japan's Economic Policy Formulation

By *Inoki Takenori*

A large number of people, from Diet members elected by the public to bureaucrats of various government ministries, are involved in Japan's economic policy planning. So are various organizations including the Council on Economic and Financial Policy and the Policy Board of the Bank of Japan (BOJ). Judging from the constitutional national framework, what are the problems with Japanese systems in the implementation of economic policy? This question amounts to exploring the cause of the recent confusion in Japan's economic policy. In this paper, I would like to focus on two problems related to the formulation and implementation of economic policy inherent in the Constitution and laws. One is the extent to which specialists' professional knowledge is put to use. The other is whether policies are being implemented quickly enough.

Issues of Professionalism

In a representative democracy, how should specialists' judgments be adopted in regard to policy matters? As economic society has become huge and complex, and as interdependent relations among countries have become strengthened, a high level of professionalism is increasingly required in making judgments on policy matters. It is a mere fiction to assume that politicians, who debate and pass final judgments on public matters, have sufficient knowledge of all the relevant issues. Also, there is a limit to the media's role of supplementing the undue fiction. Even though the media employs a number of gifted people, the promotion of professionals capable of analyzing important policy matters has not yet been facilitated. In this regard, Japan lags far behind its counterparts in Western and some East Asian countries. More importantly, even if it had a sufficient number of professionals,

Japan lacks a legal framework which clearly positions professional judgment. This is evidenced by the fact that key policy matters are decided by advisory councils of the government. Furthermore, there is no denying that the Japanese public lacks a sense of respect for professional knowledge.

The bureaucratic mechanism has hitherto functioned, to a degree, as a grouping of professionals who can consider public interests or long-term national interests. As a trend of the times, however, the weight of power is shifting to the political world from the bureaucracy. But in a democracy, the political world often becomes nothing more than an aggregate of private interests. Accordingly, if politicians' initiatives gain further momentum, as symbolized by the abolition of the parliamentary system under which bureaucrats answer opposition questions instead of Cabinet ministers in committee sessions, what grouping would play the role of professionals who can consider public interests or long-term national interests? This is an important question that becomes evident when fiscal and monetary policies are compared.

Fiscal and monetary policies have similar impacts in the sense that both greatly influence the distribution of the people's incomes. A draft budget, which constitutes the basis of national finance, is deliberated in the Diet and made into law by democratically elected Diet members. This system is known as "financial constitutionalism." Similarly, the imposition of a new tax or revision of the current taxation system must be carried out under laws or conditions stipulated by laws (the principle of no taxation without law). Accordingly, a clash of interests comes into an exposition in the Diet regarding the choice of taxation or fiscal measures, and thus taxation reform takes time.

Imposition of a Tax Based on the Size of a Business on Banks

Take for example the case of the special tax on banks in Tokyo which was proposed by Tokyo Governor Ishihara Shintaro on Feb. 7, 2000. This is a type of local taxation system, whereby the taxation base for the enterprise tax on a corporation is expanded beyond incomes so that the amount of tax is decided on the basis of a company's capital, floor space, the number of its employees and other things which can be easily observed from the outside. Such a system has been adopted in many developed countries, and some countries have set detailed standards for such taxation according to business types. But it is quite unusual for a tax to be imposed on companies of a specific business sector and size. Ishihara proposed imposing for five years a 3% tax in principle on the gross profits of major banks with a fund volume of ¥5 trillion or more operating in Tokyo. The Japanese Bankers Association filed a court suit against the new tax, contending that Ishihara's proposal, targeted only at financial institutions, was an unequal tax policy which runs counter to equality under the law and to the protection of private assets.

Ishihara insists that there is no problem with imposing such a tax on the principle of "no taxation without law," because 1) banks have paid little tax as they continue to write off non-performing loans (NPLs), although they collect deposits with almost zero interest and earn profits in their main business, and 2) local governments can legally alter corporate taxation systems. In fact, most banks continue to post deficits due to the disposal of NPLs, and therefore have paid little business tax which is currently based on their incomes. The Tokyo Metropolitan Government has seen its tax earnings from banks fall by two digits to a little more than ¥3 billion from the ¥200 bil-

Photo: THE YOMIURI SHIMBUN

lion level in the asset-inflated bubble period. The metropolitan government now finds itself hard-pressed to compile budgets on a stable basis with corporate income tax alone. With the introduction of the proposed new tax, the Tokyo government is set to collect more than ¥100 billion in tax annually on a constant basis.

But Ishihara's proposal raises doubts over why the new tax is being imposed for a limited period of five years and only on major banks. If the main purpose of this tax is, as he claims, aimed at ensuring stable tax income without being affected by economic conditions, then on what basis did he intend to revert to the original form of taxation when banks have completed the disposal of NPLs and climb back into the black? After all, Ishihara's proposal was intended to punish major banks which had continued their "lax" management practices during and after the bubble period.

In complicated economic phenomena, policy results often differ from the original intentions. To discuss problems related to Ishihara's proposal logically, there are two points which must be considered separately. One is that while Ishihara insists that major banks which are capable of paying tax should pay more tax, the tax burden may be ultimately shifted to Tokyo residents from the banks. The tax increase could end up increasing the burden on Tokyo residents due to hikes in banks' loan rates and commissions as well as the credit crunch affecting small and medium-sized enterprises. Major banks' buck-passing can be watched from afar to a certain extent, but banks, for their part, would try to shift the burdens in various ways.

Another point is that if the new tax is introduced in Tokyo alone, how would other local governments be affected? The governors of most other prefectures, including Hokkaido, have expressed the pros and cons of the new Tokyo tax proposal in clear terms for important reasons. Only five or six governors have clearly opposed the proposal, while most of the others cautiously expressed that they would wait until the new tax was implemented nationwide. The ruling Liberal Democratic Party's (LDP) Research Commission on the Tax System decided

to hold full-scale studies on the introduction of "assessment by estimation on the basis of the size of business" (the economic term for the new tax) uniformly all over the country. The LDP sticks to uniformity because the introduction of such a tax in Tokyo alone would result in a substantial decrease in tax revenue for other local governments.

The Kanagawa Prefectural Government estimates that theoretically its annual earnings from corporate tax, including the corporate residential tax, would fall by ¥1.2 billion. The prefectural government is afraid that at a time when companies are carrying out restructuring or moving to other prefectures, the introduction of such a tax in one prefecture alone would weaken the industrial structures of that prefecture. Therefore, Kanagawa plans to persuade the LDP to introduce the tax uniformly in all prefectures.

As such, Tokyo's tax increases would have a major impact on other local governments, as well as the central government's attempts to adopt consistent policy measures. Unless Tokyo considers the complexities of its action, it can hardly expect to obtain the intended effects. If the proposed tax was originally intended to put Tokyo's financial house in order, besides punishing banks and demanding that banks adequately share public service burdens, the metropolitan government should promptly examine the complex mechanism of ripple effects and the results of the tax increase proposal, by at least listing all the advantages and disadvantages.

Utilitarian Calculations Needed

It is more important to analyze the complex economic gains or losses as strictly and promptly as possible than simply discussing so-called "social justice." Japanese politicians and administrative officials should become used to more thoroughly examining gains and losses before passing broader judgment. They should pay more attention to results and effects, instead of merely engaging in debates on the right or wrong of intentions.

The British are most adept at making such calculations because they have the



Ishihara Shintaro introduced a new tax on major banks in Tokyo on Feb. 7, 2000

tradition of utilitarianism, that is, they honestly calculate gains or losses. Take, for example, an episode of the time when Charles Darwin, the 19th century proponent of the theory of evolution, decided to marry. It is said that Darwin drew up something like an accounting table, in which he listed almost all the possible advantages and disadvantages of marriage. At the bottom line, he wrote that he decided to marry after thorough scrutiny and put the Q.E.D (*quod erat demonstrandum*: proved) mark. Many people may be repulsed by the attitude of Darwin, who thought of marriage just as a commercial deal. But it can be said that only a person with such analytical power can assume responsibilities for the results of one's intention.

The problem is that in the case of taxation policy, who would make utilitarian accounting calculations in the way that Darwin did? It would be no one but economists specializing in public finance. As far as the knowledge and understanding of fiscal structures and functions are concerned, even an economic scholar like me can hardly match a public finance specialist. The specialization of professional knowledge has advanced to such an extent. It is a matter of course that public finance scholars do not necessarily have perfect knowledge and wisdom and their calculations could produce errors. But public finance scholars undoubtedly have broader knowledge than other people concerning economic and financial matters, and expectations can duly be

placed on their professional capabilities. Utilitarian calculations are prerequisites for policy arguments. Mere arguments about intentions would not help.

In many cases, sentimental arguments on social justice have a weak basis. Prompt and thorough calculations of possible policy results by specialists should hopefully precede arguments. Arguments merely based on the sense of justice may not be useful, because this is often uncertain. In this respect, Japanese public finance scholars are not speaking up enough.

The Case of Monetary Policy

What about monetary policy? Japan's monetary policy is decided at the BOJ Monetary Policy Meeting, held twice a month in principle. Members of the meetings are not elected through democratic procedures but are monetary experts whose professional knowledge and judgment are highly evaluated (although the number of professionals seems to be lower than that of their counterparts in Western countries). They are appointed by the Cabinet, subject to Diet approval.

It is easy to understand that decision making on monetary policy, which puts a great emphasis on professionalism, is based on analytical judgment with an eye to the final overall effects. Many people focus their attention on taxes and subsidies which are directly related to individual or corporate receipts and disbursements of money, because their primary effects are easy to understand. Thus it is difficult to make a decision on a taxation system without democratic procedures. Monetary policy, on the other hand, is an extremely complex matter. It can be speedily adopted since it can be decided and implemented without parliamentary debates. But it is not possible to see how and when its effects, including secondary and tertiary effects, manifest themselves unless the policy is actually implemented. It is difficult to speculate in advance whether a lowering of interest rates would sufficiently boost capital investment. This is evident from the effects of the current zero interest rate policy. Acceleration of monetary easing could suddenly trigger violent inflation, after it

was thought that even such a policy would be unlikely to produce sufficient effects.

There is a strong likelihood of money markets provoking reaction beyond laymen's understanding or prediction. This is why decision making on monetary policy should in large part be left to specialists' judgment, not through democratic procedures. This is just like medical diagnosis and treatment. A patient's diagnosis and treatment cannot be decided by a majority and must be left to the judgment of doctors who are specialists. But it is hardly surprising that sometimes questions are raised about the advisability of leaving everything to doctors. It is important to consider what should be left to doctors and what options a patient has. Doctors have profound medical knowledge but their knowledge is not perfect. Even so, doctors' judgment can never become useless. It is essential for a patient to rely on doctors since they certainly have far more medical knowledge than laymen. This question boils down to how to balance the respect for professionalism with democratic demands.

Democratic demands could take the form of political demands. In the financial world, democratic demands could sometimes take the form of pressures from the Ministry of Finance. This issue is related to the concept of the independence of the BOJ.

When a central bank pursues a policy target of currency stabilization, what does its independence mean? In the case of the BOJ, its policy target is legally defined, under the Bank of Japan Law, as price stabilization. Its independence is thus limited to the freedom of choosing means or policy for achieving that target. But, its independence or its freedom of choosing means is, strictly speaking, not so clearly defined. Even if the BOJ chooses a monetary policy of a certain direction, its policy cannot be independent of political control if a fiscal policy adopted by the Diet was in the opposite direction. In a case where the avoidance of deflation is an overriding necessity as in today's Japan, a central bank may be forced to abandon its independence. In fact, the central banks in several Latin American countries in the past chose to abandon

their independence.

When a central bank tries to enhance its independence, it is not clear, in many respects, what it will become independent from. A central bank should be independent from politicians and administrative officials. But this is not enough. A central bank could lose its long-range viewpoints if it is preoccupied with short-term fluctuations in capital and exchange markets. Maintaining a long-range viewpoint is the main area which requires the independence of a central bank.

Can the concept of central bank independence be offered a worthwhile place in liberal, democratic countries? The issue boils down to what explanation is given for the basis of monetary policy and whether that explanation is understood by a large number of people. The BOJ has the task of explaining to the people easily and accurately the issues which even specialists find difficult to fully understand. But, in reality, since the BOJ's explanation could significantly change not only people's economic behavior but also the broader economic conditions dependent on its timing, it cannot reveal everything it knows in advance. There is naturally a limit to information disclosure and transparency even in democratic countries.

Growing Importance of Information and Anti-Emergency Mechanism

The second point to be discussed as the legal mechanism of economic policy is how to increase the speed of decision making. Japan today is not well equipped to take emergency measures during a national crisis with the prime minister's responsibility and determination. This is one of the largest drawbacks in postwar Japan's political system. Under the existing Constitution, the prime minister is not entitled to issue emergency orders, although there are some exceptions such as an emergency order under the Police Law. The only case in which the prime minister can take an emergency measure is stipulated in Items 2 and 3 of Article 54 of the Constitution. Under the article, when the House of Representatives is dissolved and the House of Councilors is closed at the same time, the Cabinet "may

in time of national emergency convoke the House of Councilors in emergency session." Unlike the Constitution of the Empire of Japan (Meiji Constitution) which was enacted in 1889, the postwar Constitution is thoroughly oriented to the Diet.

The Meiji Constitution empowered the emperor to issue an emergency imperial ordinance without Diet approval in a national emergency and the ordinance had legal validity. The current Constitution is based on the principle of legislative rights being monopolized by the Diet with no imperial ordinance being issued in a time of financial emergency. When a financial crisis struck in March 1927, an imperial ordinance was issued the next month for the enactment of a moratorium. No such speedy policy response can be practically taken at present.

Under the Meiji Constitution, an emergency imperial ordinance was supposed to be submitted to the next session of the Diet for *ex post facto* approval. Such an imperial ordinance system had the character of a double-edged sword, for there was always the danger of the government abusing steps to enact, in the form of an emergency imperial ordinance, a legislative proposal which could face tough sailing in the Diet, and have the Diet approve it retroactively after the necessary results were obtained. A good example of this was the revised Peace Preservation Law, first promulgated and enacted in the form of an imperial ordinance in June 1928, additionally incorporating the death penalty against offenses creating public disorder and making attempts to create public disorder punishable.

Financial phenomena now change at a ferocious speed on the back of economic globalization and the phenomenal development of information and communications technologies. When an emergency requiring an immediate policy response occurs amid such fantastic change, how shall we respond? It is hard to think that the existing mechanism is fully prepared to respond to such an emergency. Is it not possible to conceive a mechanism, under the existing system, to effectuate the prime minister's speedy judgment? Japan will not be able to tide over a

predicament resulting from a sudden change unless the country sets up a mechanism under which the prime minister can take prompt measures in his own judgment and responsibility, if necessary. Only by increasing the prime minister's power and enhancing his leadership can Japan's political system manage crisis control and deal with various difficulties.

Nonetheless, it is true that the issue is definitely not merely one of a decision making system aimed at strengthening the prime minister's power, because the prime minister's power has apparently become stronger since the end of World War II than before and during the war. For example, under a system revived by the military in 1936, the war and navy ministers had to be active high-ranking officers. When the Army or Navy objected to a prime minister's appointment of the war minister or navy minister, he was unable to form or carry on his cabinet. In fact, Prime Minister-Designate Ugaki Kazushige was forced to resign before organizing his cabinet in 1937 when the Army refused to recommend a candidate for the war minister of the cabinet. In 1940, Prime Minister Yonai Mitsumasa was forced to resign when the Army refused to recommend a successor to the war minister who resigned over policy differences with Yonai. Even so, with the exception of a few cases, prewar prime ministers had stronger leadership than postwar prime ministers. The prime minister's personality is just as important as the national system.

I would like to discuss another issue here in regard to Japan's decision making mechanism. For the diagnosis and treatment of the ailing Japanese economy, it is imperative to stick to professionalism and to have emergency councils staffed by economists knowledgeable in specific fields. As an old Japanese adage says "Everyman to his trade," economists knowledgeable in these fields should first offer their wisdom when there are macro-economic or financial problems. Otherwise, no solution can be offered other than those submitted by an advisory council made up of non-professional eminent persons who only hold ostensible discussions. In this advisory council system, no one knows who will take the final

responsibility. Each council member is undeniably a man of integrity with good insight, and above all a superb corporate executive. But the job of analyzing and dealing with national economic problems should be left up to persons who have received professional training. In the baseball world, Suzuki Ichiro of the Seattle Mariners is a genius at batting but he should not be given the task of conducting a dynamic analysis of batting. The same can be said of members of the Policy Board of the BOJ.

Advisory councils are consultative organizations in the administrative structure. Their recommendations or decisions are not legally binding. They have indeed performed effective functions to a certain extent in introducing professional expertise in administrative structure, ensuring administrative fairness and adjusting different interests. But in the introduction of professional expertise, their functions are hardly sufficient. Advisory councils vary in type. But their existence obscures where the responsibility of decision making lies, and in one sense they serve as a cover-up. If there are only professionals, they could pass a foolish judgment. To avoid such a risk, the coordinators might as well be non-professionals. But as far as discussions are concerned, professionals' opinions should be more respected as they are in Western countries.

The current Japanese legal framework centering around the Constitution lacks provisions regarding the capabilities to organize professional knowledge and making a prompt policy response in a time of emergency. It is a matter of course that the Constitution is not a code of laws that will be in effect forever. Points at issue must be continually examined sensitively and flexibly to meet the needs of the times. JATI

Inoki Takenori is a professor of the International Research Center for Japanese Studies. He specializes in labor economics, economic thought and the Japanese economy. His research focuses on public servants, white-collar workers and the development of human resources.