

Reform and Perspectives – FY2002 Revision

Cabinet Decision
January 24, 2003

Following the formulation of the Structural Reform and Medium-Term Economic and Fiscal Perspectives (Cabinet Decision of January 25, 2002, hereafter referred to as “Reform and Perspectives”), there was a modest recovery in real GDP to the July-September period of 2002. However, the severe deflationary situation still continues. In addition, the outstanding amount of non-performing loans increased markedly in the period to the end of March 2002, and, although there was a decrease in the September period, they remain high. Progress is being made on structural reform in each sector, but under the severe economic conditions domestically and internationally, the fruits are not yet sufficiently permeating the economy as a whole.

Deflation is closely connected to the non-performing loans issue, and together they have dragged down the Japanese economy in recent years. In this context, it is more necessary than ever that comprehensive efforts to address these two problems be strengthened.

The government has decided to accelerate the disposal of non-performing loans with the aim of resolving this issue by FY2004. Furthermore, resolve is required to make faster and more thorough progress on structural reform and, in particular, reforms that will elicit potential private demand and expand employment. The government and the Bank of Japan will also act as one to overcome deflation. Through such efforts, we aim to create “a vital private sector and a simple and efficient government” as well as the realization of “sustainable economic growth led by private-sector demand.”

It is in fact the people who are going to revitalize the economy. Through a deeper appreciation of the acceleration of the various reforms as designed in the “Reform and Perspectives-FY2002 Revision” (hereafter referred to as “the Revision”) and positive action by the people, results through reform will be achieved and the Japanese economy will be strengthened.

1. The Revision of “Reform and Perspectives”

- “Reform and Perspectives” is revised every fiscal year to correspond appropriately to economic conditions. This is the first revision.

- So that economic and fiscal management is always conducted with an approximately five-year medium-term basic policy and perspective in mind, “the Revision” covers the fiscal years 2003 to 2007. A longer-term perspective is included with regard to some issues such as a primary balance surplus in the early 2010s. Policies planned to come into practice by the final year of “Reform and Perspectives” shall be implemented without postponement by FY2006.
- “The Revision” focuses on the basic policy for medium-term economic and fiscal management and the future economic and fiscal outlook, as well as on the acceleration of structural reforms via the four main pillars of “financial system reform,” “tax reform,” “government expenditure reform,” and “regulatory reform.” Concerning the medium-term policy direction not mentioned in “the Revision,” “Reform and Perspectives” will be the basis for policy management.
- “The Revision” is closely linked to the “the Basic Policy for Macroeconomic Management and Structural Reform of the Japanese Economy” (Cabinet Decision of 26 June, 2001) and “Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2002” (Cabinet Decision of 25 June, 2002), and advances structural reform in combination with these.

2. Economic and Fiscal Conditions After the Formulation of “Reform and Perspectives”

- Following the formulation of “Reform and Perspectives,” the real growth rate recovered to the July-September 2002 quarter, almost in line with expectations. However, the tendency toward deflation, including asset deflation, remains strongly-rooted. Deflation, through increasing debt in real corporate terms and in other areas, affects the lives of the people in a variety of ways, such as by constraining private demand and employment. In addition, there was a marked increase in non-performing loans in the period to the end of March 2002, due to factors such as the result of the special inspections. In regard to fiscal conditions, the fiscal deficit will increase in FY2002 as a result of expected additional fiscal expenditure, in addition to a decrease in tax revenues.
- Moreover, heightened economic uncertainty based on concerns about the outlook for the world economy and the impact of the worldwide slump in share prices are likely to have a negative effect on the economy in the short term.

- Thus, in domestic and international economic conditions more severe than expected in “Reform and Perspectives,” the problems are compounding with respect to the financial aspects of deflation and the non-performing loans. Under such circumstances, the recovery of financial intermediary functions and a fundamental corporate revival are essential to full economic recovery and sustainable economic growth. These require the accelerated disposal of non-performing loans. The government has decided to accelerate the disposal of non-performing loans with the aim of resolving the non-performing loans issue by FY2004. At the same time, however, faster disposal of non-performing loans is expected to exert downward pressure on the economy in the short term. To counter this kind of effect, the government decided on “Comprehensive Measures to Accelerate Reforms,” as well as the “Program to Accelerate Reforms,” which supplements and reinforces it. In addition, it submitted the 2002 supplementary budget, which included the budgetary measures required by the packages, to the 156th session of the Diet. The Bank of Japan implemented further monetary easing.
- If deflation lingers it will delay the resolution of the non-performing loans issue. On the other hand, delays in the disposal of non-performing loans will prolong deflation. Therefore, rigorous measures must be taken to deal with both deflation and non-performing loans disposal.

3 . Medium-term Economic and Fiscal Management – Acceleration of Structural Reform

Based on Japan’s severe economic and fiscal situation, aiming for the realization of “sustainable growth led by private-sector demand” under the Basic Policy outlined below, economic and fiscal management will be conducted appropriately and structural reforms centered on the four-main reforms will be accelerated, with the goal of realizing “a vital private sector and a simple and efficient government.”

(1) Basic Policy on Economic and Fiscal Management

(Stable economic and fiscal management)

- Based on “the Revision,” economic and fiscal policies will be administered in a stable manner during the stipulated period, and due consideration will be given to the automatic stabilizer function of fiscal policy. In addition, under extremely severe economic conditions characterized by fear of a deflationary spiral, policy management will be carried out boldly and flexibly.

(Intensive adjustment period and measures to overcome deflation)

- Since domestic and international economic conditions more severe than assumed in “Reform and Perspectives” have continued, with the non-performing loans issue, together with concerns about the outlook for the world economy and worldwide slump in share prices, the government will accelerate various reforms such as non-performing loans disposal and extend the “intensive adjustment period” to FY2004, during which structural reforms will be promoted intensively.
- The intensive adjustment period is an important time of preparation for realizing medium-term economic growth led by private-sector demand. Moreover, the most important subject during this time is to take action to overcome deflation, including asset deflation. Therefore, as it accelerates the disposal of non-performing loans in line with the Financial Revival Program, the government will at the same time accelerate reform and, in particular, accelerate structural reforms whose emphasis is on the expansion of private-sector demand and employment.
- Additionally, considering the current deflationary situation, a comprehensive approach is necessary on aspects such as finance, and the government and the Bank of Japan should play a significant role in this. It is expected that the Bank of Japan will take yet more effective financial measures, based on “the Revision.” The government and the Bank of Japan will act as one to overcome deflation and to turn the price growth rate to a positive figure as soon as possible.

(Economic outlook)

- Because of the continuing severe domestic and international conditions noted above, the real growth rate will remain below 1% and nominal growth will go even lower during the intensive adjustment period to FY2004, or at least in the near-term.
- If an appropriate policy to counter deflation is not formulated, it is highly likely that deflation will persist in the long term. However, as noted above, through the combined efforts of the government and the Bank of Japan, the deflationary trend will improve and, following the intensive adjustment period, deflation will be overcome.

- Through recovery of the financial intermediary function and through promotion of the shift of resources into new growth areas by means of industrial and corporate revival, the accelerated disposal of non-performing loans will yield the benefit of fostering sustained economic growth in the medium term. At the same time, the four main structural reforms will create private demand and employment and strengthen Japan's industrial competitiveness. Considering severe domestic and international economic conditions and the persistent deflationary trend, the Japanese economy will face delays in achieving a medium term growth path of at least 1.5% in real terms and 2.5% in nominal terms, but is expected to come near that trajectory around FY2005 or FY2006.

(Targets for expenditure control and the primary balance)

- Over the four years to FY2006, the goal for the size of government (ratio of general government expenditure to GDP) will be to hold it at or below its present (FY2002) level. The government will also continue to consider the relationship between benefits and cost burdens. In the FY2003 budget, it established the concrete goal that general account expenditure and general expenditure be maintained at levels lower than those of the previous fiscal year in real terms. Local public finance is also in accordance with this policy.
- Considering that the population of Japan will begin to shrink in about 2007, and that between 2010 and 2015 the baby boom generation—which has been the core of the labor force—will move into retirement and become pension beneficiaries, it is desirable that the primary balance will be in surplus in the early 2010s.
- On the other hand, looking at the current fiscal position, declining tax revenues and the additional fiscal expenditure are likely to lead to a primary deficit for central and local governments of more than 5% of GDP in FY2002. In FY2003, despite efforts in the initial budget to cut expenditures, the implementation of front-loaded tax cuts will most probably sustain the high ratio of primary balance deficits to GDP.
- Fiscal soundness cannot be achieved without steady economic growth and appropriate fiscal structural reform. To ensure tangible improvement to the fiscal balance in the medium term, the government will accelerate structural reform to realize sustainable economic growth led by private-sector demand and accelerate expenditure reform. Through this kind of action, the primary balance deficit will be reduced and its ratio to GDP (currently at more than 5%) is likely to come down to approximately half of that by around FY2007, the final year of “the Revision.”

- Additionally, by FY2006, with the continuing efforts of both central and local governments to reduce expenditure, and based on assessment of necessary public services and expenditure levels, as well as on the status of economic revitalization and fiscal conditions, the government will judge what tax measures are required.
- Beyond FY2007, it will be important to make the same level of effort as before to improve the fiscal balance. The government aims to achieve surplus in the primary balance in the early 2010s through such efforts and realization of sustainable economic growth led by private-sector demand.
- The economic and fiscal outlooks mentioned above should be interpreted with considerable range, since there are various unforeseeable factors (unexpected worsening of the global economy, deflation, or rapid economic expansion, for example) in economic and fiscal perspectives in an era of rapid change.

(2) Acceleration of Structural Reform

Structural reform is progressing in each sector (see attached paper). On this basis, it is necessary to further accelerate reform in the following ways.

(Accelerating the disposal of non-performing loans and industrial revitalization)

- To build a more robust financial system to support economic activity, measures will be taken to accelerate disposal of non-performing loans, with the aim of resolving the non-performing loans issue by FY2004.
- Measures integrating industry and finance will be advanced with the aim of achieving industrial reorganization and the prompt revitalization of business activity through the establishment of the Institute for Industrial Revitalization (provisional name) and sweeping revision of the Industrial Revitalization Law.

(Comprehensive and fundamental tax reform)

- The tax reform of FY2003 is the first round of a comprehensive and fundamental tax reform. Deliberations will continue on further reform to the tax system.
- As part of those deliberations, the following issues are prioritized: 1) further reform toward sustained economic revitalization; 2) response to the 2000 supplementary provision to the National Pension Law (the regulation that “in the

period to 2004, aim to secure stable funding and raise the ratio of the state contribution to half”); and 3), a “trinity” reform plan for the allocation of financial resources, including state subsidies, local allocation taxes, and the transfer of tax sources to local government, which is to be formulated by the summer of 2003.

(Acceleration of reform in the major areas of government expenditure)

- With the aim of realizing revitalization of the private sector and lean and efficient government, expenditure reform will be accelerated. In addition, there will be a focus on the really necessary areas of budget allocation. Moreover, to realize a more efficient and effective budget, reform of the budget drafting process, including the use of policy evaluation, will continue to be advanced.
- To establish a sustainable social security system, measures will be taken to reform the pension system.
- A “trinity” reform plan for the allocation of financial resources, including state subsidies, local allocation taxes, and the transfer of tax sources to local government, will move ahead.
- Public investment reform will be advanced to select stringently the projects that are really necessary and to establish them in the most efficient manner possible.
- In the simultaneous pursuit of economic and environmental well-being, agriculture, forestry, and fisheries-related industries will aim for revival of a renewed “food industry.”
- Based on the crystallization of postal reform, policy finance institutions reform, special corporations reform, and pension reform, the ideal capital flow for realizing optimum resource allocation will be clarified and the necessary reforms undertaken.

(Acceleration of regulatory reform and the creation of special zones for structural reform)

- Expectations are higher than ever for regulatory reforms that will bring about the creation of new demand and employment and an affluent lifestyle for the people in which diversity of choice is secured, and regulatory reform is to be pushed forward yet more aggressively.

- In addition, the special zones for structural reform, touted as a breakthrough for regulatory reform and to be implemented in parallel with preparations for the introduction of Special Zones for Structural Reform Law, are aimed at further strengthening the system.

(Advancing the “strategy for economic revitalization” and the creation of lifestyle industries)

To realize economic revitalization, the “strategy for economic revitalization” stipulated in “Basic Policy 2002” must be steadily implemented. Therefore, through a follow-up to this strategy, the government will clarify a direction and accelerate measures on matters clearly in need of acceleration and expansion such as human resource training and person-to-person exchange, and the pursuit of Free Trade Agreements (FTAs). In addition, action will be taken to flesh out the strategy outlined by the Cabinet Secretary in December 2002 to cultivate new industries in four areas.

- Moreover, alongside eliciting potential demand among the people and enriching people’s lifestyles, it is extremely important that lifestyle industries are created to expand employment and business opportunities. Therefore, the revitalization of the culture and tourism industry, and an industry contributing to health will promote creative innovation that will generate a lifestyle industry and a way of life suited to the new age.

Attached Paper

Progress of reform since the formulation of “Reform and Perspectives”

Since the formulation of “Reform and Perspectives”, structural reform has advanced in all areas. Major developments are as follows.

(1) Structural reform toward economic revitalization

< Tax reform >

In order to establish a desirable tax system to achieve sustainable invigoration of the economy and society, while taking into account the current economic and fiscal environment, the FY2003 tax reform will take the following measures outlined below:

- R&D tax credit and IT investment incentives to improve competitiveness of Japanese industry
- Measures to 'integrate' inheritance and gift taxes from the viewpoint of facilitating the transfer of assets from the older generation (i.e. parents) to the younger generation (i.e. children), and tax rate cuts
- Reduction and simplification of taxation of financial transactions and stocks for promoting the shift 'from deposits to investment
- Tax rate cut of registration and licence taxes (transaction tax) for promoting utilization of lands
- Abolishment of “special allowance” for spouse (exceeding the amount of “allowance for spouse”) from the viewpoint of integrating numerous personal deductions
- Reduction of the tax exempt threshold (¥30 mil) and the eligible vendors for the simplified regime (¥200 million) of consumption tax in order to improve trust and transparency of the system
- Review of liquor and tobacco taxes
- Other relevant measures

< Government expenditure reform >

- Through allowing requests of up to 120% of the previous year, the FY2003 budget will be allocated to four new priority areas that will work to create private demand
- Drastic reallocation to science and technology expenditure based on prioritization grading

< Regulatory reform >

- Organization of a simpler and easier business creation system in order to generate new businesses such as venture firms.
- For the smooth promotion of business activities, the Council for Regulatory Reform has decided on the simplification of administrative procedures for 77 items, including the easing of requirements to apply for experimental radio licenses
- Review of the worker dispatch system to advance further improvement in employment choice, and plans to amend the law in relation to the expansion of fixed-period labor contracts
- Establishment of special zones for structural reform whose aim is to revitalize regional economies through implementation of regulatory reforms in accordance with local characteristics
- Formulation of the Urban Renaissance Special Measures Law and designation of areas for urgent urban renaissance (44 areas nationwide) with the goal of promoting urban development projects bearing the hallmarks of private business ingenuity

(2) Structural reform toward the creation of a more robust financial system

- Compilation of the “Program for Financial Revival” and the “Reform Work Schedule” with the aim of resolving the non-performing loans issue in FY2004
- In order to make powerful progress on corporate and business revival, the Strategic Headquarters for Industrial Revival and Employment Measures has decided on the “Basic Policy on Corporate and Industrial Revival”
- With regard to policy finance institutions reform, the Council on Fiscal and Economic Policy has drafted a plan to boldly merge and integrate policy finance institutions in a three-stage reform

(3) Structural reform toward the establishment of a sustainable social security system which allows people to plan their future, free of worry

- Amendment of the Health Insurance Act in order to build a sustainable medical insurance system
- Based on the safety net role of employment insurance, in the FY2003 budget radical revision of the employment insurance system with the aim of securing its stable operation
- Implementation of indexation of pension and other benefits in the FY2003 budget corresponding to 2002 change in consumer price

(4) Structural reform toward the goal of downsizing central and local government administration through reducing the involvement of central government and expanding the authority and responsibilities of local governments

- Advancement of review in the trinity of issues of state subsidy, local allocation tax and tax resource allocation including transfer of tax resources to local governments with the aim of reforming these during the period of “Reform and Perspectives”
- In the FY2003 budget, implementation of a large reduction in state subsidies, and reform of the local allocation tax and tax resource allocation including transfer of tax resources to local governments (increase in the local governments’ share of automobile tonnage tax revenue)

(5) Structural reform toward simpler, more efficient government

- Integration of the nine land, infrastructure and transport-related long-term public works plans to increase prioritization and efficiency in social infrastructure development
- Formulation of the Principle and Outline of the rice policy reform which includes the reform of rice production adjustment measures and other measures on paddy-field farming
- Advance Private Finance Initiatives (PFI) projects at the national level in the development of facilities at national universities and construction of public servant housing
- Acceleration of efforts toward building e-government through bringing forward the schedule for allowing administrative procedures such as applications and notifications to be made on-line