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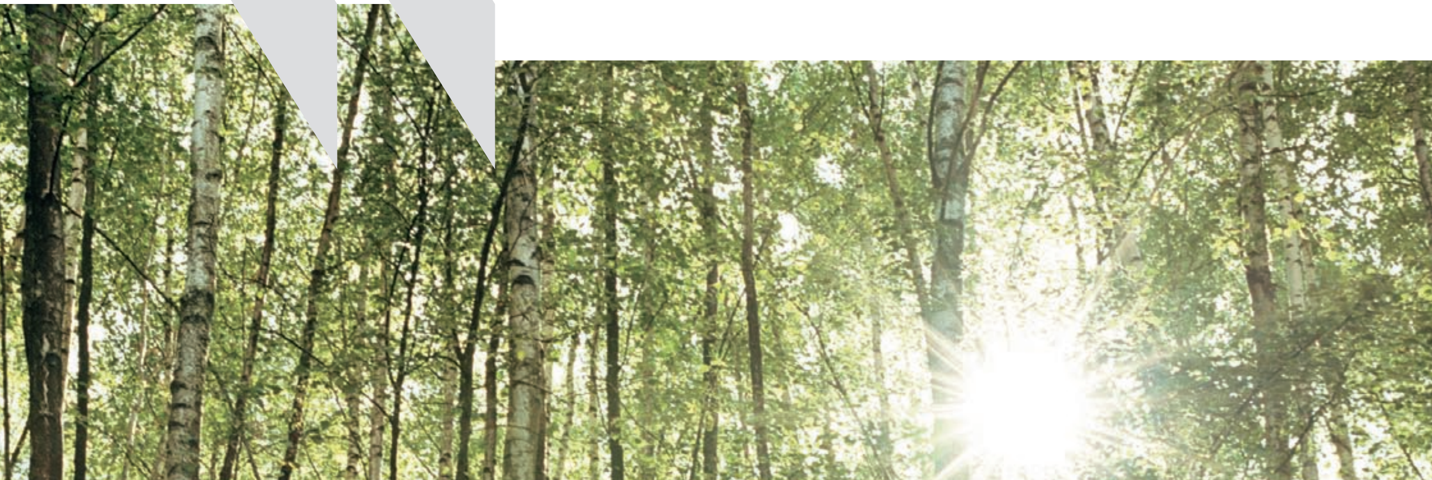

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This survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

Publié également en français

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BASIC STATISTICS OF JAPAN

THE LAND

Area (1 000 sq. km), 2002	377.9	Major cities, March 2003 estimate (million inhabitants):	
Cultivated agricultural land (1 000 sq. km), 2001	48.0	Tokyo (23 wards)	8.1
Forest (1 000 sq. km), 2001	251.1	Yokohama	3.5
Densely inhabited districts[1] (1 000 sq. km), 2000	12.5	Osaka	2.5
		Nagoya	2.1
		Sapporo	1.8
		Kobe	1.5
		Kyoto	1.4

THE PEOPLE

Population, October 2003 estimate (1 000)	127 619	Labour force in per cent of total population, 2003	52.2
Number of persons per sq. km in 2003	338	Percentage distribution of employed persons, 2003:	
Percentage of population living in densely inhabited districts in 2000[1]	65.2	Agriculture and forestry	4.4
Net annual rate of population increase (1995-2000)	0.2	Manufacturing	18.8
		Service	62.8
		Other	14.0

PRODUCTION

Gross domestic product in 2003 (billion yen)	497 783	Share of agriculture, forestry and fishery in gross domestic product, at producer prices in 2002 (per cent)	1.3
Growth of real GDP, 2003	1.3	Net domestic product of agriculture, forestry and fishery, at producer prices, in 2002 (billion yen)	4 747
Gross fixed investment in 2003 (per cent of GDP)	24.0	Growth of industrial production, 2003	3.3
Growth of real gross fixed investment, 2003	0.9		

THE GOVERNMENT

Public consumption in 2003 (in per cent of GDP)	17.7
Current public revenue in 2002 (in per cent of GDP)	29.7
Government employees in per cent of total employment, 2003	8.8

	House of representatives	House of councillors
Composition of Parliament, December 2004:		
Liberal Democratic Party	249	114
Democratic Party	177	84
Peace and Reform (*Komei*)	34	24
Communist Party	9	9
Others	9	11
Vacancy	2	0
Total	480	242
Last elections	November 2003	July 2004

FOREIGN TRADE AND PAYMENTS
(2003, billion yen)

Commodity exports (fob)	51 934
Commodity imports (fob)	39 675
Services	–3 904
Investment income	8 281
Current balance	15 767
Exports of goods and services (in per cent of GDP)	11.8
Imports of goods and services (in per cent of GDP)	10.2

	Exports	Imports
Percentage distribution		
OECD countries	53.8	41.7
of which:		
North America	27.2	18.1
Other Asia	31.2	37.9
Other	15.0	20.4
Total	100.0	100.0
Crude material and fuels (SITC 2, 3, 4)	1.3	27.6
Semi-manufactured goods (5, 6)	18.6	16.4
Machinery and transport equipment (7)	66.8	27.6
Other (0, 1, 8 ,9)	13.3	28.4
Total	100.0	100.0

THE CURRENCY

Monetary unit: Yen		Currency unit per US$, average of daily figures:	
		Year 2003	115.9
		December 2004	103.9

Note: An international comparison of certain basic statistics is given in an annex table.

1. Areas with over 5 000 population whose population density exceeds 4 000 persons per sq. km.

Executive summary

The strengthening of the economy has raised hopes that Japan is emerging from a decade of stagnation. Output has been increasing at a more than 2 per cent annual rate since 2002, reflecting strong external demand and the progress made in corporate restructuring and economic reform. However, Japan still faces a number of serious headwinds to sustained growth, notably entrenched deflation and continued declines in bank lending and land prices. Meanwhile, the government's financial position continues to deteriorate, raising concerns about fiscal sustainability at the same time that population ageing is increasing demands for public spending. Addressing these challenges requires a combination of well-designed macroeconomic policies and structural measures to boost the growth potential and ensure rising living standards in the face of rapid population ageing.

Monetary policy: ending deflation and supporting the expansion

The priority should be to end six years of deflation by maintaining the quantitative easing policy until inflation is sufficiently high so as to make the risk of falling back into deflation negligible. Setting a higher inflation threshold as a condition for changing monetary policy would also help guide private-sector expectations and help limit the reaction in markets. While it is essential to avoid a premature tightening of monetary policy, maintaining the quantitative easing policy for too long after deflation ends could lead to sustained inflation at high rates. Coping with the shocks likely to accompany the end of quantitative easing would be facilitated by further progress in rehabilitating the banking system through continued reductions in non-performing loans and a strengthening of capital, particularly in the regional banks. Moreover, a stronger banking system is essential to reverse the decline in lending and help sustain the expansion.

Fiscal policy: achieving fiscal sustainability through a more ambitious medium-term consolidation plan

Large government budget deficits have boosted gross public debt to over 160 per cent of GDP, the highest in the OECD area, raising concern about the possibility of a rise in the risk premium. The government's medium-term plan aims at keeping the size of government spending around its FY 2002 level through FY 2006, a goal that requires additional reductions in discretionary outlays and further reform of the social security system. However, spending restraint alone will not be sufficient to achieve fiscal sustainability, which is likely to require a fiscal consolidation of more than 5 per cent of GDP. Increases in government revenue thus seem unavoidable and will require a broadening of tax bases and a hike in the consumption tax rate at some point. Confidence in the fiscal position would be sustained by larger deficit reductions, provided the recovery keeps momentum. This should be accompanied by a credible medium-term plan that is more ambitious and detailed than the 2004 plan.

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Reforming the relationship between different levels of government

With the debt of local government rising sharply in recent years, fiscal consolidation also requires a revamping of relations between different levels of government. The "Trinity Reform", which aims at cutting earmarked grants and reforming block grants provided by the central government while increasing local tax revenues, is a step in the right direction. However, this initiative should include stronger mechanisms to discipline local government fiscal behaviour. To benefit more fully from decentralisation, local authorities should be allowed greater autonomy by reforming the grant system to increase their ability and incentives to provide better services at lower cost. In addition, the tax autonomy of local governments should be increased, while keeping the tax system as simple and neutral as possible.

Accelerating structural reforms to increase potential growth

Faster output growth is a key to meeting the challenges posed by the fiscal situation and population ageing. The top priorities are the privatisation of Japan Post and accelerating regulatory reform, in part by extending the measures in the special zones nation-wide. Competition should be enhanced by strengthening the Japan Fair Trade Commission, improving the regulatory framework in network industries and increasing openness to trade and inflows of FDI.

Addressing problems in the labour market

The share of non-regular workers has risen to more than a quarter of employees, enabling firms to reduce wage payments while enhancing flexibility. However, the increasing dualism of the labour market poses a number of efficiency and equity concerns that should be addressed by a comprehensive approach, including enhancing employment flexibility for regular workers, expanding the social security coverage of non-regular workers and other policies, such as training. Encouraging higher employment rates, particularly among women and youth, is essential to sustain Japan's growth potential in the face of rapid population ageing.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Japan were reviewed by the Committee on 6 December 2004. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 6 January 2005.

The Secretariat's draft report was prepared for the Committee by Randall S. Jones, Tadashi Yokoyama and Isabelle Joumard under the supervision of Willi Leibfritz.

The previous Survey of Japan was issued in February 2004.

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Assessment and recommendations

The current expansion is entering its fourth year

The Japanese economy is in its best shape in a decade thanks to buoyant external demand, the progress in restructuring the corporate sector and economic reforms. Output has increased at an annual rate of more than 2 per cent since 2002 and 3¼ per cent excluding the negative contribution from the public sector. The pace of growth has been sufficient to boost employment during the past year and reduce the unemployment rate from its record high. Profit margins, as well as confidence in the business and household sectors, are at their highest levels since the early 1990s. These positive developments raise hopes that Japan is emerging from a decade of economic stagnation, although there are a number of risks to the current expansion.

Nevertheless, Japan faces a number of serious challenges to sustained growth over the medium term

Despite these favourable trends, Japan must successfully address a number of challenges in order to sustain a robust expansion and ensure rising living standards in the face of rapid population ageing:

- Deflation remains entrenched, though at a low rate, and nation-wide land prices fell again in 2004, the 13th consecutive annual decline. In addition, bank lending continues to fall despite progress in rehabilitating the banking system.
- Large government budget deficits have boosted gross public debt to more than 160 per cent of GDP – the highest in the OECD area – just as Japan enters a phase of rapid population ageing, reinforcing concern about fiscal sustainability.
- A lack of fiscal discipline at the local government level is contributing to the run-up in debt. Moreover, problems in the relationship between different levels of government prevent Japan from reaping the benefits of decentralisation more fully.
- A number of structural problems, including weak competition in some sectors, limit Japan's growth potential.
- Increasing dualism in the labour market creates both efficiency and equity concerns, while population ageing is reducing the size of the workforce.

In sum, the positive developments during the current expansion do not reduce the urgency of a broad programme combining macroeconomic and structural policies.

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Despite the recent weakness, the economic upturn is projected to continue, bringing an end to deflation…

The expansion is projected to continue through the end of 2006, though at a more moderate pace of around 1½ per cent. The upturn has been led by business investment, reflecting the progress made in restructuring and rising profits from strong exports. China has played an important role, accounting for a third of the increase in Japanese exports during the past two years. Although the pace of business investment and export growth may slow, employment gains are likely to support private consumption. Such an outcome would help make this the longest upturn since the 1980s and may bring an end to six years of deflation, as measured by the consumer price index. However, the expansion paused in the second and third quarters and there are risks, both domestic and external, to a sustained expansion. On the domestic side, the strains related to the rising public debt and the risk of a marked increase in interest rates are most important, while a continued decline in nominal wages would weaken private consumption. On the external side, a slowdown in world trade in the context of rising oil prices, or a sharp appreciation of the yen could also weaken growth. All of these factors make the current outlook more uncertain.

… thanks in part to the Bank of Japan's policy of quantitative easing

In this uncertain context, *the Bank of Japan should remain focused on ending deflation* and its negative implications for economic growth. The quantitative easing policy has boosted the monetary base by 60 per cent over the past three years, preventing financial instability and keeping long-term interest rates low. The stability of the effective exchange rate during the first three quarters of 2004, despite no further intervention in the foreign-exchange market since March 2004, has helped to keep monetary conditions relaxed. The Bank of Japan promised in 2003 to continue the quantitative easing policy at least until core consumer price inflation (excluding fresh food, but including energy) is zero or above and the Bank's Monetary Policy Board projects it to be positive during the forecast period. The latter condition was partially fulfilled when the Board projected core inflation at 0.1 per cent in FY 2005, although it expects it to remain negative at –0.2 per cent in FY 2004.

When deflation ends, the exit from the current monetary policy should be carefully timed…

The success of the exit from the quantitative easing strategy depends in part on its timing. The stated conditions for changing monetary policy noted above leave open the possibility that an end to quantitative easing could occur when inflation is only marginally above zero. However, an early tightening of monetary policy could push Japan back into deflation. *The Bank of Japan should thus raise the threshold for ending quantitative easing to a level that is sufficiently high – such as 1 per cent – to make the risk of renewed deflation negligible*. On the other hand, maintaining the current monetary policy for too long may lead to high and sustained inflation, given the large expansion of the monetary base since 2001. On balance, though, the cost of overshooting the optimal level of inflation is less than remaining mired in deflation.

… and designed to help maintain financial-sector stability

Setting a higher inflation threshold as a condition for changing monetary policy would also help to guide private-sector expectations and prevent a large reaction in markets that could occur even before policy changes. The quantitative easing policy is implemented through central bank purchases of securities such as government bonds, commercial paper, bank bills and asset-backed securities. The Bank of Japan's purchases of government bonds have attracted private-sector investors to this market and resulted in a large run-up in bond prices. Once the current monetary policy comes to an end, there is a risk that long-term interest rates will increase substantially, leading to significant losses for financial institutions. Such a risk could be kept to a minimum by a clear communication strategy that provided as precise information as possible to the markets on how the exit strategy from quantitative easing would be conducted. At a minimum, a higher inflation threshold for ending quantitative easing as recommended above would delay the normalisation of interest rates, thus allowing banks more time to strengthen their balance sheets and increasing the scope for offsetting capital gains in other assets, including land and equities.

Further progress in rehabilitating the banking sector…

There has been progress in rehabilitating the banking sector, which is necessary for an effective monetary policy and a sustained recovery, given Japan's bank-centred financial system. The major banks, which have reduced their stock of non-performing loans (NPLs) from 8.4 per cent of their total lending in March 2002 to 4.7 per cent in September 2004, are on track to achieve the government's goal of reducing the ratio to about half of the March 2002 level by March 2005. At the same time, the banking sector has returned to operating profitability for the first time in a decade. However, the core profitability of banks remains low and there remains concern about the strength of their capital, given that "deferred tax assets" account for a third of the major banks' Tier I capital and are conditional on future profitability. This may be contributing to a decline in bank lending, adjusted for write-offs of NPLs, which has fallen for seven straight years. *The supervisory authorities should maintain the pressure on the banking sector to cut NPLs and strengthen capital.*

… particularly the regional banks, is a priority

Compared to the major banks, less progress has been achieved in restructuring the regional banks. Government policies towards these banks are driven, in part, by concerns about financing for small and medium-sized enterprises (SMEs). The authorities are monitoring plans submitted by 626 financial institutions in 2003 to revitalise SMEs and it recently bailed out a bankrupt regional bank in an effort to limit systemic risk in the region. These policies have contributed to a rising trend in regional bank lending, although this is due in part to their loans for housing, which are replacing declining public lending. However, pressuring banks to achieve targets for lending to SMEs may conflict with the banks' primary responsibility to their shareholders and may result in significant fiscal costs in the future. *To avoid such problems, the guidelines for lending to SMEs should be removed.*

The authorities should also establish specific measures for reducing NPLs, similar to those for major banks, and use caution in implementing the new scheme for public fund injections into regional banks to avoid moral hazard problems and large budgetary costs.

Fiscal consolidation is required to ensure the sustainability of public finances…

Addressing the government's budget deficit should be an important aspect of an exit policy as it would help avoid an abrupt rise in interest rates. Strong economic growth and spending restraint reduced the deficit in the primary budget (which excludes net interest payments) from 6¼ per cent of GDP in 2003 to an estimated 5 per cent in 2004. However, the current fiscal situation is clearly not sustainable. The impact of the sharp run-up in debt over the past decade has been limited by the exceptionally low level of interest rates on government bonds, reflecting easy monetary policy, the risk aversion of investors and the persistence of deflationary expectations. Consequently, government interest payments as a share of GDP are lower than a decade ago despite the higher level of public debt. The transition to positive rates of inflation will boost interest payments, creating a risk of financing strains. As long as higher interest rates are accompanied by a pick-up in nominal growth, the risk is limited as there should be higher tax revenue, although the tax base has been eroded by various exemptions introduced during the past decade. A more serious threat to the fiscal situation would be a rise in the real interest rate.

… through a more credible and detailed medium-term plan…

The government's *Medium-Term Economic and Fiscal Perspective*, revised in early 2004 and extending through FY 2008, set a target of a primary budget surplus by the early 2010s. Indeed, a surplus is likely to be necessary to stabilise government debt, depending on the path of growth, interest rates and inflation, implying a fiscal adjustment of more than 5 per cent of GDP. The *Perspective* calls for limiting the size of general government spending to near its FY 2002 level (38 per cent of GDP) through FY 2006, combined with some unspecified revenue increases, to reduce the primary deficit by ½ per cent annually over the next four years. Preliminary budget plans suggest that a reduction of around ¼ per cent of GDP will be achieved in 2005, thanks to continued economic growth, spending restraint and some revenue measures, including a hike in the pension contribution rate. Even if consolidation advanced at the ½ per cent of GDP pace included in the *Perspective*, it would take more than a decade to meet the target, by which time gross debt might have risen to 200 per cent of GDP or more, imposing a significant burden on the economy and increasing the possibility of a rise in the risk premium. The negative impact of the high debt in Japan, however, is limited by the high private-sector saving rate and the low level of interest rates. Nevertheless, the medium-term plan should be more ambitious, even though special circumstances make fiscal consolidation more challenging in Japan than in other OECD countries. At a minimum, *the government should achieve its goal of a ½ per cent reduction in the budget deficit per year. However, if economic outturns are better than expected, the pace of consolidation should be faster. The credibility of the Perspective should be enhanced by establishing a stronger link to spending and revenue decisions, as well as by securing effective policy feedback to prevent slippage from the target. Finally, the medium-term plan should be extended beyond 2008 and should be based on more realistic economic assumptions.*

… that includes reform of the social security system and cuts in public investment…

The objective of freezing government expenditures as a share of GDP should be achieved through FY 2006 and continued efforts to restrain spending are necessary in the future. *This will likely require further reform of social security programmes – pensions, healthcare and long-term nursing care* – given the spending pressures related to population ageing. Despite the 2004 reform to cut pension benefits, social security outlays are projected to rise by 1½ per cent of GDP by 2010, and this may underestimate the impact of population ageing. Legislation passed in June 2004 to increase the pension contribution rate for the Employees' Pension Insurance from 13.6 to 18.3 per cent by 2017 may help finance rising expenditure. However, already in 2002, the proportion of pension contributions that are evaded was 37 per cent – well above the level assumed in the government's projections – and the increase in the contribution rate may further reduce participation in the system and weaken work incentives. The 2004 reform is projected to reduce the pension benefit replacement rate from 59 to 50 per cent – the minimum level allowed – over the next two decades. *Contribution rates should not be raised further, even if unfavourable developments were to require lower replacement rates. Moreover, reforms are needed to slow the growth of public spending on health and long-term nursing care*. Given the challenge of limiting social security expenditures and rising interest payments, significant cuts in discretionary outlays are required to achieve the spending ceiling. *In particular, public investment, much of which is characterised by low efficiency, should be cut further.* At 5 per cent of GDP, public investment remains above the OECD average of 3 per cent.

Fiscal consolidation will require increased tax revenues…

Achieving the target of freezing public expenditures as a share of GDP will be challenging in the context of population ageing, as well as rising interest payments. Consequently, the necessary fiscal consolidation – more than 5 per cent of GDP – will require increases in government revenue, which, at 30 per cent of GDP, is among the lowest in the OECD area. To increase revenue, *the government should put more emphasis on closing loopholes and streamling tax relief and allowances so as to broaden the tax base, thus limiting the extent of tax hikes*, which have negative effects on growth. Nevertheless, given the size of additional revenue that is needed, *higher tax rates will be necessary, particularly for the consumption tax.* However, the timing of such increases should take into account economic conditions.

… and reforming relations across levels of government

Revamping fiscal relations across levels of government, the topic of the special chapter in this *Survey*, is of paramount importance in supporting fiscal consolidation. Local government debt has ballooned from less than 15 per cent of GDP in the early 1990s to 40 per cent in FY 2003. While the negative aspects of decentralisation have thus materialised, the benefits have not yet been fully reaped. In particular, local government's ability to innovate and respond to the preferences of local citizens is constrained, the fragmented provision of publicly-funded services results in diseconomies of scale and the

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decentralised tax system is too complex. The "Trinity Reform" plans to reduce earmarked grants, reform equalisation grants and increase local taxes. However, for this reform to be fully effective, it must be accompanied by bolder initiatives in at least three areas: mechanisms to discipline local government fiscal behaviour and to improve the efficiency of intergovernmental grants and local taxes.

Reform should focus on strengthening mechanisms to discipline local government fiscal behaviour…

Mechanisms to secure fiscal discipline at the local government level need to be improved as they are too lenient and their coverage is inadequate. Such mechanisms were overridden by expansionary fiscal policies implemented during the past decade. The planned removal of the central government's approval system for local bond issues in FY 2006 calls for a strengthening of other instruments, notably fiscal rules and market instruments. *To be effective, existing fiscal rules should be hardened, while support to local jurisdictions facing financial troubles should be reduced, so as to limit moral hazard problems. Financial markets should be allowed to play a more prominent role in disciplining local government behaviour through credit ratings in bond markets. This would require that the central government state clearly that it will not intervene as a lender of last resort to local governments and ensure that adequate information on local governments' outstanding and implicit liabilities is readily available.*

… improving the grant system…

Intergovernmental grants have been used extensively for macroeconomic stabilisation and income redistribution, often at the expense of allocative efficiency. *The grant system should be reformed to promote local governments' ability and incentives to introduce managerial innovations so as to better respond to needs at lower cost*. This would require basing the equalisation criteria on objective needs, rather than actual spending, and changing the conditionality of earmarked grants from input or procedural criteria to outcomes. *In parallel, the use of earmarked grants should be reduced*, relying as much as possible on independent cost-benefit analysis and examining whether alternative financing methods – block grants or direct transfers to individuals – would be more cost-effective. *The grant system should also be amended to eliminate incentives to issue debt by removing local bond repayment costs from the formula used to calculate grant entitlements*. This would also help to contain sub-national spending or at least encourage the development of the local tax base. In addition, *the amount available for equalisation grants should no longer be set at a fixed share of annual national tax revenues* in order to avoid a pro-cyclical trend in local government spending.

… and increasing the tax autonomy of local governments to ensure neutrality

Making the cost of local public services more visible to local taxpayers can enhance fiscal discipline. *This calls for increasing the effective tax autonomy of local governments while keeping the tax system as simple and neutral as possible*. Although there are a number of local government taxes, revenues have been restricted by a proliferation of rebates and existing discretionary powers have been used in a limited and often distorted way. *Rather than* *creating new local taxes, many of the existing rebates should be removed, while introducing market valuation of property for tax purposes. In addition, the deduction of local taxes from central government tax bases should be ended, while central government permission to issue local bonds should no longer be conditional on local authorities applying tax rates at, or above, the rates set by the central government. At the same time, reliance on taxes that are highly volatile or can be easily shifted to other jurisdictions or which may hamper the swift adjustment of the economy over the economic cycle should be avoided.*

Special zones should be used to increase local autonomy while accelerating the pace of structural reform

Getting the most out of decentralisation requires complementing greater fiscal autonomy for local governments with more independence in the regulatory framework. The major initiative in this regard is the creation of special zones in which key regulations are abolished or modified on a trial basis. Since April 2003, 328 such zones have been created, based on 120 special measures. Successful reforms will be expanded nation-wide following evaluation by a special committee. *It is essential to make this initiative an effective tool for advancing nation-wide reform rather than simply a policy for regional development. This distinction could be reinforced by separating the responsibility for regional policy from the office in charge of special zones. In addition, reforms in the zones should be applied on a national basis as quickly as possible, avoiding extended evaluation periods.* Rather than depending solely on the initiative of local governments, *there should be a top-down aspect to the programme to identify districts that are suitable for certain regulatory changes.*

Building on the success of past efforts…

Such an approach should help make the special zones an effective tool for accelerating regulatory reform, a government priority that has had some success during the past decade. For example, entry barriers in the trucking industry were eliminated, large consumers of electricity have been allowed to choose suppliers and price controls on petroleum products have been abolished. Moreover, urban zoning regulations have been reformed to encourage more efficient use of land and the requirements for starting new companies have been relaxed. According to the government, regulatory reform has boosted consumer surplus by an amount equal to almost 5 per cent of national income.

… it is essential to speed up regulatory reform…

Regulatory reform is directed by the newly created *Headquarters for the Promotion of Regulatory Reform*, which is composed of all cabinet members. *The new framework, which allows proposals to be discussed by all ministries, including those favouring change, should be used effectively to overcome vested interests opposed to reform.* It should also help narrow the gap between the annual report prepared by the private-sector council of experts and the *Three-Year Plan for Promotion of Regulatory Reform*, which is updated annually by the government. The 2004 version focuses on opening "government-driven markets" to the private sector. *The government should make the reform of these sectors, concentrated in social welfare areas such as medical services and nursing care, a priority given rapid population ageing.* A new initiative is the introduction of "market testing" to determine what services currently provided by the government could be produced more efficiently by the private sector. *Such an approach should be used effectively to benefit consumers, promote fiscal consolidation and provide new opportunities to the business sector.*

… and introduce measures to enhance competition, especially in network industries…

Opening government-dominated markets to the private sector would enhance competition, which appears weak in Japan according to a number of indicators. Stronger competition would help lower prices that are high by international comparison and promote innovation, thus boosting consumer welfare and improving resource allocation. *A priority is to upgrade competition policy by increasing surcharges on violations of the Anti-Monopoly Act*. This would make firms take competition policy more seriously and allow the introduction of an effective leniency programme for firms reporting collusive activities to the competition authority. In addition, *a whistleblower programme to counter widespread anti-competitive collusion should be implemented to protect individuals*. Competition is also weakened by a *regulatory policy framework for network industries that still needs to be improved*. Most OECD countries have established sectoral regulators, independent of the government, to ensure pro-active *ex ante* regulation, a necessary condition for introducing competition in markets dominated by strong incumbents. Japan tries to achieve these objectives through government ministries. In the electricity and natural gas sectors, competition has been hampered by market structures characterised by local monopolies. The reforms in the past year were important steps for the establishment of physical interconnection and non-discriminatory access charges and conditions. *The vertical unbundling of activities should be considered for further enhancement of competition*.

… while increasing openness to trade and investment

Greater openness to direct investment and trade are also keys to enhancing competition. The government has established a goal of doubling the cumulative amount of foreign direct investment in Japan in five years. In fact, there was a three-fold rise between 1998 and 2003. The objective of doubling the amount is to be accomplished by reducing obstacles and pro-active measures such as disseminating relevant information. Attracting more foreign direct investment, though, will likely require additional steps. *First, regulatory tools, particularly the No-Action Letter system and the Public Comment Procedure, should be improved to enhance transparency and encourage greater foreign participation in the Japanese economy. Second, the mergers and acquisition market should be activated by removing discriminatory provisions governing the acquisition of Japanese firms by foreign investors. In addition to direct investment, barriers to trade should be reduced through multilateral trade negotiations, as well as Japan's inclusion in regional free trade agreements*. Both are likely to require reductions in the level of protection granted to farmers in Japan, including *a further opening of the rice market. Aspects of multifunctionality in agriculture, such as protecting the environment, should be dealt with by adopting well-targeted policy measures that minimise trade distortions.*

The privatisation of Japan Post is the government's top priority for structural reform

The centrepiece of the government's structural reform programme is the privatisation of Japan Post, which is the world's largest financial institution. It includes postal savings and life insurance, which dominate their respective sectors in Japan thanks to special privileges such as government guarantees and exemption from taxes. The privatisation of Japan Post offers a number of potential benefits: providing better services at a lower cost for consumers; removing government support and improving resource allocation; and shifting the flow of funds from the public to the private sector, thereby enhancing Japan's growth potential and promoting fiscal consolidation. The privatisation is to begin with the separation of Japan Post into four entities, including a Postal Savings Company and a Postal Life Insurance Company, in April 2007. However, realising the desired benefits requires that:

- *There should be a level playing field between Postal Savings and Postal Life Insurance and private institutions, including equal treatment under the regulatory framework.*
- *Postal Savings and Postal Life Insurance should not be allowed to offer new products before the establishment of equal treatment.*
- *The privatisation, which is to be finished by 2017 at the latest, should aim at a complete divestiture of the government's holdings in financial services.*

The management of Postal Savings and Postal Life Insurance should have the same independence as private institutions in formulating their business plans once a level playing field is achieved.

Reforms are needed in the labour market, where dualism is increasing…

Employment flexibility is being achieved through increased hiring of non-regular workers, who have temporary contracts, boosting their share over the past decade from 19 to 29 per cent of total dependent employment. In addition to enhancing flexibility, non-regular workers are relatively inexpensive; the average hourly wage of part-time employees, who account for three-quarters of non-regular workers, is only 40 per cent that of regular workers. The increasing dualism is creating a group, concentrated among young people, with short-term employment experience and low human capital, given the important role of firm-based training in Japan. There are also important equity problems, given that the difference in productivity between regular and non-regular workers is much smaller than the wage gap. The equity concern is magnified by the lack of movement between the two segments of the workforce, trapping a significant portion of the labour force in a low-wage category from which it is difficult to escape. *Stopping the trend towards increased dualism requires a comprehensive approach. This should include reducing employment protection for regular workers, increasing the coverage of temporary workers by social security insurance and other policies, such as training programmes, to enhance the employment prospects of non-regular workers.*

… in part to address the high unemployment rate for young people…

A significant portion of non-regular employment is concentrated among young people. Nevertheless, the unemployment rate for the 15 to 24 age group is about 10 per cent, about double the national average. Increased unemployment of young people reflects reduced hiring of new graduates as firms have cut their workforces during the past decade of sluggish growth. *Reducing employment protection for regular workers could reverse this trend by preventing the adjustment of the workforce from falling disproportionately on young people.* The government has taken steps to increase the capacity of the public employment service to assist young people. *It is important, though, to improve job training programmes aimed at young people in order to enhance their job prospects.*

… while taking measures to promote higher labour force participation of women

With women accounting for more than two-thirds of non-regular workers, reversing the trend toward labour market dualism may help to boost female participation rates by providing more attractive job opportunities. A higher participation rate of women would help buffer the impact of the decline in the working-age population, which is projected to fall by 5 per cent in the decade 2000 to 2010. Private-sector practices, such as company allowances for spouses, the importance of tenure in setting wages and the use of age limits on potential new workers may also have a negative impact on female participation in the labour force. *The government should reduce or eliminate aspects of the tax and social security system that discourage women from working full-time. In addition, relaxing licensing conditions for private-sector childcare facilities may facilitate female labour force participation. Finally, the high participation rate of older workers should be maintained by further reforming the pension system to reduce incentives to retire between the ages of 60 and 64.*

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Chapter 1

Key economic challenges facing Japan

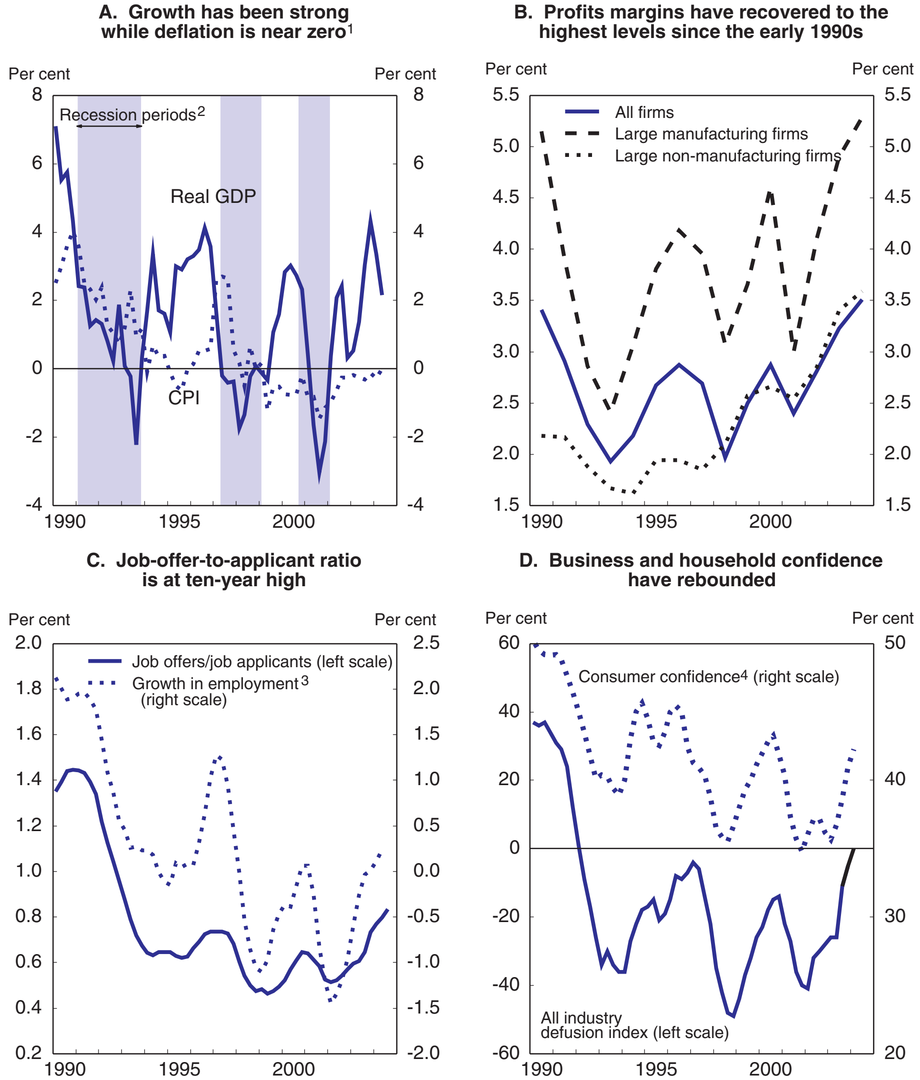
This chapter discusses the key challenges facing the Japanese economy. Although the current expansion is encouraging, there are a number of problems that will make it difficult to sustain growth over the medium term and ensure rising living standards. Five key challenges are addressed in this chapter: i) *bringing an end to deflation, which has negative implications for growth, and further rehabilitating the banking sector to sustain the expansion;* ii) *ensuring fiscal sustainability in the face of the sharp run-up in debt and population ageing;* iii) *improving relations between levels of government in order to benefit more fully from decentralisation and increasing the fiscal discipline of local governments;* iv) *raising Japan's growth potential through structural reform and stronger competition; and* v) *improving the functioning of the labour market by addressing the trend toward greater dualism and encouraging greater labour force participation.*

Following a decade of stagnation in the wake of the collapse of the bubble in the early 1990s, a number of indicators suggest that there has been a marked improvement in the Japanese economy (Figure 1.1). Output has been growing at an annual rate of slightly more than 2 per cent since 2002, according to the revised national accounts using the chain-linked methodology (see Annex 1.A1). The rate of deflation, as measured by the consumer price index, has been stable at less than ¼ per cent (Panel A). Profit margins and the return on assets have risen to their highest levels since the early 1990s (Panel B). In the labour market, the job offer to applicant ratio is now more than 0.8, a level not seen since 1993, and employment is increasing (Panel C). These favourable developments have boosted business confidence to its highest level since the early 1990s (Panel D).

The improved economic conditions are due in part to buoyant export growth and the progress made in restructuring the corporate sector, which have boosted profitability and helped to fuel a rebound in business investment. In addition, the present government has contributed importantly to these positive developments through the implementation of a reform programme aimed at shifting power from the government to the private sector and from central to local government. Perhaps most important has been the emphasis placed on restructuring the banking sector and upgrading prudential supervision, thereby reducing the threat of financial-sector fragility. And in contrast to the ineffective fiscal stimulus programmes pursued during the 1990s, the government has cut public investment by more than a quarter during the past three years, thus improving the allocation of resources and limiting the growth of public expenditures. In addition, important regulatory reforms, such as easing requirements for starting new companies and relaxing land-use regulations in urban areas, have been implemented. The government has now embarked on its most ambitious project – the privatisation of Japan Post, the largest financial institution in the world. It has also made the strengthening of international competition a top priority, notably through increasing inflows of foreign direct investment and pursuing free trade agreements.

While the recent progress is certainly encouraging, there are a number of difficult challenges that must be overcome in order to put a definitive end to a decade of economic stagnation. Deflation, as measured by the consumer price index, is now in its sixth year, while the GDP deflator has been declining since 1995. The fall in bank lending since 1998 has reduced total bank credit by 150 trillion yen (30 per cent of GDP). Given the reliance on land as collateral for lending, banks have been negatively affected by the fall in nation-wide land prices, now in its 13th year. Looking ahead, financial institutions may be vulnerable to turbulence in financial markets during the transition to positive inflation and the end of zero interest rates. Meanwhile, the government's financial position continues to deteriorate, in part due to a lack of fiscal discipline at the local government level. Gross public debt has surpassed 160 per cent of GDP, the highest in the OECD area, just as Japan enters a period of declining population and pressure for increased ageing-related expenditures. The growing share of the elderly makes productivity growth essential to support rising living standards. However, the reforms needed to accelerate productivity

Figure 1.1. **The best economic conditions in a decade**



1. Seasonally-adjusted quarterly changes at annual rate, three-quarter moving average.
2. The identification of recessions is based on detailed analyses of a variety of indicators.
3. Growth over four quarters with a three-quarter moving average.
4. Three-quarter moving average.

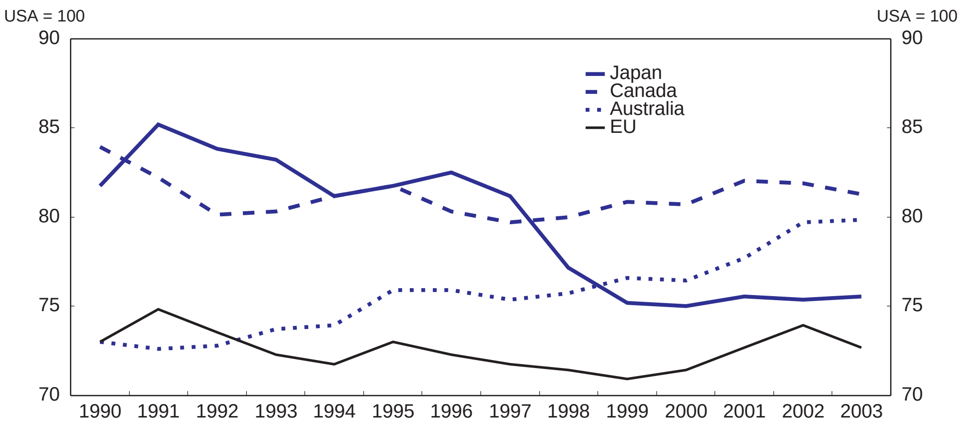
Source: Cabinet Office, Bank of Japan, Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications and Ministry of Economy, Trade and Industry.

gains continue to advance at a modest pace. In the labour market, the rising share of non-regular workers, who are subject to significantly lower wages, precarious employment and less protection by the social safety net, creates both efficiency and equity concerns. After a brief look at Japan's growth prospects over the medium term, this chapter addresses the key challenges of bringing deflation to an end and supporting the recovery, achieving fiscal sustainability, reforming relations between levels of government, removing obstacles to faster economic growth and improving the functioning of the labour market. The chapter concludes with a brief assessment.

Japan's economic prospects over the medium term

Japan's per capita income relative to the United States has fallen from a peak of 85 per cent when the bubble collapsed in the early 1990s to 75 per cent in 2003, in contrast to many other OECD countries that were able to continue the convergence process or at least avoiding losing ground (Figure 1.2). This disappointing performance reflects a sharp deceleration in Japan's growth potential from a rate of nearly 4 per cent in the later half of the 1980s to 1½ per cent during the past decade (Figure 1.3). A report by the Cabinet Office estimates that potential growth fell even further, to 1.2 per cent in the first half of 2004. One key factor in the deceleration was the shift of labour inputs from a positive to a negative contribution since 1990, reflecting a reduction in working hours, a substantial rise in structural unemployment and a decline in the working-age population since 1996. A

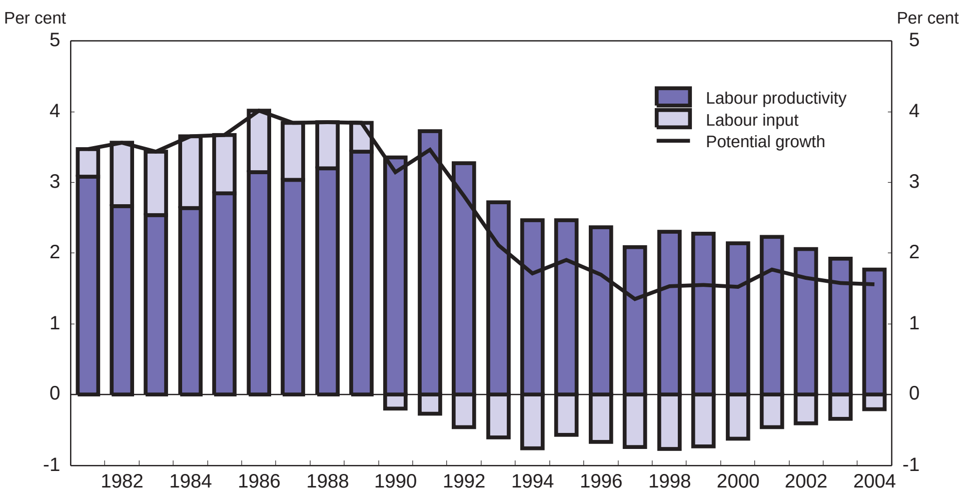
Figure 1.2. **Per capita income in Japan has fallen relative to other OECD countries**



Note: Based on current purchasing power parities.

Source: OECD, *National Accounts of OECD Countries*.

Figure 1.3. **Potential growth in Japan**



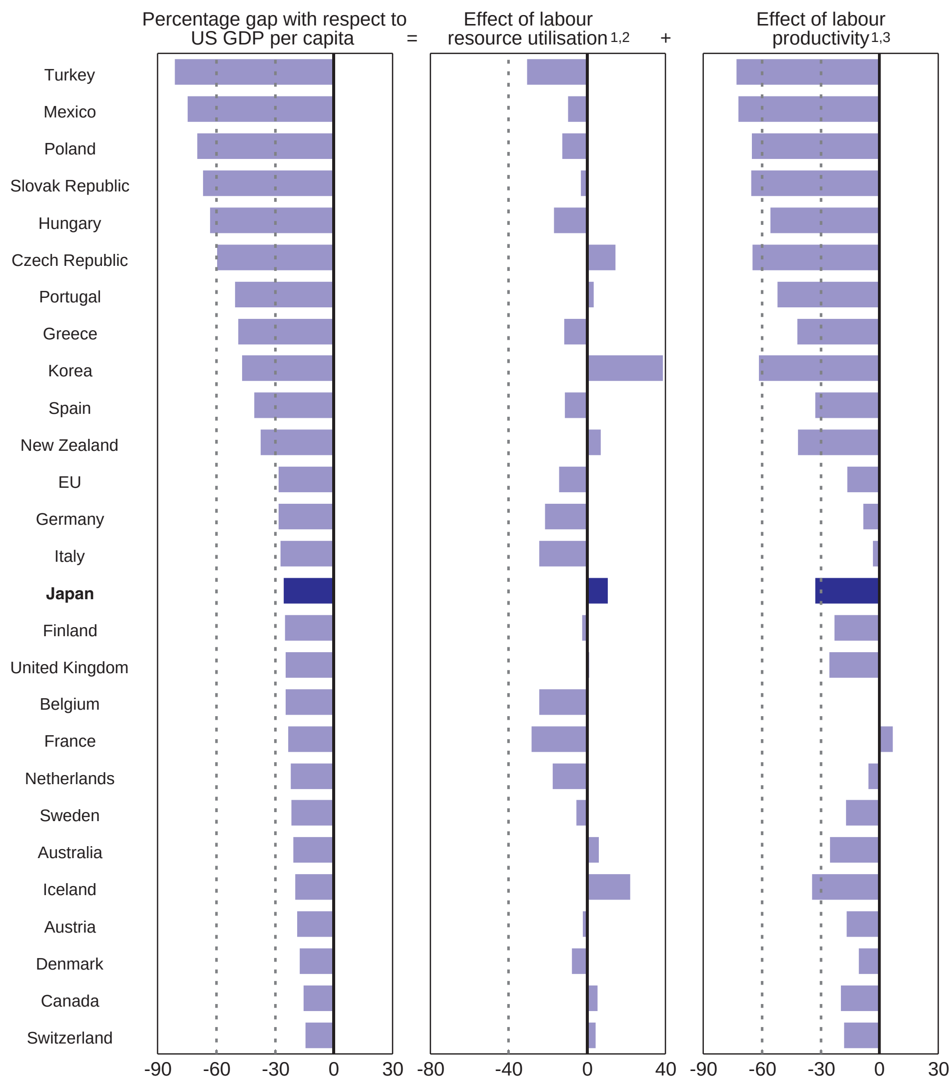
Source: *OECD Economic Outlook*, No. 76.

second, more important factor has been a deceleration in labour productivity growth from more than 3¼ per cent in the second half of the 1980s to around 2 per cent during the past decade.

Japan's income per capita is a quarter below the US level, putting it in the middle of the OECD countries by this criterion. Taking account of the level of labour inputs, labour productivity in Japan is more than 30 per cent below that in the United States, the largest gap among the seven major economies (Figure 1.4). The size of the gap and the deceleration of Japan's growth potential are somewhat surprising in light of Japan's strong fundamentals in some of the indicators identified in the OECD's *Growth Study* as important determinants of

Figure 1.4. **The sources of real income differences**

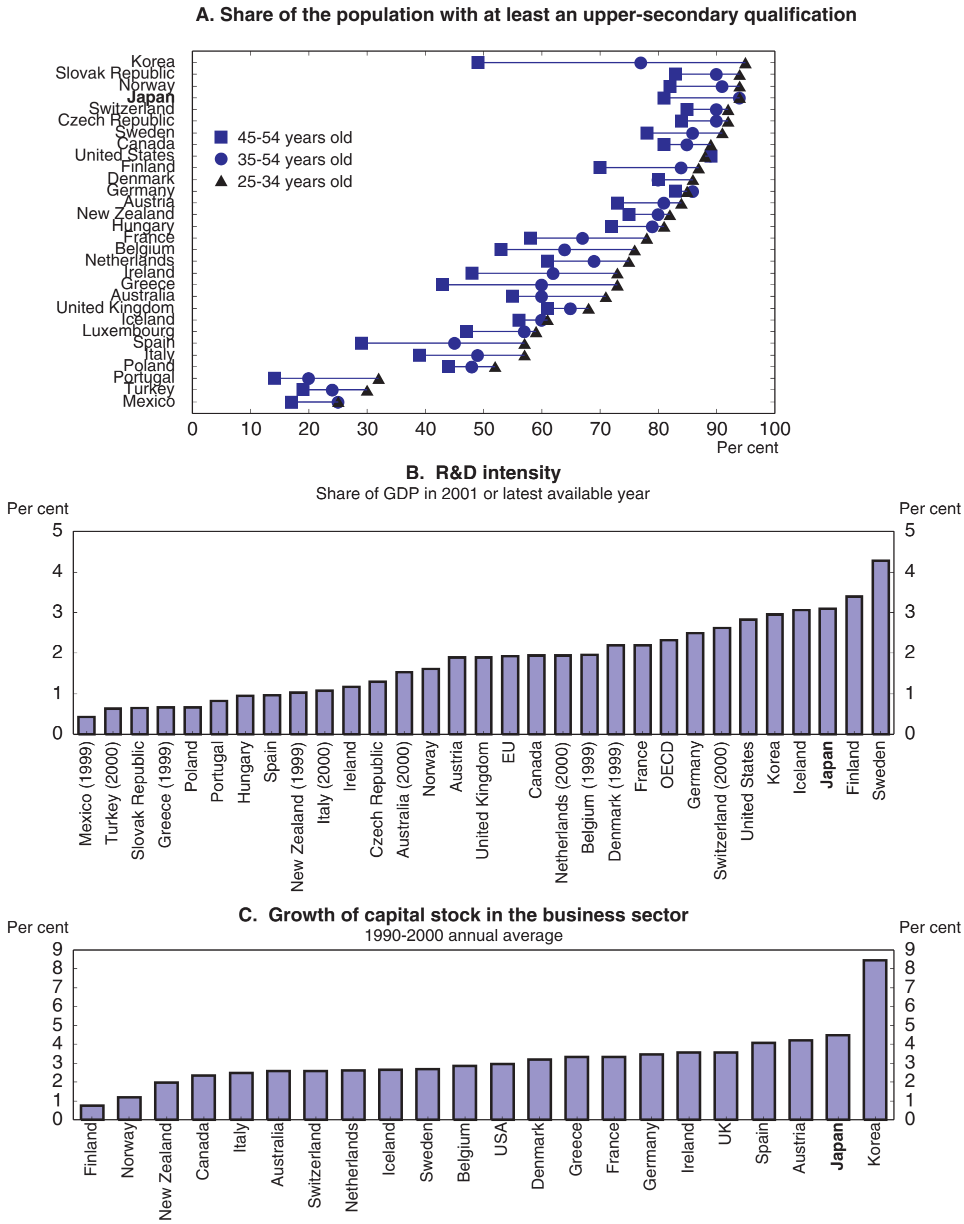
In 2002, using PPP exchange rates



1. Percentage gap with respect to the United States level.
2. Labour resource utilisation is measured as trend total number of hours worked divided by population. Information on hours worked for Austria, Luxembourg and Poland is not available.
3. Labour productivity is measured as trend GDP per hour worked.

Source: OECD, *The Sources of Economic Growth in OECD Countries*.

Figure 1.5. **Sources of growth**



Source: *OECD Education at a Glance*, *OECD Science, Technology and Industry Scoreboard* and *OECD Economic Outlook*, No. 76.

growth. For example, the proportion of the population between the ages of 35 and 54 with at least a secondary school education is the highest in the OECD area (Figure 1.5). Educational standards appear high, according to the PISA tests comparing the performance of 15-year-old students. Indeed, Japan ranked first among the OECD countries in math and second in science. In addition, R&D expenditures in Japan account for 3 per cent of GDP, the third-highest share in the OECD area, with an exceptionally large share funded and undertaken by the business sector (Panel B). Another positive factor for growth is investment in physical capital. During the 1990s, Japan's capital stock increased at an annual rate of 4.5 per cent, the second highest in the OECD area after Korea (Panel C).[1] Japan has also shown improvement in the degree of openness to international competition, another key to growth identified in the *Growth Study*.

The stock of inward foreign direct investment tripled between 1998 and 2003, although its level as a share of GDP is still the lowest in the OECD area. Manufactured imports as a share of GDP have also been on an upward trend. Despite the high level of investment in physical capital and knowledge and increasing international openness, Japan experienced a sharp slowdown in growth in the 1990s and the emergence of a significant productivity gap relative to some other leading economies. While weak demand in the wake of the collapse of the bubble was certainly an important factor in this decline, it also suggests fundamental problems in allocating resources efficiently in Japan.

Future economic growth prospects, as noted above, can be attributed to labour inputs and labour productivity growth. Labour inputs are determined in part by working hours and the labour force participation rate, which are both high in Japan. Indeed, working time, at about 1 800 hours per year, is 8 per cent above the OECD average, while the labour force participation rate, at 77½ per cent of the working-age population, is significantly higher than the OECD average of 70 per cent.[2] If these factors, as well as the structural unemployment rate, were to remain unchanged at their 2004 levels, and if the decline in the working-age population continues at the 0.2 per cent annual rate recorded in the first four years of this decade, the potential growth rate would remain at 1.6 per cent over the period 2004 to 2010 (Scenario B in Table 1.1).[3]

However, labour inputs are likely to be reduced more sharply by demographic factors. Between 2004 and 2010, the Japanese government projects that the decline in the working-age population will accelerate to a 0.7 per cent annual rate (Table 1.2), while an increasing number of elderly persons will keep Japan's total population virtually constant. Consequently, the elderly dependency ratio will rise by 3 percentage points by the end of the decade, although it will be accompanied by a decline in the youth dependency ratio. Indeed, the number of workers per elderly person is projected to fall from 2.6 in 2004 to 2.1 in 2010. The demographic projection of the Japanese authorities implies that potential growth would slow to a 1.1 per cent rate over the period 2004 to 2010 (Scenario C in Table 1.1), assuming as before that working time, the labour force participation rate and structural unemployment remain at their present levels. However, if in addition, working hours were to fall halfway to the OECD average,[4] the potential growth rate would be reduced to only 0.4 per cent over the period 2004 to 2010.

In summary, while a few other OECD countries will also experience negative contributions to growth from demographic factors, the impact in Japan is by far the largest (Table 1.3). The OECD's Medium-Term Baseline (Scenario A in Table 1.1) projects a potential growth rate of 1.3 per cent over the period 2004 to 2010. This is based on the assumption that working hours remain virtually unchanged and that the participation rate rises by 1 percentage point. In addition, it incorporates a 1.7 per cent annual rise in trend labour productivity, compared to an OECD average of 2¼ per cent. Even if these favourable assumptions are fulfilled, the resulting potential growth rate would be significantly below the 2 per cent rate included in the Medium-Term Economic and Fiscal Perspective, which aims at a primary budget surplus by the early 2010s (see below). Achieving such a growth rate would require that labour productivity growth accelerate to a 2½ per cent annual rate (Scenario D). In sum, Japan needs to increase labour force participation rates and keep working hours relatively high, while maintaining productivity growth, in order to sustain per capita income gains at around 1½ per cent a year, which is close to the average of the other G-7 countries since 1990.

Table 1.1. **Japan's potential growth rate over the medium term**

Annual average in percentage points[1]

	2000-04	2004-10	2000-10
A. The OECD's medium-term baseline			
Potential growth	1.6	1.3	1.4
Labour force	0.0	–0.5	–0.3
Working-age population	–0.2	–0.7	–0.5
Trend participation rate	0.2	0.2	0.2
Potential employment[2]	–0.1	–0.5	–0.3
Hours worked[3]	–0.2	0.0	–0.1
Total labour input	–0.4	–0.5	–0.4
Labour productivity growth	2.0	1.7	1.8
Potential growth rate per capita	1.5	1.3	1.4
B. Ageing advances at a constant rate and no change in the participation rate[4]			
Potential growth	1.6	1.6	1.6
Labour force	0.0	–0.2	–0.1
Working-age population	–0.2	–0.2	–0.2
Trend participation rate	0.2	0.0	0.1
Potential employment[2]	–0.1	–0.2	–0.1
Hours worked[3]	–0.2	0.0	–0.1
Total labour input	–0.4	–0.2	–0.2
Labour productivity growth	2.0	1.7	1.8
Potential growth rate per capita	1.5	1.6	1.6
C. Ageing accelerates as projected and no change in the participation rate[5]			
Potential growth	1.6	1.1	1.3
Labour force	0.0	–0.7	–0.4
Working-age population	–0.2	–0.7	–0.5
Trend participation rate	0.2	0.0	0.1
Potential employment[2]	–0.1	–0.7	–0.4
Hours worked[3]	–0.2	0.0	–0.1
Total labour input	–0.4	–0.7	–0.5
Labour productivity growth	2.0	1.7	1.8
Potential growth rate per capita	1.5	1.2	1.3
D. Baseline scenario with an acceleration in productivity growth			
Potential growth	1.6	2.0	1.8
Labour force	0.0	–0.5	–0.3
Working-age population	–0.2	–0.7	–0.5
Trend participation rate	0.2	0.2	0.2
Potential employment[2]	–0.1	–0.5	–0.3
Hours worked[3]	–0.2	0.0	–0.1
Total labour input	–0.4	–0.5	–0.4
Labour productivity growth	2.0	2.5	2.2
Potential growth rate per capita	1.5	2.0	1.8

1. These estimates were made prior to the introduction of chain-linked indices in the national accounts in December 2004.
2. During the 2000 to 2004 period, the rise in the structural unemployment rate made a negative 0.1 contribution to potential employment.
3. In each of the scenarios, hours worked during the period 2004 to 2010 are assumed to increase by a small positive amount that rounds to zero.
4. The decline of the working-age population continues at the 2000 to 2004 pace of 0.2 per cent over the period 2004 to 2010, while the participation rate remains at its 2004 level of 78.3 per cent.
5. The decline of the working-age population accelerates to the 0.7 per cent rate projected by the government, while the participation rate remains at its 2004 level.

Source: OECD Economic Outlook, No. 76.

Table 1.2. **Japan's demographic outlook**

	2000-04	2004-10[1]	2000-10
A. Growth rates			
Working-age population	–0.2	–0.7	–0.6
Population over 65	2.9	2.5	2.7
Total population	0.1	–0.0	0.0
	2000	2004	2010
B. Dependency ratios			
Elderly dependency ratio[2]	17.4	19.4	22.5
Youth dependency ratio[3]	14.6	14.0	13.4
Total dependency ratio[4]	32.0	33.4	35.9
Number of employed per elderly person[5]	2.9	2.6	2.1

1. Projection by the Ministry of Health, Labour and Welfare.
2. Population over 65 years of age as a share of working-age population (15 to 64).
3. Population under 15 years of age as a share of working-age population (15 to 64).
4. Sum of elderly and youth dependency ratios.
5. Assuming that the unemployment and participation rates remain at their 2004 levels.

Source: Ministry of Health, Labour and Welfare.

Table 1.3. **International comparison of potential output growth**

Annual average from 2004 to 2010 in percentage points

	Potential GDP growth rate	Potential labour productivity growth (output per hour)	Potential labour input (total hours worked)	Components of potential employment				Hours worked
				Trend participation rate	Working-age population	Structural unemployment	Potential employment growth	
Japan	**1.3**	**1.7**	**–0.5**	**0.2**	**–0.7**	**0.0**	**–0.5**	**0.0**
Australia	3.4	2.2	1.2	0.0	1.1	0.0	1.1	0.1
Austria	2.1	1.9	0.2	0.1	0.0	0.0	0.2	0.0
Belgium	2.1	1.9	0.2	0.3	0.3	0.0	0.6	–0.3
Canada	3.0	2.1	1.0	0.1	1.0	0.0	1.1	–0.1
Denmark	1.9	1.7	0.2	–0.1	0.0	0.0	–0.1	0.3
Finland	1.9	2.3	–0.4	–0.3	0.1	0.1	–0.1	–0.3
France	2.0.	1.5	0.6	–0.1	0.4	0.0	0.3	0.3
Germany	1.6	1.8	–0.2	0.2	–0.2	0.0	0.0	–0.2
Greece	3.7	3.0	0.7	0.4	–0.1	0.1	0.5	0.2
Iceland	3.9	2.6	1.3	0.0	1.3	0.0	1.4	–0.1
Ireland	4.6	3.7	0.9	0.3	0.8	0.1	1.3	–0.3
Italy	1.6	1.5	0.1	0.5	–0.2	0.1	0.2	–0.1
Korea	4.6	3.6	1.0	0.2	0.9	0.0	1.1	0.0
Netherlands	1.8	1.3	0.5	0.2	0.3	0.0	0.6	0.0
New Zealand	3.4	2.2	1.1	0.1	1.1	0.0	1.2	0.0
Norway	2.9	2.4	0.5	0.1	0.7	0.0	0.7	–0.3
Spain	2.8	1.4	1.4	1.0	0.8	0.1	1.6	–0.1
Sweden	2.4	1.4	1.0	–0.2	0.5	0.0	0.3	0.7
Switzerland	1.5	1.2	0.3	0.1	0.3	0.0	0.4	0.0
United Kingdom	2.6	2.2	0.3	0.0	0.5	0.0	0.5	–0.1
United States	3.2	2.3	0.9	–0.2	1.1	0.0	0.8	0.1
Euro area	2.0	1.6	0.3	0.3	0.1	0.1	0.4	–0.1
Total OECD	**2.7**	**2.2**	**0.5**	**–0.2**	**0.7**	**0.0**	**0.5**	**0.0**

Source: OECD Economic Outlook, No. 76.

Key challenges facing Japan

The medium-term outlook underlines the need to accelerate output growth in the context of population ageing and rising public debt. It is thus essential to avoid complacency about the strength of the recovery and to press ahead with macroeconomic policies to promote sustainable growth while speeding up structural reforms to remove obstacles limiting the economy's growth potential. This section outlines the major challenges that will be analysed in the following chapters. A serious environmental problem – improving air quality – is addressed in Box 1.1.

Ending deflation and sustaining the economic expansion

Overcoming deflation remains the top priority for the monetary authorities. The persistence of price declines in the face of a 4¼ per cent pace of growth during the first half of 2004 indicates the degree to which deflation has become entrenched after six years. Indeed, about 60 per cent of the items in the consumer price index are reporting falling prices. Nevertheless, the growth-inhibiting effects of deflation have diminished as deflation has moderated, at least according to some measures (Box 1.2), and the risk of a deflationary spiral has receded. However, even the low rate of deflation appears to have a negative impact, particularly on the financial sector. *First*, it increases the burden of liabilities, thereby resulting in delayed payments and defaults, which hurt financial institutions. *Second*, deflation transfers income from debtors to creditors, who generally have lower marginal propensities to spend, thus tending to reduce aggregate demand. *Third*, falling prices of goods and services are linked to declining asset prices, notably the unremitting fall in land prices, which has a negative effect on banks' balance sheets. *Fourth*, deflation has kept real interest rates higher than they should be, thus reducing the potency of monetary policy.

The path of deflation depends to a great extent on the duration and strength of the current expansion. A continued recovery sufficiently robust to narrow the output gap should bring an end to deflation. However, there are questions about the strength of the upturn that began in 2002; it appeared to have peaked in early 2004, followed by a marked deceleration in the following two quarters. Most recent indicators give mixed signals. Moreover, there are a number of external risks to a continued expansion, such as a hard landing in China and further increases in oil prices. On the domestic side, there are also a number of uncertainties, including the continued fall in wages. Given the sharp decline in the household saving rate, a further increase in private consumption is likely to require income gains. Furthermore, there is the ever-present risk of a substantial hike in long-term interest rates in the context of the sharp run-up in public debt.

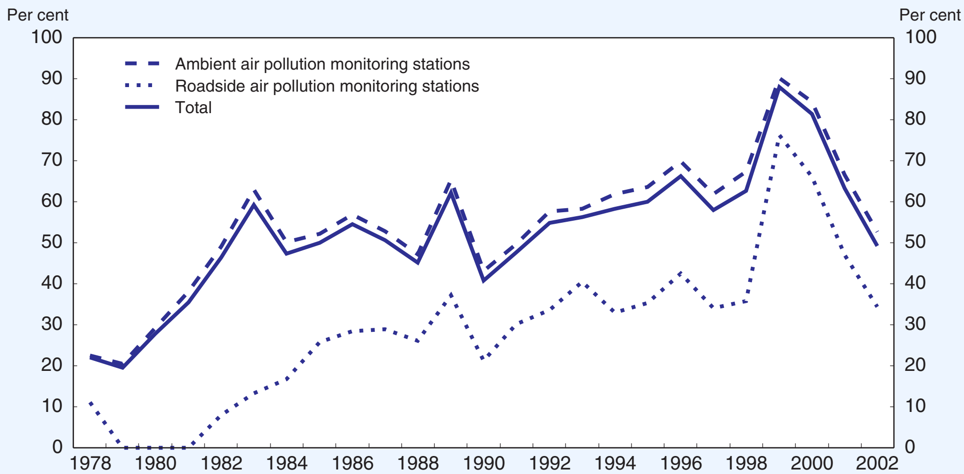
Meanwhile, the Bank of Japan maintains its policy of zero short-term interest rates and quantitative easing, which it introduced in 2001. While this policy has boosted the monetary base by 60 per cent during the past three years, its effectiveness in ending deflation has been limited by the closure of the credit transmission channel. Bank lending, adjusted for write-offs of non-performing loans, is still declining at a year-on-year rate of more than 1 per cent (Figure 1.8), despite increased mortgage loans from banks that have taken the place of government housing loans. The sharp rebound in investment suggests that the continued decline in lending is due in part to the persistent reluctance of banks to take credit risks and increased reliance on retained earnings. Marked progress has been achieved in reducing non-performing loans and operating profits were recorded in FY 2003

Box 1.1. **Improving air quality in Japan**

The level of emissions of sulphur dioxide and nitrogen dioxide are only between a fifth and a quarter of the OECD average (see the 2003 *Survey*). Nevertheless, the geographically concentrated nature of economic activity has resulted in poor air quality in some areas. One problem is photochemical oxidants; high concentrations of this so-called "photochemical smog" can cause respiratory problems in addition to affecting plants. In March 2003, less than 1 per cent of monitoring stations nation-wide achieved the environmental quality standard of 0.06 ppm. Moreover, 40 per cent showed levels that were at least twice that standard. A second major concern is "suspended particulate matter", which also damages human respiratory organs. The proportion of monitoring stations achieving the quality standard fell from 88 per cent in FY 1999 to 49 per cent in FY 2003 (Figure 1.6), in part due to windblown yellow sand from China.

Figure 1.6. **Air quality in Japan**

Achievement rate of the environmental quality standard



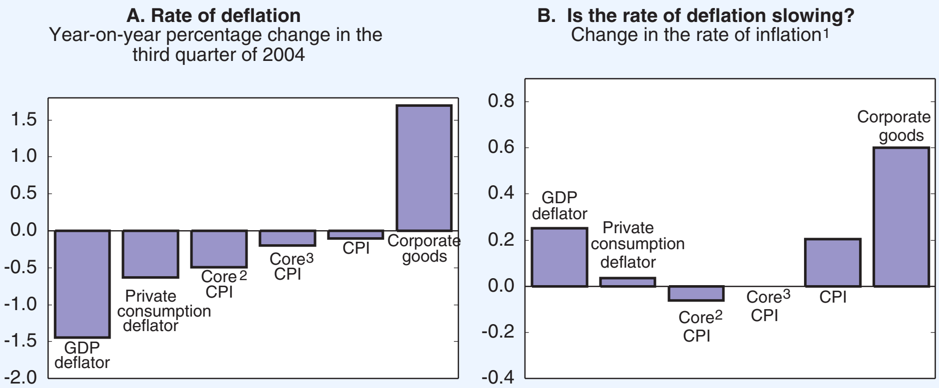
Source: Ministry of the Environment.

Particulate matter emissions from diesel vehicles have not been sufficiently reduced because particulate filters have not yet been attached to vehicles. Therefore, the government decided in 2000 to reduce the sulphur content of diesel from 500 ppm to 50 ppm by the end of 2004, allowing particulate filters to be used effectively on vehicles. Following this decision, fuel suppliers began to sell diesel fuel with a sulphur content of less than 50 ppm on a voluntary basis since April 2003. The availability of cleaner fuel has been accompanied by regulations limiting emissions by heavy diesel trucks. It is important to make further progress by implementing the Central Environmental Council's recommendation to move to ultra-clean diesel fuel – which has a maximum sulphur content of 10 ppm, a level below US and European standards – by 2007. In addition to these regulatory moves, vehicles that reduce air pollutants by 50 per cent below the 2005 emission standard are subject to lower tax rates. Similar benefits are accorded to vehicles meeting the Automobile Fuel Efficiency Target for FY 2010. The use of such economic instruments should be encouraged to improve air quality. In addition, the use of road pricing can be a useful strategy to reduce both congestion and pollution.

Box 1.2. **The different measures of inflation**

Understanding the path of inflation is complicated by the diverging trends reported by the various measures of the overall price level. Indeed, the rate of inflation is significantly negative, close to zero or positive depending on the index chosen. The most important indicator for the Bank of Japan is the core consumer price index, which excludes fresh food but includes energy. By this measure, the price level fell slightly in the third quarter of 2004, while the price deflators in the national accounts showed faster rates of decline of 0.6 per cent (year-on-year) for private consumption and 1.4 per cent for GDP (Figure 1.7).* The high rate of deflation reported by the GDP deflator reflects significant falls in the price of investment goods, which declined 2 per cent in 2003. Indeed, the prices of some ICT products have fallen at rates of more than 30 per cent a year. In contrast, the domestic corporate goods price index, which is limited to sales between firms, has reported positive inflation since the beginning of 2004. In addition to the large differences in the level of inflation, the various measures do not agree on whether the rate of deflation accelerated in the third quarter of 2004 (Panel B).

Figure 1.7. **Different measures of inflation**



1. Change in the rate of inflation in percentage points, in the third quarter of 2004 compared to the second quarter of 2004. A negative number indicates that the rate of deflation accelerated.
2. OECD measure of core CPI excludes food and energy, which account for about a quarter of the index.
3. Japanese definition of core CPI, which excludes only fresh food.

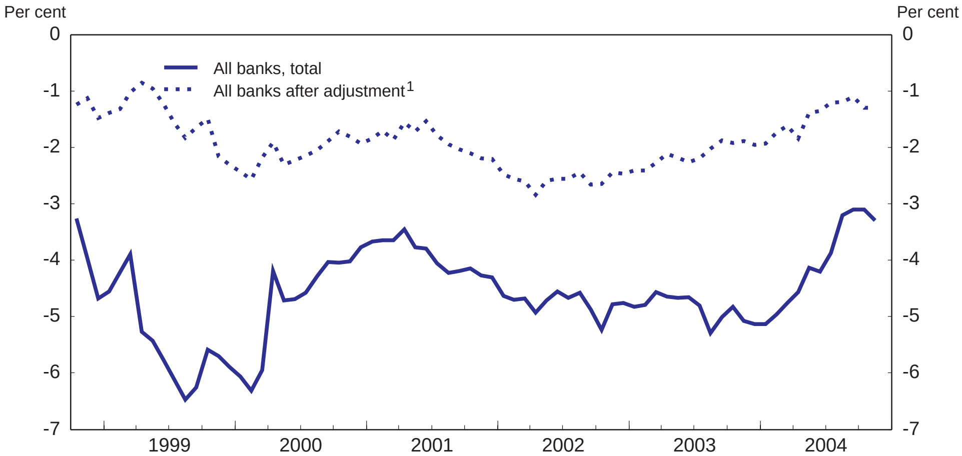
Source: Bank of Japan, Ministry of Internal Affairs and Communications and *OECD Economic Outlook*, No. 76.

* The gap between the consumer price index (CPI) and the private consumption deflator reflects differences in method of calculation. The CPI is a Laspeyres-type index, while the deflator is a Paasche-type index.

for the first time in a decade. Nevertheless, bank profits are low, lending margins are narrow and their capital base is weak. Indeed, deferred tax assets account for more than a third of Tier I capital. Moreover, the improvement in the regional banks has lagged behind that of the nation-wide banks. The health of the banking sector and the durability of the economic expansion are likely to be closely interrelated. Continued output growth will further strengthen the banks and eventually end the contraction in lending. At the same time, increased lending is necessary for a sustainable and broad-based expansion, given Japan's bank-centred financial system.[5]

Figure 1.8. **Bank lending continues to decline**

Year-on-year change



1. Excluding loan write-offs and related items and securitisation of loans, and adjusting for exchange-rate changes.

Source: Bank of Japan.

Once deflation ends, the monetary authorities will face the challenge of exiting its current policy of quantitative easing and zero interest rates. One issue is the appropriate timing of this policy shift. A premature exit could undermine the expansion and send the economy into renewed deflation. On the other hand, maintaining the current policy stance too long could result in high and sustained rates of inflation once the money multiplier begins to work again, given that the monetary base has expanded from 13 to 21 per cent of GDP over the past three years. The Bank of Japan will need to absorb the excess liquidity at some point in order to achieve price stability. The quantitative easing policy was implemented through large central bank purchases of government bonds amounting to about one-third of new issues, boosting the central bank's holdings to 60 trillion yen (12 per cent of GDP). Such purchases encouraged private-sector purchases as well; banks' holdings of government bonds have reached 169 trillion yen (34 per cent of GDP). While these purchases have helped to keep long-term bond yields below two per cent, it has created concern about a possible bubble in this market. Once the Bank of Japan ends its purchases of government bonds and begins to reduce its holdings, there is the potential for a rapid and significant decline in bond prices, which might result in large capital losses for financial institutions. Moreover, a sharp rise in interest rates has implications for the real economy and the budgetary situation.

In sum, the key challenges, which are discussed in Chapter 2, are:

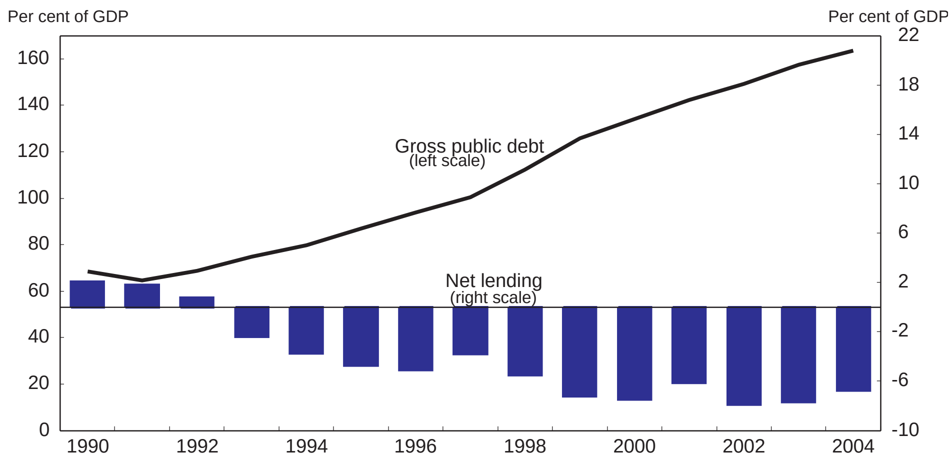
- Sustaining the current expansion long enough to bring deflation to an end.
- Correctly timing the end of the Bank of Japan's quantitative easing policy in order to limit the risk of falling back into a deflationary trap, while absorbing the excess liquidity in time to avoid sustained inflation at high rates.
- Developing an effective exit strategy from the current monetary policy so as to limit the impact on the real economy and financial institutions.
- Further strengthening the banks in order to end the contraction of bank lending and thereby re-open the credit transmission channel necessary for effective monetary policy, thus providing the basis for a sustainable and broad-based expansion.

Achieving fiscal sustainability

Japan's budget deficit peaked at nearly 8 per cent of GDP in 2002 and 2003 (Figure 1.9). Relative to 1992 – the year with the last budget surplus – the deterioration in the balance was due largely to a rise in spending (5 per cent of GDP) resulting from social security outlays. Revenues also declined (3 per cent of GDP) because of tax cuts and weak economic growth. Large deficits over the past decade have boosted gross public debt to 160 per cent of GDP. With long-term interest rates substantially higher than the growth of nominal GDP, the size of public debt relative to the economy continues to increase at a rapid rate.

Figure 1.9. **Fiscal indicators for general government**

Per cent of GDP[1]



1. OECD estimates for 2003 and 2004.
Source: OECD Economic Outlook, No. 76.

The government's current objective, set out in the *Medium-Term Economic and Fiscal Perspective* revised in early 2004, is to limit public outlays through FY 2006 to the FY 2002 level of 38 per cent of GDP. This objective has been achieved thus far primarily through double-digit cuts in public investment spending. However, pressure for increased expenditures resulting from population ageing will make it increasingly difficult to limit spending over the medium term. Under current programmes, social security outlays – for pensions, health and long-term nursing care, will increase by 1½ per cent of GDP by 2010. Freezing total government spending as a share of GDP will likely require both significant cuts in discretionary expenditures combined with further reform of the social security system to limit the increase in outlays.

The government's *Perspective* also sets the objective of achieving "a surplus in the primary budget by the early 2010s". In 2004, the primary deficit, which excludes interest payments, is estimated to have fallen by 1 per cent of GDP to around 5 per cent of GDP. However, the decline was due in part to exceptionally strong output growth of around 3 per cent; in cyclically-adjusted terms, the primary deficit fell by about ½ per cent of GDP.

The *Medium-Term Economic and Fiscal Perspective* includes a decline of ½ per cent of GDP in the primary budget deficit each year during the period FY 2004 to FY 2008, its final year (Table 3.4). If this pace of fiscal consolidation continues beyond 2008, it would take a full decade to reach a primary budget balance (Table 1.4). Achieving a balance would be

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Table 1.4. **Fiscal consolidation scenarios**

Per cent of GDP

Case 1: Medium-Term Economic and Fiscal Perspective (MEFP) baseline[1] Real growth of 2 per cent; real long-term interest rate of 2 per cent	
Target primary budget[2]	0.0
Number of years from 2004 to achieve target	10
Level of debt when stabilised	186.2
Additional debt, compared to 2003	23.2
Additional debt burden	0.5
Case 2 Real growth of 1.3 per cent;[3] real long-term interest rate of 2 per cent	
Target primary budget[2]	1.1
Number of years to achieve target	12
Level of debt when stabilised	200.3
Additional debt, compared to 2003	36.8
Additional debt burden	0.9
Case 3 Real growth of 2 per cent; real long-term interest rate of 3 per cent[4]	
Target primary budget[2]	1.4
Number of years from 2004 to achieve target	13
Level of debt when stabilised	207.8
Additional debt, compared to 2003	44.3
Additional debt burden	1.3
Case 4 Real growth of 1.3 per cent;[3] real long-term interest rate of 3 per cent[4]	
Target primary budget[2]	2.6
Number of years from 2004 to achieve target	15
Level of debt when stabilised	230.3
Additional debt, compared to 2003	73.2
Additional debt burden	2.2

1. The average real GDP growth rate for the period 2004 to 2014 is based on the *Medium-Term Economic and Fiscal Perspective* for 2005 to 2008. The growth rate for 2008 (2.1 per cent in real terms) is assumed to continue indefinitely. The real interest rate is the *Perspective's*"nominal long-term interest rate" deflated by the implied GDP deflator in the baseline. Similarly, the nominal interest rate of 2.8 per cent in 2008 and the rise in the GDP deflator of 0.8 per cent are assumed to continue indefinitely.
2. Primary budget needed to stabilise public debt as a share of GDP. It is calculated as:
   $b_t = d_t + b_{t-1} * [(1 + r)/(1 + g)]$,
   where b is the debt to GDP ratio; d is the primary deficit to GDP ratio; r is the nominal interest rate; and g is the nominal growth rate.
3. The potential growth rate in the OECD Medium-Term Baseline for 2004 to 2010 is assumed to continue into the next decade.
4. The real long-term interest rate has averaged around 3 per cent over the period 1990 to 2004, as well as during 2000 to 2004.

Source: Structural Reform and Medium-Term Economic and Fiscal Perspective and OECD calculations.

sufficient to stabilise public debt if both the real growth of output and the real long-term interest rate – assumed to be around 2 per cent in 2008 by the *Perspective* – remain indefinitely at that level. In this case, public debt would stabilise in 2014, though at a higher level of around 186 per cent of GDP.

However, public debt would rise significantly more under less optimistic economic assumptions. If the real growth rate were 1.3 per cent – the rate in the OECD Medium-Term Baseline and near the current estimate published by the Cabinet Office – a primary budget surplus of 1 per cent of GDP would be necessary to stabilise the debt to GDP ratio, assuming a 2 per cent real long-term interest rate (Table 1.4, Case 2). At the *Perspective's* consolidation pace of ½ per cent of GDP per year, it would take 12 years to stabilize the debt to GDP ratio, though at around 200 per cent of GDP. Moreover, if the real long-term interest rate were higher at 3 per cent – its average level during the past 15 years – it would take 15 years to stabilize the debt to GDP ratio at around 230 per cent of GDP (Case 4). The cost of servicing this higher level of debt would amount to more than 2 per cent of GDP, requiring higher taxes that impose deadweight costs.

The pace of fiscal consolidation incorporated in the *Medium-Term Economic and Fiscal Perspective* thus suggests a substantially higher level of debt in the future. A continued run-up in debt raises the possibility of a higher risk premium, which would further exacerbate the fiscal position. The key to avoiding such an outcome is a credible medium-term plan. However, the *Perspective* that was announced in 2002 and updated annually should be more detailed and credible. Its economic assumptions may be on the optimistic side and it only indicates a spending and revenue path to achieve the fiscal target. The size of the fiscal consolidation needed to stabilise public debt – likely to be at least 6 per cent of GDP – appears to be too large to be accomplished through spending cuts alone. Consequently, the fiscal strategy will require increased government revenue, which at present is the second lowest in the OECD area at around 30 per cent of GDP. However, the government has no specific plans at present to increase taxes and has pledged that there will be no increase in the consumption tax rate during the term of the current prime minister, which continues until September 2006.

In sum, the key challenges to achieving fiscal sustainability, which are discussed in Chapter 3, are:

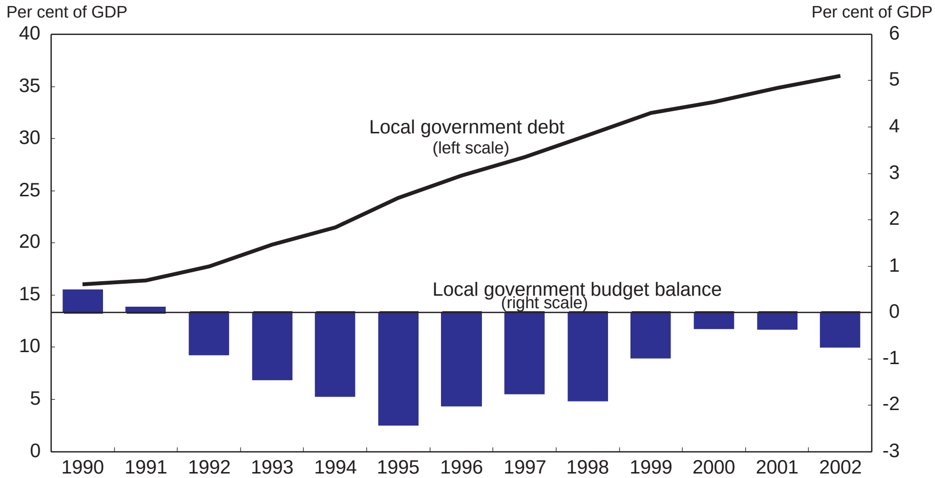
- Achieving the expenditure target by cutting discretionary spending and further reforming the social security system in order to limit the rise in ageing-related outlays.
- Boosting revenues from the current low level.
- Establishing a more credible medium-term plan with more information on the spending and revenue changes needed to achieve a primary budget surplus large enough to stabilise public debt, thereby helping to maintain confidence in the government's financial position.

Revamping the relationship between different levels of government

One element of the public finance problem is the large budget deficit at the local level. Indeed, local government debt has risen from 15 per cent of GDP in the early 1990s to 40 per cent in 2003 (Figure 1.10). The lack of fiscal discipline reflects lenient budgetary rules and implicit guarantees from the central government to support financially-troubled jurisdictions. Spending pressures at the local level will increase with population ageing since local governments are largely responsible for healthcare and other welfare programmes, in addition to pensions for their own employees. The scope for achieving greater efficiency in the delivery of government services is limited by the fragmented nature of local government, which includes 47 prefectures and more than 3 000 municipalities. Given the 40 per cent share of local government in total public spending, the resulting efficiency costs are significant.

While Japan has a high degree of decentralisation, the ability of local governments to innovate and respond to preferences of local citizens is constrained. Major spending programmes at the local level, including education, social welfare and public works, are controlled by the central government and largely financed through earmarked grants (national

Figure 1.10. **The fiscal situation of local government**



Source: Cabinet Office.

treasury disbursements). Such grants, which account for 40 per cent of intergovernmental transfers, are used to steer local government spending decisions. Regulations to ensure equity by specifying minimum standards across the country also limit the scope for innovation.

In addition to grants, local government outlays are financed by 13 different taxes at the prefectural level and ten at the municipal level, resulting in overlapping tax bases. The complexity of the system is further increased by a proliferation of deductions and exemptions. Another weakness is the volatility of the major local taxes over the business cycle. In addition, tax bases are unevenly distributed across regions, requiring complicated equalisation schemes to achieve equity objectives. Although local governments have some flexibility in setting the rates and bases of some taxes, they rarely use it in practice. Local autonomy has thus failed to promote tax competition and discipline.

In sum, the key challenges in the relations between local governments, which are discussed in Chapter 4, are:

- Increasing fiscal discipline at the local government level as part of the fiscal consolidation process.
- Achieving greater efficiency in local government spending programmes, in part through economies of scale.
- Reaping the full benefits of decentralisation by allowing more scope for local governments to innovate and respond to the preferences of local citizens.
- Improving the grant system in order to enhance the autonomy of local governments, while strengthening incentives for fiscal discipline.
- Reducing the proliferation of local taxes and exemptions, thereby simplifying the local tax system and enhancing efficiency.

Removing obstacles that limit Japan's growth potential

As noted above, weak economic growth has created a significant gap between per capita income levels in Japan and the most advanced OECD countries. Accelerating productivity growth is essential to improve living standards as the working-age population declines at a faster pace (Table 1.1). Increasing the pace of productivity gains requires a wide range of reforms to reduce the government's role, accelerate regulatory reform and strengthen competition.

The top priority of the government is the privatisation of Japan Post, which is the world's largest financial institution with assets amounting to 80 per cent of Japanese GDP. The important role of Japan Post poses a number of problems. *First*, postal savings and life insurance provide the government with a large source of funds to support public corporations and finance public investment projects. Shifting a greater share of resources from such activities, which tend to be characterised by low productivity, to the private sector would allow for a better allocation of resources and thereby enhance Japan's growth potential. *Second*, Japan Post undermines the operations and health of private financial institutions, which are subject to taxes and have to pay for deposit insurance as well as facing various risks. Given these advantages, it is not surprising that the postal saving system's share of total assets of deposit-taking institutions nearly doubled from 11 per cent in 1989 to 20 per cent in 2000, at the expense of banks. The privatisation of Japan Post, however, is a daunting task. With 25 000 branches and 400 000 employees, it plays a fundamental role in rural areas without private financial institutions. Consequently, there remains significant opposition to the plan to separate Japan Post into four entities by 2007, including Postal Savings and Postal Life Insurance, which are to be privatised by 2017 at the latest. The government is probably justified in citing this as one of the most important reforms to be undertaken since the Meiji Era in the 19th century.

Although Japan has placed considerable emphasis on regulatory reform in recent years, overcoming vested interests in the ministries and among politicians slows progress. The reform proposals made by the private-sector *Council for Regulatory Reform*[6] form the basis of the government's Three-Year Plan for Promoting Regulatory Reform, which is updated each year. However, the three-year plans have generally been markedly less ambitious than the Council's initial proposals, as key reforms are blocked by the responsible ministries. The creation of Special Zones for Structural Reform, which allows the introduction of certain reforms on a trial basis in limited geographical areas, was intended to circumvent such opposition. However, it may fall short of expectations unless local governments play a more active role and there is a definite timetable for extending these reforms on a nation-wide basis. In addition, the ability of the government to achieve high quality regulation is limited by problems in regulatory institutions, tools and procedures. The resulting lack of transparency is one factor limiting foreign direct investment (FDI).

Increased inflows of foreign direct investment would help strengthen competition, which is essential to improve resource allocation and raise Japan's growth potential. At present, the enforcement of the competition law by the Japan Fair Trade Commission (FTC) is not strong enough, in part because of the low level of sanctions on violations of the Anti-Monopoly Act. Moreover, the regulatory policy framework for network industries still needs to be improved to enhance the scope for competition. Foreign competition is limited by the low level of FDI inflows. Achieving the government's goal of doubling the stock of FDI, which despite recent increases amounts to only 2 per cent of GDP, will likely require steps to improve the business environment by enhancing transparency. In addition, despite past increases, the level of imports of goods and services is surprisingly low, even after adjusting for transportation costs and other factors. Further increasing openness to international trade is thus another challenge for boosting competition.

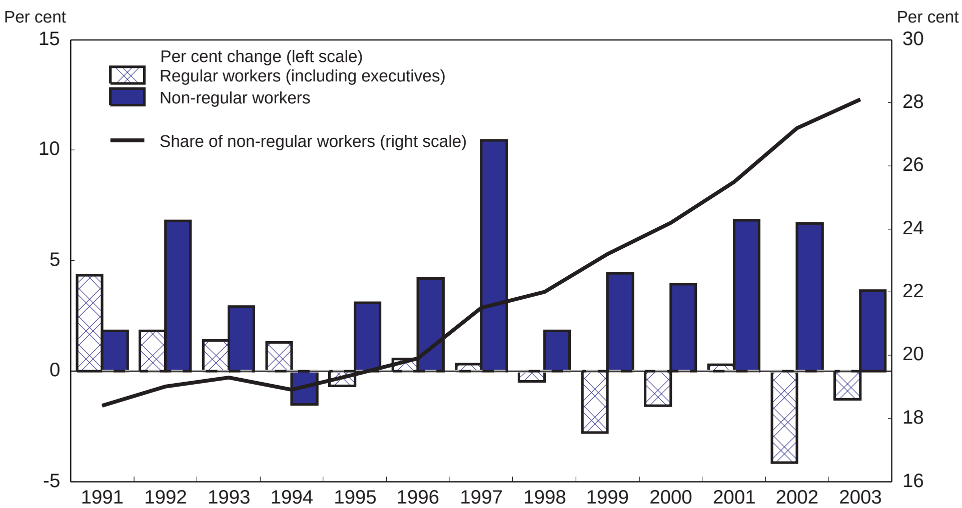
In sum, the key challenges to removing obstacles to growth, which are discussed in Chapter 5, are:

- Privatising Japan Post in order to reduce the flow of resources for public corporations and public investment and to level the playing field with private-sector financial institutions.
- Accelerating regulatory reform through better implementation of the three-year programmes and by making the special zone initiative an effective tool for nation-wide reform.
- Strengthening competition by upgrading the FTC and increasing its effectiveness through heavier sanctions.
- Improving the regulatory framework in the network industries in order to enhance competition.
- Increasing openness to international trade and inflows of FDI.

Addressing emerging problems in the labour market

Employment has begun rising and the unemployment rate has fallen from a record high of 5.5 per cent to under 5 per cent. However, gains in employment are due to an increased number of non-regular workers, such as part-timers and those with temporary contracts, while the number of regular workers has been declining since 1998 (Figure 1.11). Consequently, the share of non-regular employees has risen over the past decade from 19 per cent of total dependent employment to 29 per cent. Non-regular workers, who generally have temporary contracts, provide greater employment flexibility than regular workers who are covered by relatively strict employment protection. In addition to employment flexibility, non-regular workers receive substantially lower wages. The total savings to firms are even larger since employees working less than 30 hours a week are exempt from all social charges except unemployment insurance. While the increased availability of part-time positions provides job opportunities to people who would otherwise be unable to find work, the unemployment rate is relatively high at 10.1 per cent for the 15 to 24 age group. In addition, the incidence of long-term unemployment has risen markedly to a level above the OECD average.

Figure 1.11. **The share of non-regular workers is rising**



Source: Ministry of Internal Affairs and Communications.

The increasing dualism of the labour market poses a number of efficiency and equity concerns. Perhaps most importantly, it is creating a group of primarily young people with only short-term employment experience.[7] Given the important role of firm-based training in Japan, such workers risk being left behind with a low level of human capital. There are also important equity problems. Although there is little evidence on the difference in productivity between regular and non-regular workers, it is likely to be much smaller than the 60 per cent wage gap. The equity concern is magnified by the fact that there is little movement between the regular and non-regular workforces. Consequently, a significant portion of the labour force may be trapped in a low-wage category from which it is difficult to escape. In sum, a quarter of the population is subject to low wages and reduced social protection, while bearing the brunt of adjustments in employment.

As noted above, Japan is one of the few OECD countries where the working-age population is already declining. Although this is partially offset by the upward trend in participation rates, the size of the labour force is shrinking. In addition, the number of hours worked, which remains higher than in most other major countries, may fall further. The accelerating decline in labour inputs will put a growing burden on workers as the population ages. The scope for boosting labour force participation of older workers (ages 55 to 64) is limited, given that it is already the highest in the OECD. There is scope to increase the female participation rate, which is low compared to some other major economies. Moreover, 42 per cent of women who do work are employed part-time. The fact that women account for two-thirds of non-regular employment may discourage their participation in the labour force.

In sum, the key challenges to improving the labour market, which are discussed in Chapter 6, are:

- Reversing the increased dualism in the labour market resulting from the preference of firms to hire non-regular workers.
- Lowering unemployment among young people.
- Addressing the problem of long-term unemployment.
- Limiting the decline in the labour force by maintaining the high labour force participation rate of older persons and boosting the share of prime-age women who work.

Conclusions

The current economic upturn is helping to correct many longstanding problems in the Japanese economy. The expansion has helped to reduce deflation to a low level and to strengthen the banking system, thus slowing the contraction of bank lending. Structural reforms appear to have encouraged new investment and employment opportunities. However, while the Japanese economy is in its best shape since the early 1990s, the basis for comparison – the weak economic performance of the last decade – does not set the bar very high. Moreover, a number of short-term risks, such as higher oil prices and slower world trade growth, reflecting the cooling off of demand in China, have emerged, in addition to the medium-term challenges discussed above.

There is no room for complacency in this uncertain environment. While Japan may be emerging from a decade of stagnation and the risk of a deflationary spiral, the linked problems of rapid population ageing and the rising level of public debt present new challenges over the medium term. The remaining chapters discuss policy options for ending deflation and sustaining the recovery, achieving fiscal sustainability, revamping relations between levels of government, removing obstacles to economic growth and improving the functioning of the labour market.

Notes

1. Japan has thus required large increases in capital in order to sustain productivity growth, suggesting a lack of efficiency.
2. This is calculated as total employment divided by the working-age population (15 to 64 years of age). If labour force participation rate is measured as the number of employed in the 15 to 64 age group divided by the working-age population, Japan's rate would be 72 per cent, which is close to the OECD average of 71.5 per cent by this definition.
3. The working-age population is defined as persons between the ages of 15 and 64. This scenario assumes trend labour productivity growth of 1.7 per cent, the rate in the Secretariat's Medium-Term Baseline. Japan is projected to have a positive output gap of 1.2 per cent in 2006. The assumption in the Baseline that output gaps close by 2010 reduces labour productivity growth slightly from the 2 per cent rate estimated for the period 2000 to 2004.
4. The average, for the 20 OECD countries for which data are available, was 1 648 working hours per year in 2003.
5. It should be noted that Japanese capital markets have been developing. In this regard, the Financial Services Agency has taken an initiative, the Program for Promoting Securities Markets Reform, to encourage greater reliance on direct financing and thereby reduced Japan's dependence on bank-centred finance.
6. The Council for Regulatory Reform consisted of 15 experts from business and academia, organised into eight working groups.
7. In Japan, this group is knows as "freeters". Initially, members of this group appeared to have voluntarily rejected the traditional approach of regular employment in favour of increased flexibility.

ANNEX 1.A1

The revision of Japanese national accounts

In December 2004, the Cabinet Office revised Japan's national accounts for GDP (by expenditure components) using the chain-linked methodology for the period between 1994 and the third quarter of 2004. The introduction of this approach had been studied since 2001 in order to avoid the distortions created by using a fixed-year base. Indeed, the distortions increase as one moves away from the base year, which had been set as 1995 for Japan. This bias is due to the fact that items whose prices are falling rapidly, such as computers and other ICT products, are given too much weight, leading to an almost 5 per cent decline in the business investment deflator in 2003. As a result, the fall in the GDP deflator – at 2.5 per cent that year (Table 1.A1.1) – was much larger than for the private consumption deflator and consumer price index, which fell by 1.7 and 0.3 per cent, respectively. The overestimation in deflation resulted in a corresponding overestimation of the rate of real growth.

Table 1.A1.1. **Change in GDP growth and deflation with chain-linked methodology**

Percentage change from previous period at an annual rate

	2000	2001	2002	2003	2004		
					1st quarter	2nd quarter	3rd quarter
GDP deflator[1]							
Fixed-year methodology[2]	–2.0	–1.6	–1.1	–2.5	–2.8	–1.9	–0.7
Chain-linked methodology	–1.5	–1.3	–1.3	–1.4	–2.0	–1.7	–0.4
Real GDP							
Fixed-year methodology[2]	2.9	0.4	–0.5	2.5	7.6	–0.4	0.6
Chain-linked methodology	2.4	0.2	–0.3	1.3	6.8	–0.6	0.2

1. The quarterly changes in the GDP deflator are calculated by the OECD Secretariat.
2. These figures were announced in late December, after the introduction of the chain-linked methodology.

Source: Cabinet Office and OECD calculations.

The chain-linked weighting method of price measurement is generally considered superior when relative prices are changing rapidly. The 1993 System of National Accounts recommends the chain-linked approach, which has already been adopted by some other major OECD countries, including the United States, the United Kingdom and Canada.

As expected, the chain-linked approach lowered the rate of deflation. In 2003, the fall in the GDP deflator is now reported to be 1.4 per cent, compared to 2.5 per cent under the old methodology. With nominal levels of expenditure unaffected by the shift to the chain-linked approach, real GDP growth in 2003 rate was revised downwards by a similar magnitude, from 2.5 to 1.3 per cent.

This methodological change makes the current expansion look less robust. The annual average rate of growth over the ten quarters since the beginning of 2002 is now 2.1 per cent, a full percentage point lower than the rate reported by the fixed-weight approach. However, this methodological change does not negate the positive developments in the Japanese economy that are noted in Figure 1.1. Indeed, profit margins, confidence of firms and the job offer to applicant ratio have each risen to their highest levels since the collapse of the bubble economy at the beginning of the 1990s.

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Chapter 2

Ending deflation and achieving a self-sustained expansion

This chapter discusses the factors driving the current expansion and the economic outlook. Despite risks, such as rising oil prices and slowing demand in China, the upturn is projected to continue at a more moderate pace through 2006, helping to bring an end to deflation. The Bank of Japan should continue its quantitative easing policy until inflation is sufficiently high to make the risk of renewed deflation minimal. A clear exit strategy, including a significantly positive rate of inflation as a condition for changing monetary policy, would limit the possibility of a premature rise in long-term interest rates, which might have a negative impact on the banking sector. Further progress in rehabilitating the banking sector, through continued reductions in non-performing loans and a strengthening of their capital base, may help reverse the decline in bank lending. Regional banks should not be granted special treatment in this regard.

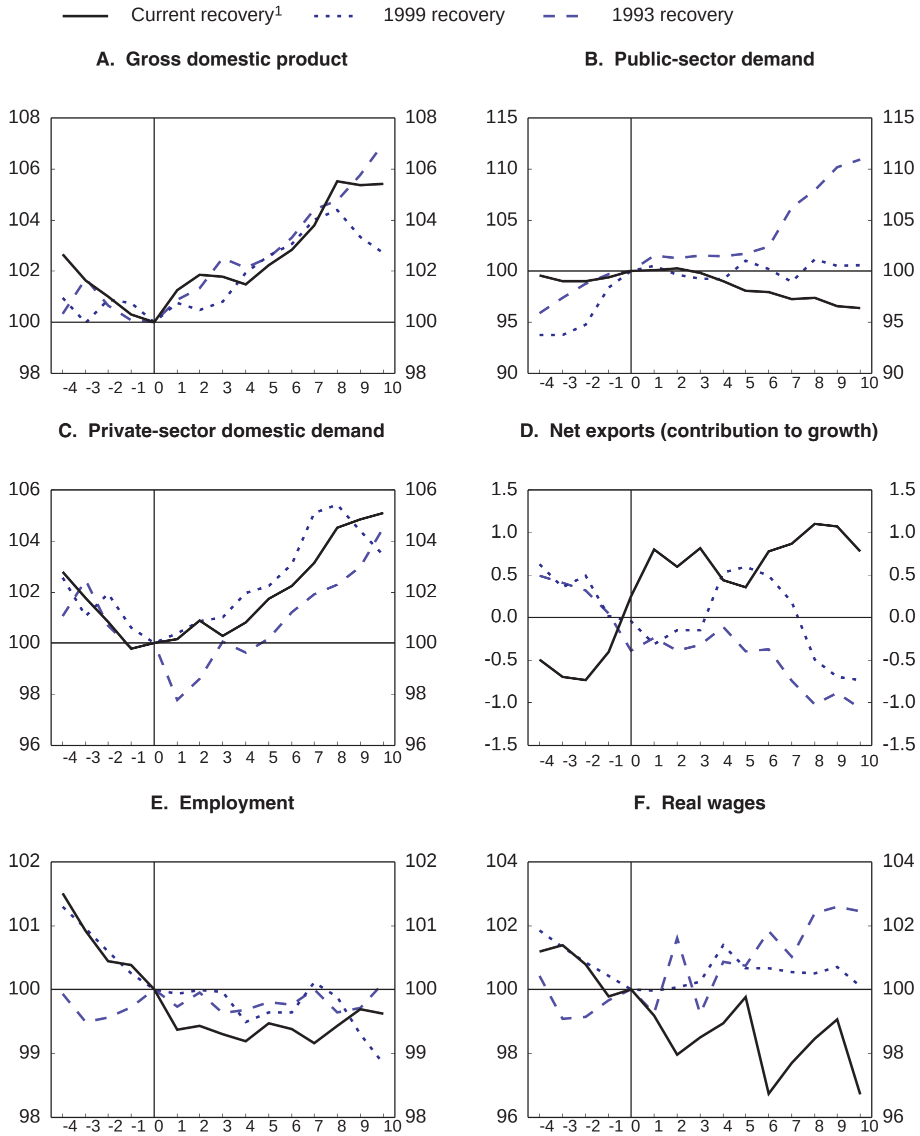
The Japanese economy has grown at around a 1 per cent annual rate since 1992 in a context of deflation, falling asset prices and a contraction of bank lending. These negative conditions persisted through two economic upturns, beginning in 1993 and 1999. The current expansion, which began in 2002, has helped to slow deflation, as measured by the consumer price index, to a stable rate close to zero. However, there are a number of challenges to a sustained expansion, including rising oil prices and slower growth in world trade, particularly in China, which has been a key source of demand for Japan. This chapter examines the forces driving the current upturn to evaluate whether it will be sufficiently robust and long-lasting to end the persistent headwinds slowing the Japanese economy since the collapse of the bubble in the early 1990s. It then looks at the role of the Bank of Japan's quantitative easing policy in supporting the expansion and how monetary policy may change once deflation ends. The third section discusses the banking sector and whether it has become sufficiently healthy to support a sustained expansion. The final section provides an overall assessment.

This chapter concludes that achieving a self-sustained recovery will depend to an important degree on developments in the labour market, where nominal wages continue to decline. Nevertheless, given the strength of business investment, Japan's expansion is likely to continue through 2006 despite adverse developments, such as rising oil prices and some deceleration of world trade, thus closing the output gap and bringing an end to deflation. The quantitative easing policy should be continued in order to support the expansion until inflation is high enough to make the risk of falling back into deflation negligible. Making a significantly positive rate of inflation – rather than simply a rate above zero – a condition for exiting the current monetary policy stance would reassure markets that the quantitative easing policy will continue and reduce the risk of a premature rise in long-term interest rates, which would have adverse implications for economic activity, the banking sector and the fiscal balance. Some overshooting of inflation is likely to be less costly than an early and abrupt steepening of the yield curve. The continued decline in non-performing loans and the improved profitability in the banking sector are welcome. However, reversing the on-going contraction in lending to the corporate sector requires further efforts to improve the health of the banks, including a strengthening of the capital base. Such efforts should include the regional banks, where progress lags behind the major banks.

Has Japan achieved a self-sustained recovery?

The current expansion has achieved output growth at an annual rate of slightly more than 2 per cent since 2002. It differs significantly from the two expansions of the 1990s in three respects (Figure 2.1). *First*, the public sector has made a negative contribution during the current upturn, primarily as a result of deep cuts in public investment (Panel B). *Second*, declining public demand has been offset by private domestic demand, which has expanded at an annual pace of 2½ per cent since 2002 (Panel C). *Third*, in contrast to the experience in the 1990s, external demand has played a positive role, accounting for a third of growth (Panel D). Despite the many positive indicators, the slowdown in the second quarter of 2004 and other signs of weakness since then have raised concern that the

Figure 2.1. **A comparison of the current recovery with past business cycles**
Change in the ten quarters following the trough (Q0)



1. The beginning of the current recovery – time = 0 in the charts – is the first quarter of 2002.
Source: Cabinet Office, Ministry of Health Labour and Welfare and *OECD Economic Outlook*, No. 76.

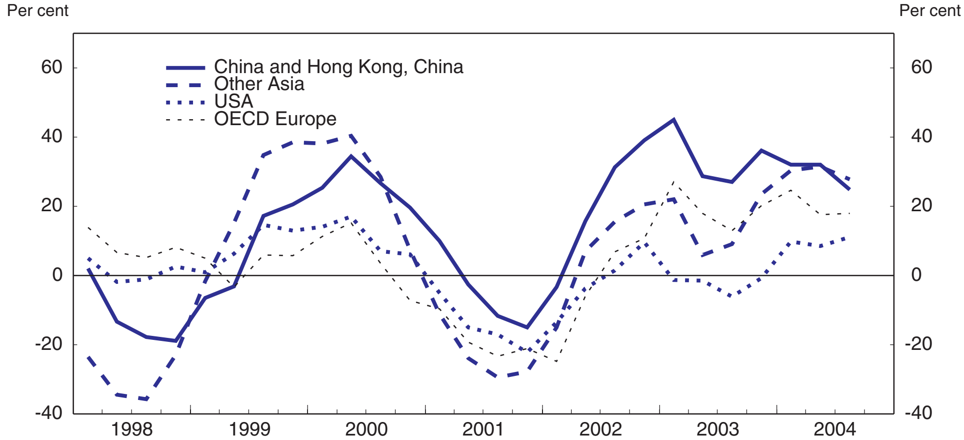
expansion may be faltering. This section identifies the factors that have driven the upturn and considers whether it is likely to be sustainable. Such an assessment is essential to evaluate whether deflation will continue and if fiscal consolidation can be more ambitious without bringing a premature end to the expansion.

Factors responsible for the strong expansion

Double-digit export growth since mid-2003 has played a major role in this recovery. China (including Hong Kong, China) has been the key market, accounting for a third of the rise in Japanese exports during the course of the expansion, supported by strong demand

Figure 2.2. **Japanese export growth by region**

Year-on-year percentage change, US dollars



Source: OECD, *Monthly Statistics of International Trade.*

from other Asian countries (Figure 2.2). The positive effect of rising exports on profits has been magnified by corporate restructuring that has reduced costs, notably through cuts in employment and wages, and improved balance sheets. Indeed, de-leveraging has reduced the liabilities of the non-financial corporate sector from a peak of 200 per cent of GDP to around 170 per cent at present, near the level during the bubble period.[1] These factors have helped to boost profits by more than a quarter over the years 2002 and 2003. Improved profitability and rising capacity utilisation have driven business investment at an annual rate of 6 per cent. Capital spending has also been encouraged by profitable investment opportunities based on advances in information technology.

While employment continued to decline during the early part of the recovery, the positive developments in the corporate sector spilled over to the labour market during the first half of 2004, reversing the downward trend in employment (Figure 2.1, Panel E). Consequently, the unemployment rate has fallen from a post-war high of 5.5 per cent at the beginning of 2003 to under 5 per cent, although declines in the working-age population and in the participation rate also contributed. Nevertheless, nominal wages have continued to fall on a year-on-year basis (see Box 2.1).

The improved labour market conditions slowed the fall in employee compensation and boosted consumer confidence by reducing concern about job security.[2] In this context, the already low household saving rate appears to have declined further in 2004 (Figure 2.4). These factors have sustained private consumption, which has also benefited from the easy stance of monetary policy. The prolonged period of zero interest rates has favoured consumption, rather than investment in financial assets offering low returns. Private consumption has risen at an annual rate of 1.2 per cent since 2002, accounting for about a third of the rise in aggregate demand during the expansion thus far.

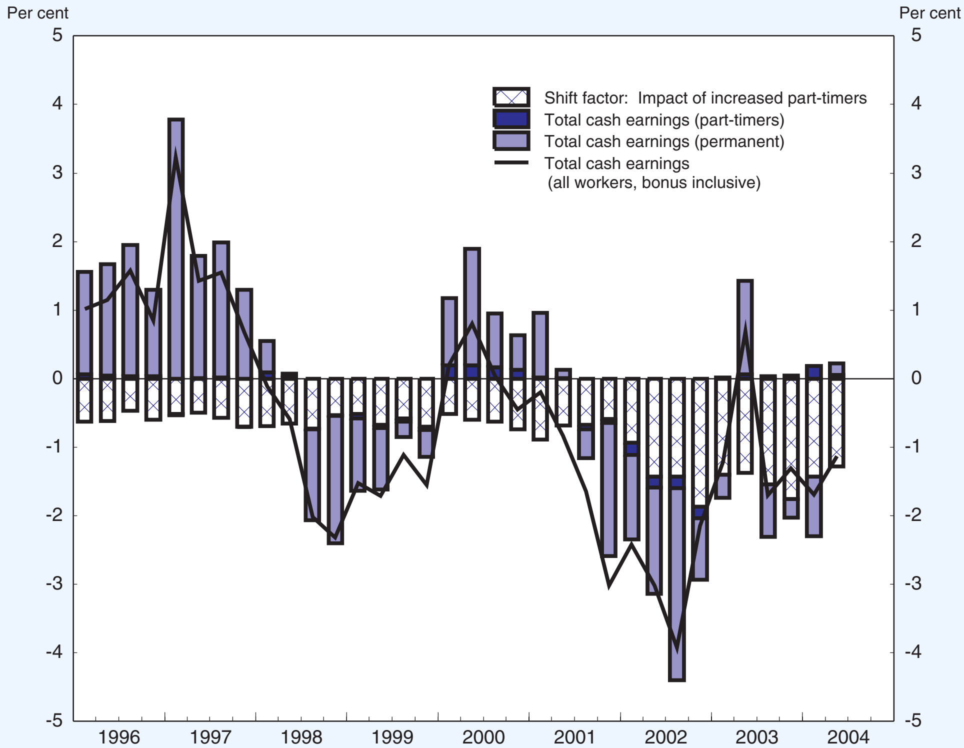
Despite the fastest rate of growth since the 1980s, the rate of deflation, as measured by the consumer price index, has remained roughly constant since the first half of 2003 (Figure 1.1). Indeed, the year-on-year decline even accelerated slightly in the second quarter of 2004 to 0.3 per cent, despite the sharp hike in oil prices and a poor rice harvest, demonstrating the degree to which deflation has become entrenched after six years (see Box 1.2).[3]

Box 2.1. **Why are wages still falling?**

Despite the strength of the expansion and the sharp rebound in corporate profits, wages (including bonuses) continued to decline through the first half of 2004 in both nominal and real terms (Figure 2.3). Although earnings of both regular and non-regular workers are rising, the increasing proportion of non-regular employees is reducing compensation per employee.[1] Indeed, the average hourly wage of part-time workers (who account for three-quarters of non-regular employees) was only 40 per cent that of regular workers in 2003. In addition, non-regular employees, a category that also includes temporary and dispatched workers, provides firms with greater flexibility since employment protection is much lower than for regular workers. The significant cost savings and increased flexibility help to explain why the number of regular workers has been declining since 1998. Consequently, the share of non-regular workers has risen from 19 to 29 per cent of total employees over the past decade.

Figure 2.3. **Developments in the labour market**

Average wages and contribution of the shift factor
Year-on-year changes



Source: Hasegawa (2004).

The fall in the 2004 summer bonus payments suggests that corporations remain focused on reducing costs. Although output growth surpassed 4 per cent in the first half of the year and the corporate profit situation improved further, bonuses decreased by 3 per cent, compared to a decline of only 1 per cent in 2003. According to the Japanese authorities,

Box 2.1. **Why are wages still falling?** *(cont.)*

about half of the fall in bonus payments in 2004 was due to the increased share of non-regular workers, who typically receive very small bonus payments. For regular workers, most of the decline in bonus payments resulted from two factors:[2]

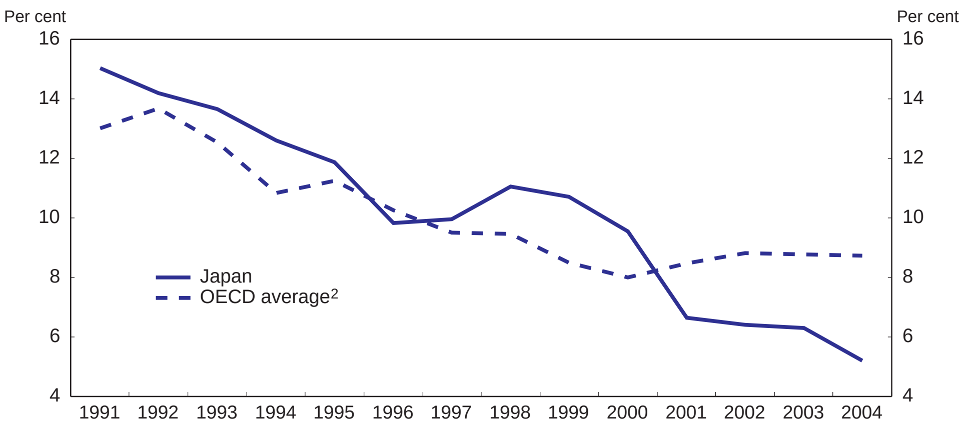
- The economic expansion has been uneven, with smaller companies lagging behind larger ones. Consequently, bonus payments declined at firms with less than 500 workers.
- Bonus payments for government employees were cut by nearly 7 per cent, accounting for about one-sixth of the overall decrease in summer bonuses in 2004.

The wage decline has helped to boost profitability in the corporate sector, while the shift to non-regular workers has sustained employment by allowing some workers who would otherwise be unemployed to find jobs. However, the overall effect of increased non-regular employment on total employment earnings appears to be negative, and has contributed to a fall in labour income from a peak of 54 per cent of GDP in 2001 to an estimated 52 per cent of GDP in 2004, reversing the upward trend during the 1990s. The labour share in 2004 is thus likely to be close to the 51.6 per cent share recorded in 1990.

1. The category of non-regular workers includes temporary and dispatched employees (*i.e.* employed by a temporary agency) and part-time workers. Part-timers are defined as those working fewer hours than regular workers in the same workplace. For example, an employee working 35 hours a week in a workplace where 40 hours is the norm is thus defined as part-time. Although they often perform the same tasks as full-time workers, part-timers' hourly earnings are substantially less.
2. These factors explain why some private-sector surveys that are limited to large firms reported a rise in summer bonus payments.

Figure 2.4. **Household saving rates**

Per cent of household disposable income[1]



1. OECD projection for 2003 and 2004.
2. A simple average of countries for which data are available.

Source: OECD Economic Outlook, No. 76.

Prospects for continued growth

The slowdown in growth to a more sustainable pace since the first quarter of 2004 is typical of economic expansions.[4] The usual pattern is likely to be reinforced by the terms of trade loss from higher oil prices and slower growth in overseas markets. Consequently, growth may slow to less than 1 per cent in the second half of 2004, resulting in a rate of around 3 per cent for the year (Table 2.1).

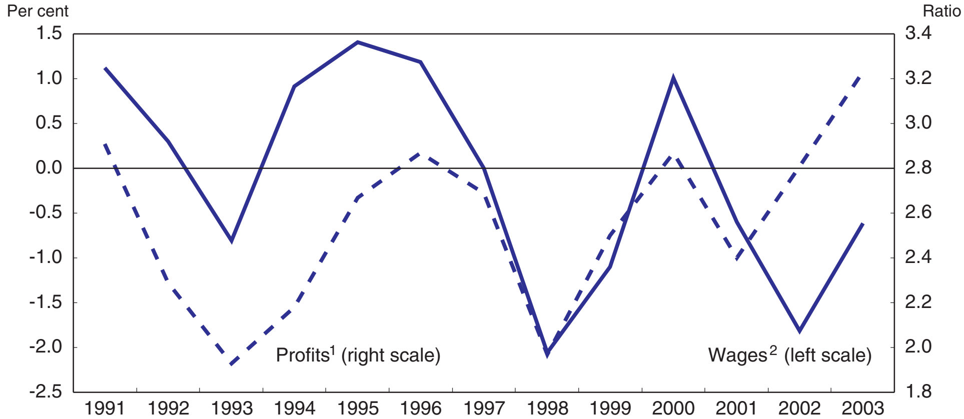
Table 2.1. **Short-term outlook**[1]

	2003[2]	2004[3]	2005[4]	2006[4]	2004 1st half[2]	2004 2nd half	2005 1st half	2005 2nd half	2006 1st half	2006 2nd half
Demand and output (volumes)										
Consumption										
Private	0.2	2.0	1.1	1.0	2.8	1.1	1.1	1.3	0.9	0.8
Government	1.2	2.6	2.1	1.8	3.3	2.2	2.1	1.9	1.8	1.8
Gross fixed investment	1.0	1.9	0.4	0.5	1.9	–0.1	0.5	0.8	0.5	0.2
Public[5]	–10.7	–11.1	–9.8	–4.8	–4.6	–22.2	–5.1	–4.8	–4.8	–4.8
Private residential	–1.3	1.8	1.6	0.2	0.8	2.7	1.4	1.1	0.2	–0.6
Private non-residential	6.5	6.5	3.2	1.9	4.3	6.9	1.9	2.2	2.0	1.6
Stockbuilding[6]	0.2	0.1	–0.1	0.0	0.4	–0.6	0.1	0.1	0.0	0.0
Total domestic demand	0.8	2.1	1.0	1.0	3.1	0.3	1.2	1.4	1.0	0.8
Exports of goods and services	9.0	14.3	7.2	7.6	19.2	6.3	7.4	7.6	7.6	7.6
Imports of goods and services	3.9	8.4	5.2	5.3	11.4	6.5	4.6	5.3	5.4	5.0
Net exports[6]	0.6	0.9	0.4	0.5	1.1	0.2	0.5	0.5	0.5	0.5
GDP	1.3	2.9	1.4	1.5	4.2	0.5	1.7	1.8	1.4	1.3
Inflation and capacity utilisation[7]										
GDP deflator	–1.4	–1.4	–0.2	0.7	–1.9	–0.8	–0.2	0.4	0.7	0.9
Private consumption deflator	–0.7	–0.6	0.3	1.1	–0.9	–0.3	0.3	0.8	1.1	1.4
CPI[8]	–0.3	–0.2	0.1	0.6	–0.2	–0.2	–0.1	0.3	0.5	0.7
Core CPI[8]	–0.3	–0.4	–0.0	0.5	–0.4	–0.5	–0.2	0.1	0.4	0.6
Unemployment rate	5.3	4.7	4.4	4.0	4.8	4.6	4.5	4.3	4.1	3.9
Output gap	–3.3	–0.7	0.1	1.2	–1.0	–0.5	–0.1	0.4	1.0	1.5
Memorandum items:										
Net government lending[9]	–7.7	–6.5	–6.4	–6.3						
Net primary balance[9]	–6.2	–5.0	–4.7	–4.3						
Gross debt[9]	157.5	163.5	170.0	175.4						
Net debt[9]	79.2	84.4	90.1	94.7						
Current account[9]	3.1	3.6	3.6	3.8						

1. Assuming an exchange rate of 105.7 yen to the dollar.
2. Using the chain-linked index method. The annual and semester figures are the sum of the seasonally-adjusted quarterly figures.
3. Based on the first three quarters using the chain-linked method and an estimate for the fourth quarter by the OECD Secretariat. The estimate assumes that the nominal growth rate of each expenditure component is the same as in the *Economic Outlook* No. 76 projections, but that the deflators are less negative. As a result, real growth for the quarter is 1.9 per cent, rather than the 2.8 per cent in the *Economic Outlook* No. 76.
4. Assumes that the nominal growth of each expenditure component is the same as in the *Economic Outlook* No. 76 projections, but that the deflators are less negative.
5. Including public corporations.
6. Contribution to GDP growth.
7. The figures in this section (except for the GDP and private consumption deflators) are unchanged from *Economic Outlook* No. 76, which was finalised before the chain-linked methodology was introduced. It is not yet possible to calculate the output gap on a chain-linked basis.
8. Compared to the same semester of the previous year.
9. Per cent of GDP.

Source: OECD Economic Outlook, No. 76, and OECD calculations based on the new chain-linked methodology introduced in December 2004.

Figure 2.5. **Real wage growth and profits to sales ratio**



1. Current profits as a share of sales for all industries.
2. Wages at firms with five or more employees, deflated by the CPI.

Source: Ministry of Health, Labour and Welfare and Bank of Japan.

The expansion should prove resilient given accommodative monetary conditions, continued world trade growth and the investment rebound. Indeed, rising profits (Figure 2.5) and improved balance sheets in the corporate sector will support fixed capital spending, as suggested by machinery orders (Box 2.2).[5] The most recent surveys show a broad-based improvement in business sentiment that covers firms of all sizes, and services

Box 2.2. **Business investment and the capital stock**

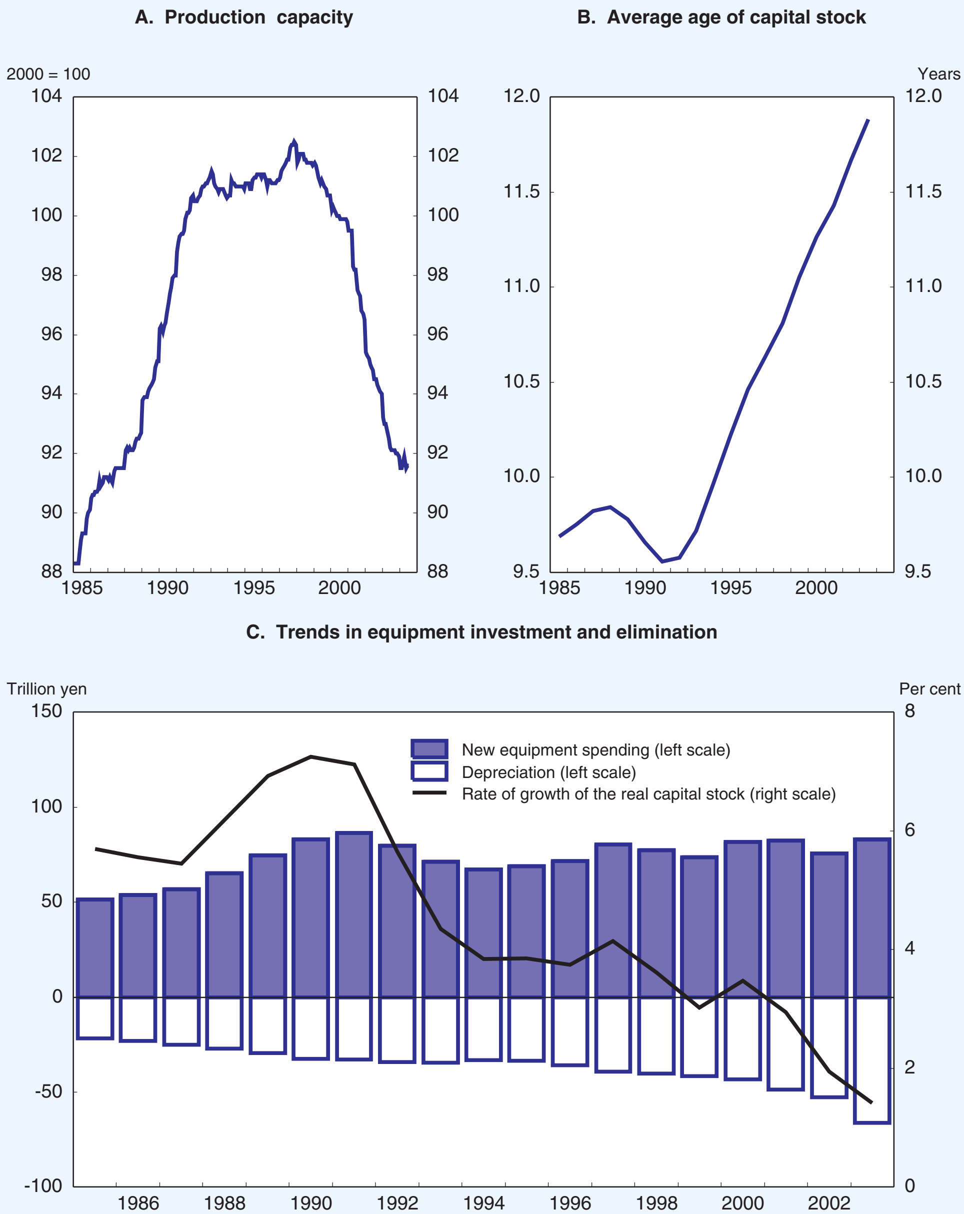
Although business investment has fallen from 20 per cent of GDP in 1990 to around 15 per cent at present in nominal terms, its share of GDP remains one of the highest in the OECD area. This contributed to the upward trend in the capital-output ratio from 158 to 212 per cent over the decade to 2000, in contrast to stable ratios in other major economies, including the United States and Germany. While the higher ratio may be an indicator of over-investment in Japan that would limit the scope for future increases in capital equipment spending, a number of factors suggest that business investment may continue to grow over the next few years.

In particular, the rise in the capital to output ratio was largely due to shrinking output. Firms postponed new investments, allowing the average age of the capital stock to increase from less than ten years in 1990 to 12 years at present and reducing production capacity by 10 per cent from its peak (Figure 2.6). The ageing of the capital stock during a period of rapid technological advance provided profitable investment opportunities that firms, having reduced costs and improved their balance sheets, were in a position to pursue. In addition, firms have boosted their scrapping rate of existing fixed capital significantly (Panel C), the counterpart to the accelerated disposal of non-performing loans. The higher scrapping rate implies that the expansion of the capital stock slowed to less than 2 per cent in 2002 and 2003, despite the increase in business investment. The increased rate of scrapping and the older age of the capital stock suggest that there is scope for continued growth of business investment to help sustain the recovery in 2005 and 2006. Finally, there are concerns, as in other OECD countries, that outsourcing to

Box 2.2. **Business investment and the capital stock** *(cont.)*

lower-cost economies will reduce domestic investment. However, foreign direct investment outflows from Japan have fallen from an annual average of 5.6 trillion yen during the 1990s (1 per cent of GDP) to 4 trillion since 2000. China accounted for a relatively small proportion, although its share rose to 8 per cent in 2003 (Figure 6.4). The net impact of increased integration with China on investment in Japan is probably positive. Indeed, the rebound in investment has been led by large manufacturers in response to a rapid increase in exports, with China playing the leading role.

Figure 2.6. **Investment and the growth of capital stock**



Source: Cabinet Office (2004a) and Ministry of Economy, Trade and Industry.

as well as manufacturing. The reduction in production capacity and the rising age of the capital stock should also help encourage firms to invest in new equipment and to introduce new technology. In addition, external demand should help sustain business investment. Growth in Japan's export markets is projected to continue at double-digit rates in 2005 and 2006, despite some moderation in China. Further gains in business investment should offset further cuts in public investment.

Japan's ability to achieve self-sustained economic growth will depend importantly on private consumption. Income gains are likely to be necessary to support further consumption growth, particularly in light of the recent declines in the saving rate. Indeed, it is now estimated to be less than half of its 1999 level and is below the OECD average (Figure 2.4). The continued shift to non-regular workers is likely to put further downward pressures on wages (Figure 2.3). However, adjusted for deflation, wages have been increasing at a 3.2 per cent annual rate since their trough in the autumn of 2003 (Figure 2.1, Panel F). Given the correlation between profit margins and real wages (Figure 2.5), further increases in corporate profitability should support wage growth.[6] In sum, continued gains in private consumption, accompanied by a smaller but still positive contribution from external demand, are projected to sustain growth at 1½ per cent in 2005 and 2006.

There are a number of potential threats, however, to the durability of the recovery. On the external side, a hard landing in China and a further increase in oil prices are perhaps the most prominent. While China has played a key role in this expansion, as noted above, the direct impact is limited by the fact that exports to China amount to less than 3 per cent of Japan's GDP. Moreover, the moderation of shipments to China has thus far been offset by higher sales to other countries, particularly in Asia (Figure 2.2), though their import growth may ultimately depend on China. In sum, a sharper-than-expected slowdown in China would certainly slow, but not end, the current expansion. As for oil prices, structural changes in Japan have made it much less sensitive to price shocks, both compared to past

Table 2.2. **Vulnerability to higher interest rates**

	United States		**Japan**		Germany		United Kingdom	
	1993[2]	2003	1993[2]	2003[3]	1993[2]	2003[3]	1993[2]	2003
Mean debt-to-equity ratio[1]	112	83	200	109	95	131	69	101
Standard deviation	712	398	691	338	388	490	318	495
Vulnerability in terms of:								
Share of market capitalisation represented by firms with high debt-to-equity ratios[4] (%)	24	19	26	36	18	38	40	30
Share of employment represented by firms with high debt-to-equity ratios[4] (%)	25	16	21	31	23	27	29	13
Memorandum item:								
Mean debt-to-equity ratio in 1993 for firms still existing in 2003	118		197		61		63	

1. Debt-to-equity ratios for individual companies were weighted with the individual firm's share of total market capitalisation and then aggregated to arrive at the economy-wide mean debt-to-equity ratio shown in this table.
2. Data for 1993 include all non-financial firms that were listed on the stock exchange in 1993 (*i.e.* firms that were delisted since then and are no longer in business are also included).
3. For some Japanese and German companies, data for 2003 are not yet available. In these cases, data from 2002 have been used. This concerns 215 companies for Japan and 68 companies for Germany. It should be noted, however, that this does not significantly change the figures obtained.
4. High debt-to-equity ratios are those that are one standard deviation higher than the mean.

Source: OECD Economic Outlook, No. 76.

experience and to other major economies (Box 2.3). A key domestic risk to the expansion is that the upward trend in wages (on a seasonally-adjusted basis) will falter, thus undermining private consumption. Another risk is the possibility of a significant rise in interest rates, which could create problems in financing the government deficit and negatively impact the corporate sector. Despite the overall reduction in debt, there is an increased divergence in the distribution of debt across the business sector (Table 2.2). Firms

Box 2.3. **Is Japan vulnerable to higher oil prices?**

During the year to July 2004, crude oil prices jumped by 40 per cent in dollar terms, although the appreciation of the yen reduced the increase to 32 per cent in local currency terms. In real terms, the world oil price has risen to its highest level since the 1979 oil shock. Thus far, though, the impact on output and inflation in Japan has been rather muted for a number of reasons:

- Mineral fuel imports have fallen from a peak of 7 per cent of GDP in the wake of the second oil shock to a range of 1 to 2 per cent during the past 18 years (Figure 2.7). The energy intensity of the Japanese economy is substantially less than that in North America (Panel B).
- The pass-through of higher crude oil prices into the consumer price index is lower than in other countries (Table 2.3). Only 10 per cent of the rise in oil prices since the beginning of 2003 had been passed through to consumer prices by mid-2004. One reason is that the reliance on long-term import contracts limited the increase in oil import prices to only 16 per cent – half of the rise in crude oil prices in yen terms. The remaining difference suggests that energy companies had sufficient margins to adjust to higher oil prices, as well as difficulty in raising prices in an economy with remaining slack.

Table 2.3. **Pass-through of oil prices increases onto consumer prices**

	United States	United Kingdom	France	Canada	**Japan**	Rise in oil prices (per cent)	
						WTI	Brent
Rise in energy components in CPI (per cent)[1]							
Since January 2002	13.9	9.1	9.3	27.1	0.3	106.8	91.3
Since January 2003	10.4	7.5	3.0	10.3	2.5	24.8	23.9
Pass-through rate (per cent)[2]							
Since January 2002	13.0	8.5	8.7	25.4	0.3		
Since January 2003	41.9	30.1	12.1	41.4	10.1		

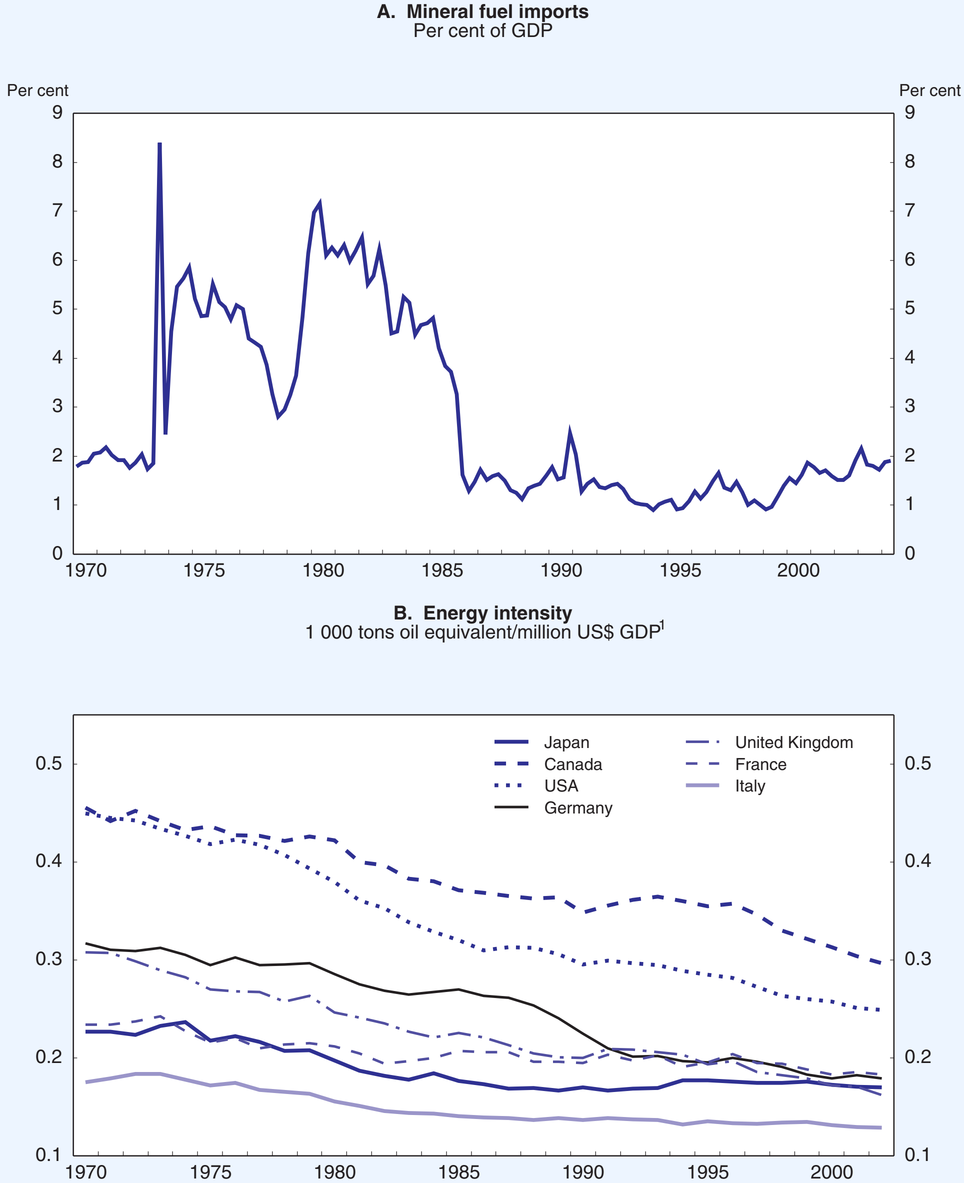
1. Changes in CPI until July 2004 for the United Kingdom and France, until June 2004 for other countries.
2. Pass-through rate = Per cent rise in energy components of CPI/Per cent rise in oil prices.

Source: Deutsche Bank (2004).

Given the lower energy intensity and reduced pass-through, the impact of the oil price hike is likely to be relatively limited in Japan. Econometric models suggest that a $10 per barrel hike in crude prices would reduce output growth by ¼ of a percentage point in 2004 and 2005, with no expected impact on prices in 2005. While the direct impact is not particularly large, a higher oil price could slow growth in Japan's major trading partners that are more dependent on oil. In sum, the indirect effect on the Japanese economy of higher oil prices via weaker external demand may be larger than the direct impact.

Box 2.3. **Is Japan vulnerable to higher oil prices?** *(cont.)*

Figure 2.7. **Energy intensity of the Japanese economy**



1. Based on current purchasing power parities.

Source: Ministry of Finance and OECD, *Energy Balances of OECD Countries.*

with debt-to-equity ratios that are more than one standard deviation higher than the mean account for 36 per cent of stock market capitalisation and 31 per cent of employment in Japan compared to 19 and 16 per cent, respectively, in the United States. Consequently, Japan may be more vulnerable to higher interest rates in the short run than its major trading partners. However, in the longer run, higher interest rates may help by forcing out weak companies that undermine the prospects of healthy companies.

Despite these risks, the current expansion should continue long enough to lift Japan out of deflation. Financial markets expect prices to begin rising in 2005, while a survey by the Bank of Japan indicates that 40 per cent of consumers believe that inflation will be positive by mid-2005, while only 6 per cent expect prices to still be falling (Table 2.4). Moreover, the rise in the domestic corporate goods price index may be a harbinger of higher inflation.

Table 2.4. **Price expectations**

Consumers' expectations of prices in one year

	Falling significantly	Falling a little	Steady	Rising a little	Rising significantly
September 2001	1.4	15.1	64.1	18.2	1.1
March 2002	1.1	12.3	66.9	18.7	0.9
September 2002	1.0	10.5	70.2	17.0	1.2
March 2003	0.7	9.9	64.4	23.5	1.4
September 2003	0.3	6.2	66.6	25.2	1.5
March 2004	0.6	9.1	59.4	28.9	1.3
June 2004	0.6	5.7	51.9	38.5	1.5

Source: Bank of Japan.

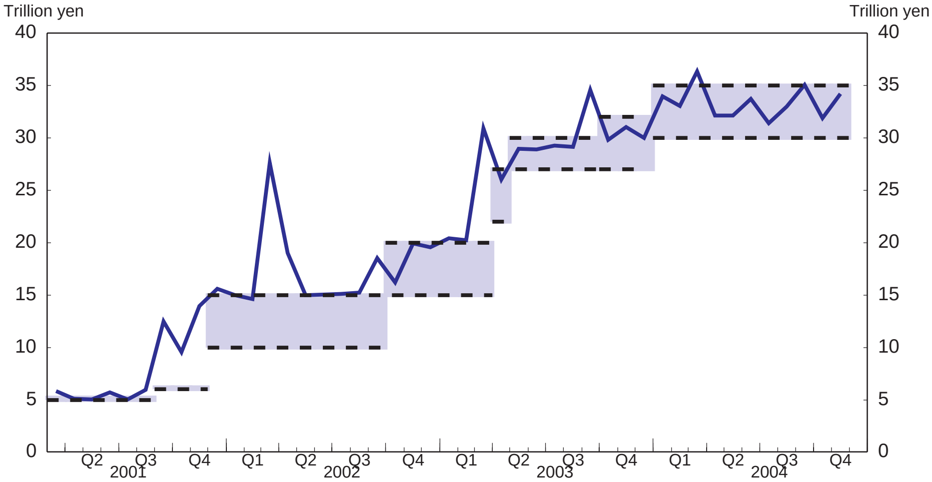
Economic theory links the end of deflation to the closing of the output gap.[7] However, accurately calculating the output gap, which depends on an estimate of the potential rate of growth, is exceptionally difficult in Japan in the wake of a decade of economic stagnation.[8] Weak demand during the prolonged period of economic stagnation tends to bias estimates of labour productivity growth, and consequently potential output growth, in a downward direction. Based on the OECD Secretariat's latest estimate of Japan's potential growth rate, at 1½ per cent over the period 2003 to 2006, the output gap is projected to close in the latter half of 2005.[9] The continued existence of an output gap and the higher rate of potential growth would suggest that Japan has more scope for strong output growth before achieving full employment and facing inflationary pressures. Another element of uncertainty is that, even with the closing of the output gap, there may be a considerable time lag before inflation turns positive. The extended period of deflation has created considerable inertia in price-setting and, consequently, the normal relationship between the output gap and inflation may no longer hold.[10] The end of deflation will also depend on the course of monetary policy.

The role of monetary policy

Under the quantitative easing policy introduced in March 2001, the Bank of Japan conducts monetary policy by setting a target for current account balances at the central bank. The target, originally set at 5 trillion yen, has been increased gradually, reaching 30 to 35 trillion yen (6 to 7 per cent of GDP) in January 2004 (Figure 2.8). To achieve the current account objective, the Bank purchases 1.2 trillion yen of government bonds per month, implying that about a quarter of the government budget deficit is effectively financed by the central bank. In addition, the Bank of Japan ensures sufficient liquidity in the money markets to keep short-term interest rates at zero.

The quantitative easing policy has boosted the monetary base by 63 per cent since 2001.[11] However, the pace of growth has moderated from 12 per cent in 2002 and 2003 to 8 per cent during the first three quarters of 2004 (Figure 2.9). The deceleration reflects the decision to leave the current account target unchanged at the 30 to 35 trillion yen level

Figure 2.8. **Outstanding current account balances at the Bank of Japan**



Note: Dotted lines show the Bank of Japan's target.

Source: Bank of Japan.

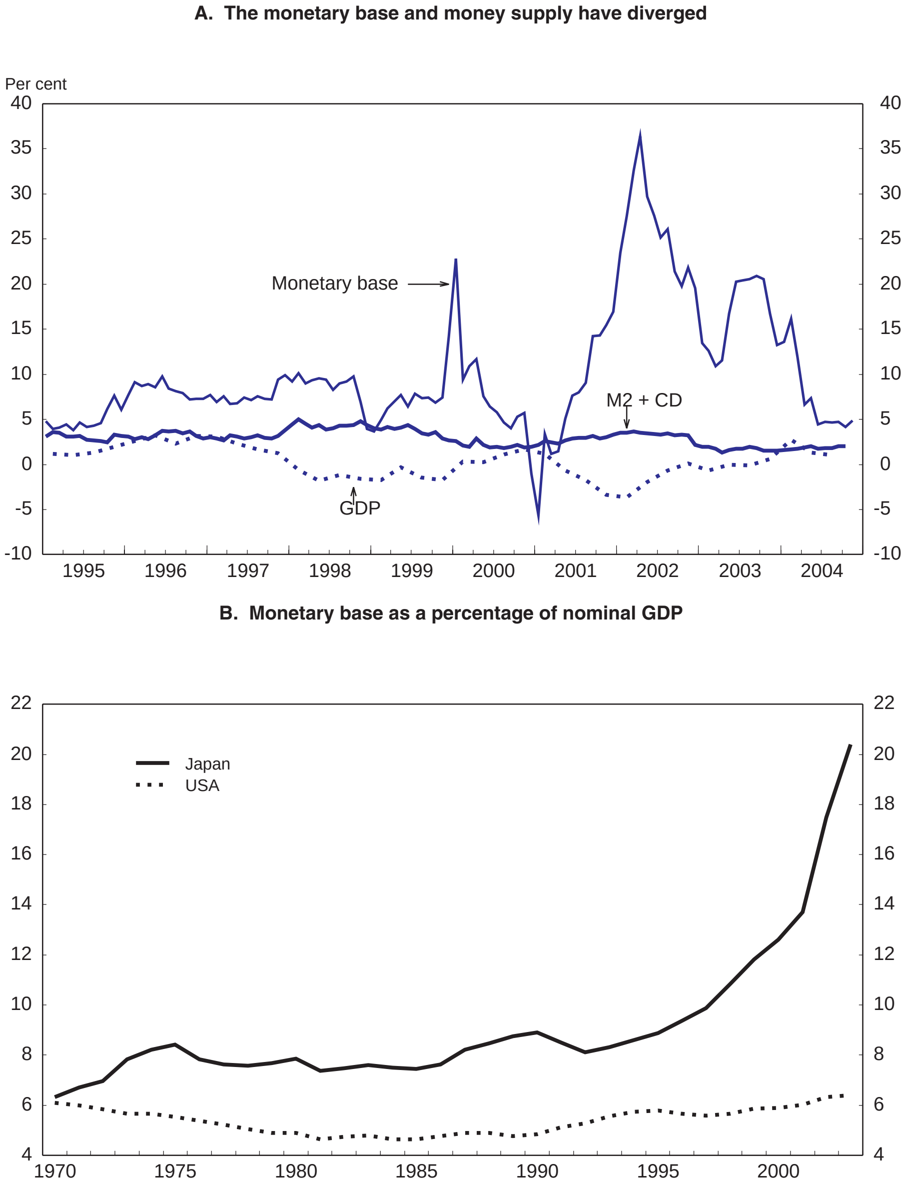
since the beginning of 2004 for several reasons. *First*, the strong economic growth in the first half of the year made a further rise in the target appear unnecessary. *Second*, the rehabilitation of the banking sector has increased stability in the financial market. *Third*, a further increase in the target would exacerbate the negative shock when monetary policy returns to an interest rate-based approach.

Deflation, as noted above, continues more than three years after the introduction of quantitative easing. Indeed, the consumer price index continues to decline, while the GDP deflator accelerated from 1.3 per cent in 2001 to 1.9 per cent in the first half of 2004. Meanwhile, the fall in the core consumer price index (CPI), which was 0.8 per cent in 2001, moderated to about half of that rate in the first semester of 2004. The inability of quantitative easing to bring deflation to an end reflects the weakness of the portfolio rebalancing effect in response to the sharp increase in liquidity. Given the extremely low interest rates, money is a close substitute for financial assets. In other words, the opportunity cost of liquidity (*i.e.* giving up risky assets) is almost zero. The portfolio rebalancing effect was also weakened by the diminished risk-taking ability of households, firms and financial institutions in the context of falling asset prices and an increase in the real value of their debt. In particular, the non-performing loan problem of the banking sector, combined with weak loan demand from the corporate sector, led to a continued decline in bank credit. With the credit channel effectively blocked, the impact of monetary easing has been reduced.

Although quantitative easing has thus far failed to stop deflation, it has had some important positive effects. *First*, it has supported the banks, thus helping to maintain the stability of the financial system.[12] *Second*, it has helped keep long-term interest rates at historically low levels of less than 2 per cent during the past few years, providing a boost to economic activity. As noted above, low interest rates have had an intertemporal effect that has encouraged private consumption by lowering the return on savings. The positive effects of quantitative easing, combined with the progress in restructuring the corporate sector and strong external demand, have sustained the current expansion, which is projected to continue long enough to close the output gap and end deflation.

Figure 2.9. **The monetary base, money supply and nominal output**

Year-on-year percentage change



Source: Bank of Japan and the Federal Reserve Board.

Monetary policy during the transition to positive inflation

In October 2003, the Bank of Japan promised to continue its quantitative easing policy until two conditions are met:

- Inflation, as measured by the core CPI, must be zero or above for a few months.
- "Many" members of the Monetary Policy Board must project that the core CPI will be above zero during the forecasting period.

The latter condition was partially fulfilled in late October when the Monetary Policy Board projected core inflation of 0.1 per cent in FY 2005, although it expects it to remain negative at –0.2 per cent in FY 2004. However, the core CPI, which was stable in the fourth quarter of 2003, has since returned to negative territory. The central bank, though, made it clear that these are necessary rather than sufficient conditions for ending its current monetary policy approach.[13]

The timing of the exit from quantitative easing is an important decision, as a premature tightening would risk pushing the economy back into deflation. For example, if the end of the current policy resulted in a ½ percentage-point drop in the rate of inflation when it was only ¼ per cent, deflation would resume. On the other hand, maintaining quantitative easing too long could result in high and sustained inflation. As noted above, the Bank of Japan's policy has resulted in a sharp rise in the monetary base, which in normal circumstances would have led to a corresponding increase in nominal output. However, such an outcome has been prevented by a "liquidity trap", in which problems in the banking sector and the impact of falling asset prices have prevented the expanding monetary base from boosting output. As a result, the ratio of the monetary base to GDP has risen from a historical average of around 8 per cent to more than 20 per cent (Figure 2.9, Panel B).

With economic conditions improving in Japan and the ongoing rehabilitation of the banking sector, liquidity trap conditions appear to be fading. Perhaps key in this regard is that the level of real interest rates, which were too high during recessionary periods given the zero bound for nominal rates and deflation, are no longer necessarily inappropriate given the economic recovery. This may be viewed as a transition period from deflation to inflation, during which monetary policy begins to regain its influence over the pace of economic growth. Thus, as the money multiplier begins to function again, nominal GDP may move back towards a more normal alignment with base money (Lebow, 2004). If this adjustment were to be realised through a rise in GDP rather than a contraction of the monetary base, the result could be a sharp acceleration of inflation (Table 2.5). For example, with a constant monetary base (of 108 trillion yen), nominal GDP would have to rise by 2.7 times to achieve the 8 per cent historical ratio. Given a potential real growth rate of around 1½ per cent, most of the rise in nominal GDP would have to come through inflation. If the adjustment were completed in five years, the average inflation rate would reach as high as 20 per cent (Case 1 in Panel A). Even if the ratio of base money to GDP remained above the historical average at a level of 10 per cent, inflation would need to run at a 15 per cent annual rate to achieve that ratio, assuming no reduction in base money (Case 1 in Panel B). While these figures are rough estimates subject to considerable uncertainty, there is a clear potential for a high rate of inflation if the monetary base remains at its current level.

Allowing a relatively high rate of inflation for a limited amount of time would have some positive features in a country with a high level of public debt. A reduction in the government debt burden eventually will have to be accomplished via inflation or through fiscal measures, which may also impose efficiency costs given the inherent distortionary effects of taxation.[14] Moreover, higher inflation would ease the burden on debtors, thus helping the banking sector. However, there would also be losers from inflation, notably the holders of government debt as bond prices fall sharply. In addition, higher inflation imposes significant efficiency costs, as well as creating inflationary expectations that would be difficult to reverse. Thus, an independent central bank committed to price stability – as the Bank of Japan is – would certainly be obliged to contract the monetary base when the money multiplier begins to function normally.

Table 2.5. **Adjustment of the monetary base**

	Case 1	Case 2	Case 3	Case 4	Case 5
Monetary base reduced by[1]	0 per cent	25 per cent	50 per cent	56 per cent	60 per cent
A. To reduce the monetary base to 8 per cent of GDP[2]					
Trillion yen	0.0	27.0	54.1	60.4	64.9
Per cent of GDP	0.0	5.4	10.7	12.0	12.9
Necessary rise in nominal GDP, in per cent	168.0	101.0	34.0	18.4	12.9
Assumed rise in real GDP over five years	7.2	7.2	7.2	7.2	7.2
Rise in price level over five years	150.0	87.5	25.0	10.4	0.0
Annual increase in price level for five years	20.1	13.4	4.6	2.0	0.0
	Case 1	Case 2	Case 3	Case 4	Case 5
Monetary base reduced by[1]	0 per cent	25 per cent	38 per cent	45 per cent	50 per cent
B. To reduce the monetary base to 10 per cent of GDP					
Trillion yen	0.0	27.0	40.6	48.5	54.1
Per cent of GDP	0.0	5.4	8.0	9.6	10.7
Necessary rise in nominal GDP, in per cent	114.4	60.8	34.0	18.4	7.2
Assumed rise in real GDP over five years	7.2	7.2	7.2	7.2	7.2
Rise in price level over five years	100.0	50.0	25.0	10.4	0.0
Annual increase in price level for five years	14.9	8.4	4.6	2.0	0.0

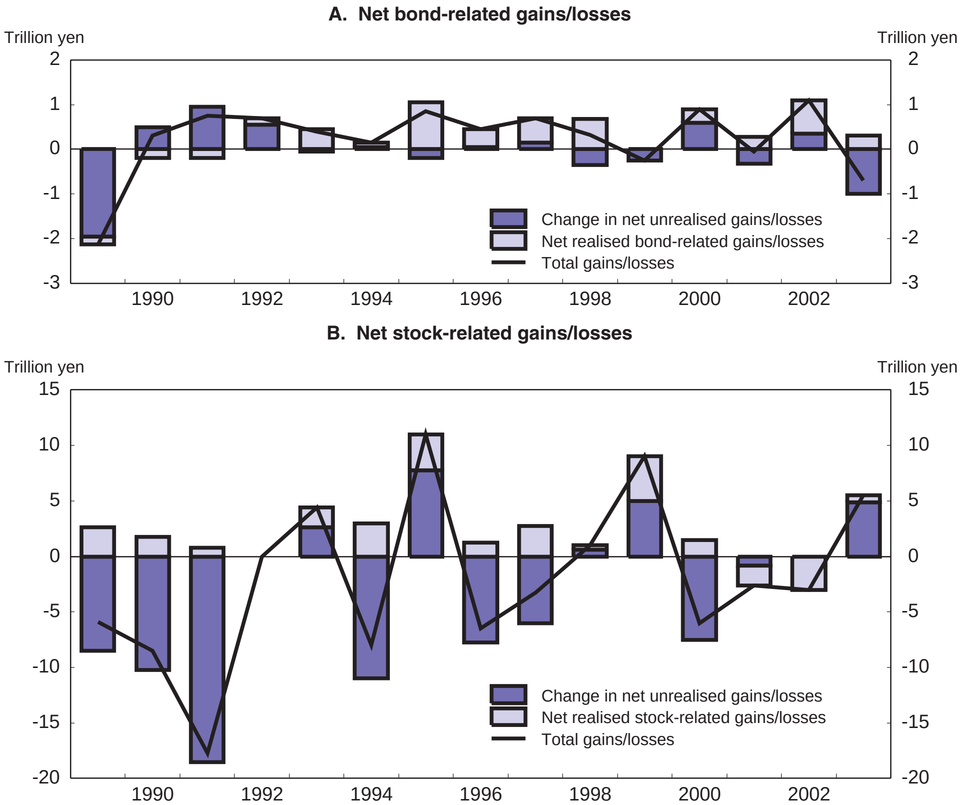
1. Relative to its level of 108.1 trillion yen in the second quarter of 2004.
2. The pre-1990 ratio of the monetary base to GDP averaged 8 per cent.

Source: Bank of Japan and OECD calculations.

The amount of monetary contraction necessary to control inflation is likely to be large. For example, limiting inflation to a 4½ per cent annual pace (Table 2.5, Case 3) would require that base money be cut by between 40 and 54 trillion yen (8 to 11 per cent of GDP) over five years. The Bank of Japan, with more than 90 trillion of government bonds on its balance sheet, would certainly be capable of open market operations on that scale to reduce liquidity. However, the impact on bond prices could be significant. Government net bond issues amounted to around 50 trillion yen (10 per cent of GDP) in 2003, with a quarter of that amount effectively financed by the Bank of Japan's quantitative easing policy. With the normalisation of monetary policy, such purchases would come to an end. If the central bank also started to sell some of its holdings of government bonds to reduce the monetary overhang, the impact would be even larger. In the example cited above (Case 3 of Table 2.5), it would amount to 40 to 54 trillion yen over five years or as much as 11 trillion yen per year. The effect of the central bank shifting from a major buyer to a major seller, which would amount to nearly 25 trillion yen (5 per cent of GDP), could have a significant impact on bond prices.

The banking sector, in particular, might be affected by a major change in bond prices. Since the introduction of quantitative easing in 2001, the banks' holdings of government bonds have risen from 12 to 15 per cent of their total assets. In FY 2003, the major banks' unrealised losses from bonds amounted to nearly 1 trillion yen (7 per cent of their Tier I capital), although the rise in the ten-year bond yield – to 120 basis points from 110 basis points during the previous fiscal year – was quite small (Figure 2.10). According to one estimate, a 100 basis-point rise in long-term interest rates would result in a 2.1 trillion yen capital loss for the major banks.[15] However, there are several factors that could limit the impact. *First*, banks are making efforts to manage interest rate risk by hedging activity and the Financial Services Agency, as the supervisory authority, monitors their risk management practices. *Second*, higher interest

Figure 2.10. **Capital gains at the major banks**



Source: Bank of Japan.

rates would presumably be accompanied by higher output growth, which tends to boost equity prices and land prices (see Box 2.4). Indeed, in FY 2003, gains from stock holdings reached 5 trillion yen, substantially more than bond-related losses (Panel B).

Managing the exit from quantitative easing

Bond yields have proven to be sensitive to changes in economic conditions. For example, after the June 2004 announcement of unexpectedly strong economic growth in the first quarter of the year, the yields on ten-year bonds surged as much as 40 basis points in a week, reflecting concern that the end of the quantitative easing policy may be in sight. Bond holders have a large incentive to exit the market before the change in monetary policy is implemented in order to avoid capital losses. As noted above, the second condition for ending the quantitative easing policy has been partially met. Meeting the first condition, which is projected to occur in 2005, would probably have a major impact on interest rates and the bond market. In addition to the potential for large losses in the banking sector, a significant hike in long-term interest rates would have negative implications for economic activity and for the fiscal situation (see Chapter 3).

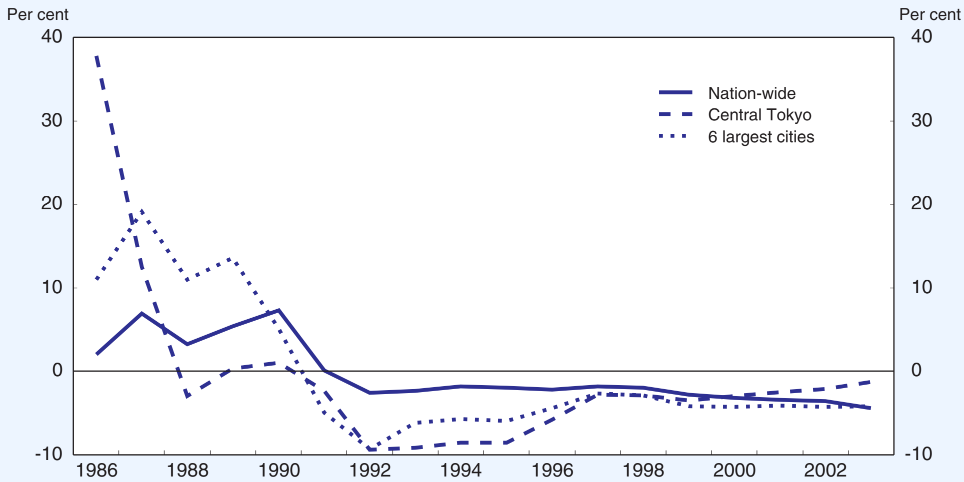
It would thus be desirable to prevent a correction in long-term interest rates and bond prices until there is sustained and robust growth of nominal GDP. Preventing a premature shift would help the banks, which achieved operating profits in 2003 for the first time in a decade, by giving them more time to strengthen their balance sheets. It would also keep the government's debt servicing costs at their low current level.

Box 2.4. **Land price deflation continues**

Land prices, which soared during the "bubble economy" of the late 1980s, have now declined for thirteen consecutive years, reducing the nation-wide average price index to less than half of its peak level (Figure 2.11).[1] However, the cause of the decline has been shifting from a simple adjustment in asset prices to major structural changes that are taking place in the Japanese economy. In particular, the fall in prices in large urban centres is slowing due to buoyant commercial and residential demand while the pace of decline in regional cities and the suburbs of large cities is accelerating. According to a survey by the Japan Real Estate Institute, the rate of decline in average land prices in regional cities accelerated from 3.5 per cent in 2003 to 4.4 per cent in 2004. In contrast, the pace of decline in central Tokyo narrowed from 2.1 per cent to 1.3 per cent over the same period. Some central districts in Tokyo are even reporting price increases.

Figure 2.11. **Land prices continue to fall**

Year-on-year per cent change



Source: Japan Real Estate Institute.

Such a prolonged decline in land price has affected bank lending practices, which have traditionally been dependent on land as collateral. The share of bank lending with real estate as collateral declined from 27 per cent in 1990 to 20 per cent in 2002, while the share of unsecured loans without collateral increased from 32 to 36 per cent. However, given the still important link to bank lending, the on-going fall in land prices continues to adversely affect the banks. In addition, the importance of land in household wealth results in a negative impact on private consumption from falling land prices.

Given the important economic impact of land prices, the government has been addressing the problem through various measures. *First*, the revitalisation of urban centres has been promoted through deregulation of planning and building codes as well as financial assistance. *Second*, taxes on landholding and transactions have been reduced.[2] However, such policies seem to have primarily affected land transactions and urban redevelopment in the centre of large metropolitan areas thus far. Indeed, structural changes such as the on-going shift to a service-based economy, increased population migration from rural areas to

Box 2.4. **Land price deflation continues** *(cont.)*

large urban centres, and the development of large-scale suburban retail centres all tend to reduce land prices in regional cities. Therefore, land price deflation on a nation-wide basis will likely persist well after the end of overall price deflation.

1. Nation-wide land price surveys are conducted by several organisations, including the Ministry of Land, Infrastructure and Transport, the National Tax Agency and private institutions such as Japan Real Estate Institute (JREI). The average rate of decline in the nation-wide land price index published by JREI accelerated to 4.4 per cent in the year to March 2004, while that published by the Ministry of Land, Infrastructure and Transport showed a slight moderation to a 5.2 per cent decline in the year to July 2004. The long-term trends indicated by these surveys, however, are very similar.
2. For example, the tax on long-term capital gains on the sale of land and housing was reduced from 26 to 20 per cent in FY 2004. In addition, the Special Landholding Tax and Land Value Tax were suspended in FY 2003 and FY 1998, respectively.

The Bank of Japan could limit the risk of an early rise in long-term interest rates by setting an inflation rate significantly above zero as a condition for such a regime change. For example, a member of the Monetary Policy Board has stated that before ending quantitative easing, the inflation rate should be at least 1 per cent.[16] While Bank of Japan officials have reassured markets that it will be very cautious in changing monetary policy, the present conditions leave open the possibility that an end to quantitative easing could occur when inflation is only marginally above zero. Setting a rate significantly above zero as the condition would give private agents confidence that monetary policy will not be tightened until deflation is definitively ended, thus helping to guide market expectations.

The Bank of Japan, however, has frequently rejected an inflation-targeting approach since becoming independent in 1998, based on a number of factors (Ito, 2004). *First*, it argued that an inflation-targeting policy was inappropriate for moving from deflation to inflation. *Second*, it would damage the credibility of the Bank, given the lack of any tools that would enable it to achieve an inflation target. *Third*, if the inflation target were credible, the long-term interest rate would rise immediately, thus undermining the expansion. However, setting a specific inflation rate as a criterion for ending quantitative easing differs from the usual inflation-targeting approach. Rather than requiring pre-emptive action aimed at achieving a specific inflation result, it would act as a trigger allowing a change in policy. Such an approach would reassure markets that the end of quantitative easing is not imminent, thus delaying and hopefully defusing the potential negative impacts on the fiscal situation, the banking sector and the economic expansion.

Improving the health of the banking sector

There has been a considerable improvement in the health of the banking sector during the past few years, reflecting upgraded supervision and the strength of the economic expansion. Perhaps most significantly, the banks earned an operating profit in FY 2003 for the first time in a decade (Table 2.6). The return to profitability reflected a decline in loan losses, which have totalled 100 trillion yen (20 per cent of GDP) over the past decade. Smaller loan losses reflect progress in reducing non-performing loans (NPLs) during previous years as well as higher prices for NPLs in secondary markets (Figure 2.12). With faster economic growth generating fewer bad loans, the ratio of NPLs to total lending by the

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Table 2.6. **The balance sheet of the Japanese banking sector**[1]

Trillion yen

Financial year	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Net interest income (A)	7.6	9.2	10.0	9.5	10.0	11.2	11.0	10.3	10.0	10.0	9.6	10.2	9.4	9.0
Other revenue (B)[2]	2.4	1.9	2.3	2.7	2.5	3.7	4.0	3.5	3.4	2.3	2.8	3.0	3.5	3.4
Operating costs (C)	7.0	7.4	7.6	7.7	7.7	7.7	8.0	7.9	7.6	7.3	7.2	7.1	6.8	6.5
Salaries and wages	3.7	3.8	3.9	4.0	4.0	4.0	3.9	3.9	3.7	3.5	3.4	3.2	3.0	2.8
Gross operating profit (D) = (A) + (B) – (C)	2.9	3.8	4.7	4.5	4.8	7.1	7.1	5.8	5.8	4.9	5.2	6.0	6.0	5.9
Loan loss (E)	0.3	0.7	1.7	4.2	5.9	13.7	7.9	14.8	20.6	8.4	6.9	9.9	6.6	5.3
Net operating profit (F) = (D) – (E)	2.7	3.1	3.1	0.3	–1.0	–6.5	–0.8	–9.0	–14.8	–3.4	–1.7	–3.8	–0.6	0.6
Realised capital gains (G)[3]	2.0	0.7	0.0	2.0	3.2	4.4	1.1	3.6	0.7	4.0	1.6	–2.5	–4.1	0.6
Net profit (F) + (G)	4.7	3.8	3.1	2.4	2.2	–2.1	0.3	–5.4	–14.1	0.6	–0.1	–6.4	–4.6	1.2
Assets	927.7	914.6	859.6	850.2	846.0	852.8	862.4	859.6	808.0	768.8	828.0	775.4	751.4	757.5
Outstanding loans	521.7	537.3	542.4	539.2	538.7	556.4	564.6	545.5	516.2	493.7	486.6	466.3	440.4	424.3

1. All commercial banks.
2. Other revenue includes all other profits such as dealing profits and fees, but excludes realised capital gains on equities and real estate.
3. Realised capital gains include gains from equities and real estate.

Source: Bank of Japan.

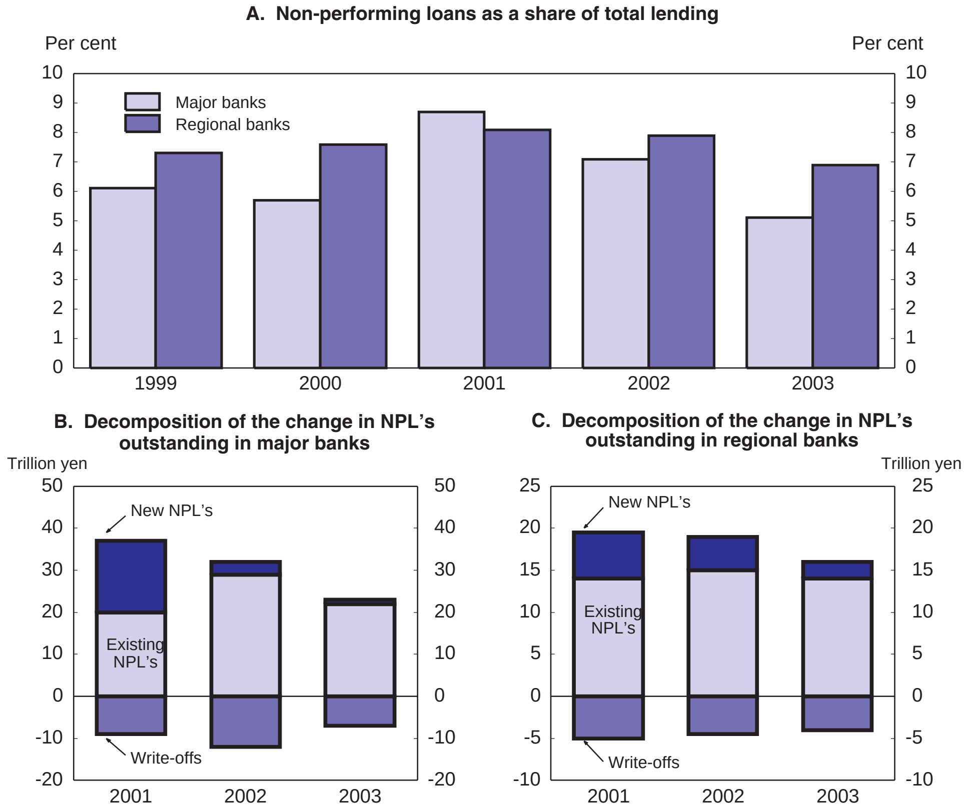
major banks has fallen from a peak of 8.4 per cent in March 2002 to 4.7 per cent in September 2004. Thus, the government's objective of reducing the major banks' NPL ratio to about half of the March 2002 level by March 2005 has nearly been achieved.

The decline in NPLs has occurred at the same time that prudential supervision has been upgraded. The Financial Services Agency (FSA) has conducted five rounds of special inspections of large borrowers, which has resulted in the downgrading of a significant amount of lending (Table 2.7). However, the amount of losses resulting from the disposal of these loans following the September 2004 inspection was only one-third of the level in March 2003, despite the increase in the number of companies downgraded. The results of the September 2004 inspection show that the conditions of large borrowers have become polarised. The results of the FSA's regular inspections show a smaller gap with the major banks' self-assessment. In the October 2003 inspections, the FSA reported classified loans to be only 6 per cent higher than the banks' self-assessment, compared to gaps of 36 per cent and 10 per cent in the first and second rounds, respectively.

Although the reduction in costs related to NPLs, together with an increase in fee income, has boosted profits, the weak core profitability of Japanese banks remains a concern. Low profitability is not due to high operating costs, as there has been a significant rationalisation of the banking sector over the past decade. Instead, it reflects low interest margins on lending. As a result, net interest income relative to assets is relatively low in Japan, making banks vulnerable to any unforeseen rises in NPLs as well as to changes in the government bond market.

Despite the positive trends in profits and NPLs, there is still concern about the quality of bank capital. The overall capital adequacy ratio, at 11.4 per cent in March 2004, is well above the 8 per cent BIS standard (Table 2.8). However, "deferred tax assets" accounted for nearly a third of the Tier I capital of internationally-active banks in March 2004. These assets – future tax deductions which are allowed to count as assets – are dependent on future profits. Given the banks' long record of losses, this raises concern. Without these

Figure 2.12. **Non-performing loans in the banking sector**



Source: Bank of Japan (2004).

assets, the capital adequacy ratio of major banks would have been substantially lower at 9.5 per cent. Deferred tax assets have declined since 2003, as the return to operating profitability allowed banks to cash in some of these assets to reduce their tax liability. Nevertheless, rigorous and transparent treatment of deferred tax assets, based on realistic projections of future income, remains necessary. Moreover, the treatment of such assets in the capital base should be reconsidered. The validity of allowing deferred tax assets to count as capital is questionable at weaker institutions, given that they would disappear when a bank fails and thus be unavailable to protect depositors. Indeed, the FSA, as a supervisory authority, plans to consider specific regulatory treatment of deferred tax assets in calculating the capital adequacy ratios in the spring of 2005, based on the Financial System Council report of June 2004. In addition to deferred tax assets, public funds account for nearly one-fifth of banks' Tier I capital. Taken together, this indicates that shareholder equity accounts for a relatively limited amount of capital.

Despite the improvement in bank balance sheets and the rebound in investment, bank lending continues to decline, though at a somewhat slower pace (Figure 1.8). Adjusted for special factors, it fell 1.2 per cent in August 2004 from a year earlier.[17] Part of the improvement, though, was due to increased lending to households, which is rising at a 5 per cent pace as banks expand housing loans in the place of a public-sector financial institution. In contrast, bank lending to the corporate sector is still falling substantially at

Table 2.7. **Results of special inspections of large borrowers**

Trillion yen

	March 2003		September 2003		March 2004		September 2004	
	Number of borrowers	Credit	Number of borrowers	Credit	Number of borrowers	Credit	Number of borrowers	Credit
Total	**167**	**14.4**	**161**	**13.1**	**133**	**10.5**	**135**	**9.2**
Upgraded	17	1.9	6	0.3	23	1.3	19	1.6
Unchanged	119	9.9	131	10.9	82	6.9	74	3.1
Downgraded	27	2.4	24	1.9	26	2.2	39	4.2
Removed from balance sheet	4	0.2	–	–	2	0.1	3	0.3
NPL disposal losses		1.3		0.9		0.7		0.4
Write-offs		0.8		0.3		0.4		0.3
Higher provisions		0.5		0.6		0.3		0.2

Source: Financial Services Agency.

Table 2.8. **Capital of the banking sector**[1]

Trillion yen

	March 2003	Sept 2003	March 2004	Percentage change in year from March 2003 to March 2004
Tier I (A)	13.5	14.8	14.2	4.9
Tier II (B)[2]	10.9	12.0	11.8	7.9
Total capital (A + B = C)	24.5	26.8	26.0	6.2
Risk-weighted assets (D)	232.7	229.5	228.8	–1.7
Loans	220.3	213.8	209.1	–5.1
Equities	14.4	16.3	17.0	17.9
Capital adequacy ratio (C/D)	10.5	11.7	11.4	
Components of capital				
Public funds (F)[3]	2.6	2.5	2.5	–3.8
Proportion of Tier I (F/A)	19.2	16.9	17.6	
Deferred tax assets (G)	6.3	5.3	4.4	–30.7
Proportion of Tier I (G/A)	46.4	35.6	30.6	
Adjusted capital (C – F – G = H)	15.6	19.0	19.1	22.8
Adjusted capital adequacy ratio (H/D)	6.7	8.3	8.4	

1. The figures are made up of the sum of internationally-active banks, 16 in total at the end of March 2004.
2. "Tier II" is calculated by (C) – (A).
3. Public funds include only preferred stocks, excluding subordinated bonds and subordinated loans. Furthermore, it does not include Mizuho Corporate Bank.

Source: Bank of Japan.

a rate of 6 per cent. Given the dependence of smaller companies on bank finance, sustaining a broad-based economic expansion will likely require a reversal of the contraction in bank lending.

A second concern is the weaker position of regional banks, which as a group are characterised by lower profits and capital adequacy ratios and higher levels of non-performing loans (Table 2.9). Although regional banks account for a third of the total stock of NPLs, the financial supervisors have not imposed targets for reducing bad loans, in contrast to major banks. The difference in supervision reflects the priority given to sustaining the role of regional banks in financing small and medium-sized enterprises

Table 2.9. **A comparison of major banks and regional banks**

March 2004

	Ordinary profits (billion yen)	Net income (billion yen)	NPL ratio[1] (per cent)	Capital adequacy ratio (per cent)
Major banks	1 236.8	1 009.7	5.2	11.4
Regional banks I	–107.2	–657.7	6.8	9.3
Regional banks II[2]	140.9	79.4	7.5	8.3

1. As a share of total lending.
2. Formerly mutual banks.

Source: Financial Services Agency.

(SMEs). Moreover, in August 2003, 626 financial institutions[18] were required to submit plans to revitalise SMEs and to activate regional economies under the Action Program concerning the enhancement of Relationship Banking Functions. The FSA monitors the implementation of these plans on a semi-annual basis. To ensure the orderly functioning of the credit channel, the government recently introduced a framework for public fund injections in regional banks based on the submission of a management strengthening plan that includes numerical targets for profitability and measures to boost regional economies.

Overall assessment

The current expansion is projected to continue through 2006, which would make it the longest since the collapse of the bubble in the early 1990s. The pace of growth, at an annual rate of around 2 per cent since 2002, has been boosted by buoyant exports, thanks in part to China. The positive impact on business-sector profits, combined with the progress made in corporate restructuring, has supported a rebound in business investment. Private consumption has also been a source of growth, thanks in part to a further decline in the household saving rate. Despite the impact of slower world trade growth and higher oil prices, the strength of domestic demand should sustain the upturn at a pace of around 1½ per cent. This current expansion is projected to bring an end to deflation, as measured by the consumer price index.

Even with the end of deflation, the Bank of Japan should continue its quantitative easing policy until inflation is sufficiently high so as to make the risk of renewed deflation minimal. The central bank has promised to maintain its current policy at least until the core consumer price index (which excludes fresh food, but includes energy) is zero or above and the Monetary Policy Board projects it to be positive over the forecasting period. These conditions, though, are not sufficiently ambitious, as they leave the possibility that the quantitative easing policy will end when inflation is positive but still close to zero. Such an early tightening of monetary policy would risk pushing the economy back into deflation. Alternatively, if the quantitative easing policy were kept in place too long, the large expansion in the monetary base could result in sustained inflation at a high rate. However, renewed deflation would impose higher costs than short-term overshooting of the optimal level of inflation.

There is a risk that the exit from quantitative easing will be accompanied by a significant rise in long-term interest rates, with potentially adverse implications for the economy, the fiscal situation and the banks. Such an event could occur even prior to any shift in monetary policy as holders of bonds sell to avoid losses. Setting a higher inflation threshold of perhaps 1 per cent as a condition for changing monetary policy would help to guide market expectations and prevent a premature reaction. In addition, a clear communication strategy on how the exit strategy will be implemented may help minimise the eventual costs. In any case, a higher inflation threshold would delay the normalisation of interest rates, and thus give banks additional time to improve their financial position.

Indeed, the health of the banking sector has improved significantly during this expansion. Non-performing loans of major banks are declining in line with the government's target, while the banking sector has returned to profitability. Despite the rehabilitation of the banks and strong business investment, bank lending to the corporate sector continues to decline. Given the importance of banks in providing funding, especially for smaller companies, a sustained economic expansion will likely require a reversal of the declining trend in bank lending. The financial supervisors should thus continue to press banks to further reduce non-performing loans and strengthen their capital base. Such an approach should also be applied to regional banks.

Notes

1. This is the average of all firms in all industries reported by the Ministry of Finance in the *Financial Statements Statistics of Corporations by Industry*.
2. Employee compensation, deflated by the CPI, fell 0.6 per cent in 2003, compared to a 2.5 per cent decline in 2002.
3. In July 2004, the impact of higher prices for gasoline and rice boosted the CPI by 0.3 per cent (year-on-year). Nevertheless, the overall index continued to decline at a 0.3 per cent rate.
4. An analysis of Japan's past 11 economic upturns shows that the initial acceleration phase of the cycle lasts between 12 and 18 months (Jerram, 2004). This is followed by a second phase of the upturn with slower growth.
5. Although volatile, this indicator suggests that business investment will continue rising. Machinery orders declined in the first and third quarters of 2004, but surged in the second quarter and the outlook is positive for the fourth quarter.
6. The positive correlation was broken in 2002, when a rise in profit margins was accompanied by a faster decline in real wages. In 2003, though, a further improvement in profits helped slow the decline in real wages.
7. A narrowing (widening) of the output gap should lead to an acceleration (deceleration) of inflation. Hence, inflation could turn positive before the output gap is fully closed. A positive gap – indicating that the economy is operating beyond potential – would seem sufficient to ensure positive inflation.
8. Indeed, prior to the shift to the chain-linked methodology, potential growth was estimated by some economists to be as high as 2.0 to 2.5 per cent, implying that the output gap is still large at 5 to 6 per cent (Matsuoka, 2004). On the other hand, potential growth is estimated at only 1.0 per cent by other experts. The Cabinet Office has published an estimate of potential growth at 0.9 per cent in the third quarter of 2004 (Cabinet Office, 2004b).
9. These estimates were made prior to the revision of Japanese national accounts in December 2004, which introduced chain-linked indices. Given the lack of chain-linked data for the capital stock, it is not possible to obtain a consistent estimate of potential growth at the present time.
10. In other words, the economy is located on a very flat part of the Phillips curve, which shows the trade-off between employment declines and inflation. Mourougane and Ibaragi (2004) demonstrate that at very low rates of inflation or deflation, the Phillips curve is nearly flat. Thus, a reduction in the unemployment rate and/or output gap has little impact on the price level.
11. The monetary base consists of banknotes and coins in circulation and the current account balances at the Bank of Japan.
12. Financial fragility in 1997 was a key factor in ending the expansion that had begun at the end of 1993.

13. Indeed, the Bank of Japan stated that: "The above conditions are necessary conditions. There may be cases, however, that the Bank will judge it appropriate to continue with quantitative easing even after these two conditions are met."
14. The third option – outright repudiation of the debt by the government – is not a realistic choice.
15. This estimate, by Standard and Poor's, was published in the *Nihon Keizai Shimbun* on 11 July 2004. A loss of this magnitude would amount to around 15 per cent of Tier I capital.
16. Bank of Japan press release, "The current monetary and economic situation", 18 February 2004.
17. Special factors include securitisation, loan write-offs and related items and exchange rate effects.
18. This includes 65 regional banks I, 51 regional banks II, 321 Shinkin banks and 189 credit co-operatives.

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Chapter 3

Achieving fiscal sustainability

This chapter discusses the deterioration in the fiscal situation and measures needed to restore fiscal sustainability in the light of future pressures for increased spending, notably from rising interest payments and the social security system. The government's Medium-Term Economic and Fiscal Perspective should be improved to meet these challenges. Preventing a hike in the risk premium calls for a more credible and ambitious medium-term plan that includes a stronger link to specific spending cuts and revenue increases to reduce the budget deficit. Spending should be contained by further reform of pensions and healthcare, continued reductions in public investment and improvements in the public expenditure framework. On the revenue side, broadening the bases of personal and corporate income taxes is a priority, while the rate of the consumption tax (VAT) should be increased at some point. With growth projected to remain above potential, progress in fiscal consolidation should not be delayed.

Although Japan has made some progress in addressing the deterioration in the fiscal situation that occurred during the decade 1992 to 2002, the fiscal consolidation process is still at an early stage. There have been significant cuts in public investment and limits on overall spending, making the public sector a drag on growth during this recovery (Figure 2.1). Such spending restraint, combined with the strong economic recovery, is expected to reduce the government deficit by around 1 per cent of GDP in 2004 to 6½ per cent. Nevertheless, public debt, already the highest in the OECD area as a share of GDP, continues to increase at a rapid pace. Although the low level of long-term interest rates may suggest that the fiscal problem is not serious, the current situation is supported by a number of exceptional factors, including a lack of credit demand by households and the corporate sector and a very accommodative monetary policy. With the economic recovery and the restoration of the credit transmission channel, these conditions will change at some point, creating a risk of an even faster run-up in public debt.

This chapter focuses on how Japan can achieve fiscal sustainability during the coming decade.[1] After examining the size and seriousness of the fiscal situation, the chapter looks at pressures for increased spending in the medium term. The third section reviews the government's *Medium-Term Economic and Fiscal Perspective* and how it has been applied in practice, followed by a look at how other OECD countries accomplished major shifts in budget balances. The final sections discuss specific expenditure and tax measures to promote consolidation. The chapter ends with an overall assessment.

This chapter concludes that Japan's fiscal situation is cause for concern. A decade of economic stagnation and tax cuts has reduced government revenue as a share of GDP to one of the lowest levels in the OECD area. Meanwhile, outlays have edged closer to the OECD average, due in part to numerous fiscal stimulus packages and pressure from population ageing. As a result, Japan's budget deficit as a share of GDP in 2003 was the largest among member countries. The solution is clear: Japan needs to cut expenditures to match the low level of revenues or raise revenues closer to OECD norms. The experience of other OECD countries that have achieved large reductions in budget deficits suggests that some combination of the two will be needed to ensure fiscal sustainability. While the size of the adjustment needed to stabilise the public debt to GDP ratio is clear, concern that deficit reduction will undermine the current expansion makes it difficult to develop the political consensus necessary for action. However, there are costs to postponing fiscal consolidation. The longer it takes to achieve a primary budget balance, the higher the eventual level of public debt and the greater the resulting burden on the economy. Moreover, a drawn-out fiscal consolidation process raises the possibility of a destabilising increase in the risk premium on government bonds. Such an increase could be limited or avoided by a credible fiscal consolidation programme. However, the government's *Medium-Term Economic and Fiscal Perspective* should be more ambitious and detailed than the plan that was revised in early 2004 and include effective policy feedback to prevent slippages from the target. Establishing a credible medium-term plan, while stepping up the pace of deficit reduction during periods of strong growth, is essential to achieve fiscal sustainability.

How serious is the fiscal situation?

Japan began the 1990s with a government budget surplus and a modest level of public debt. However, expansionary fiscal policies and a decade of economic stagnation resulted in a record budget deficit of nearly 8 per cent of GDP in 2002 and 2003 (Table 3.1).[2] The primary budget deficit, which excludes interest payments, was also the highest in the OECD area. Although the deficit will decline in 2004, public debt relative to GDP is still rising at a rapid pace. Fiscal sustainability requires that nominal GDP grow at least as fast as the stock of government debt in the long run.[3] However, during the decade since 1992, government debt has risen at a 7½ per cent annual rate, far outstripping the weak 0.3 per cent rise in nominal GDP. Clearly, on current trends, there will be an explosive rise in public debt, an outcome projected by a number of studies.[4] On a net basis, government debt is among the highest in the OECD area at nearly double the average, although including the assets of the central bank would significantly reduce the level (see Box 3.1). Given the rapid rise in indebtedness, international rating agencies have downgraded Japan's sovereign debt rating to the lowest among the G-7 countries.[5]

Table 3.1. **The fiscal situation in Japan**

Per cent of GDP for general government[1]

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Net lending	–5.5	–7.2	–7.5	–6.1	–7.9	–7.7	–6.5	–6.4	–6.3
Net primary balance[2]	–4.1	–5.8	–6.0	–4.7	–6.4	–6.2	–5.0	–4.7	–4.3
Cyclically-adjusted net lending	–5.3	–6.7	–7.2	–5.5	–6.8	–6.8	–6.3	–6.4	–6.6
Cyclically-adjusted primary balance	–3.9	–5.2	–5.8	–4.1	–5.4	–5.4	–4.8	–4.7	–4.5
Total receipts	30.6	30.5	30.7	31.6	30.2	29.9	30.2	30.7	31.2
Total disbursements	36.1	37.7	38.2	37.7	38.1	37.6	36.7	37.2	37.5
Gross debt	112.2	125.7	134.1	142.3	149.3	157.5	163.5	170.0	175.4
Net debt	45.8	53.6	59.1	65.2	71.4	79.1	84.4	90.1	94.7

1. OECD estimates and projections for 2004 to 2006.
2. Excludes net interest payments by the government.

Source: Cabinet Office and OECD calculations.

The seriousness of the public debt problem is to some degree masked by the low level of long-term interest rates on government bonds, indicating that the risk premium is still low. The rate on ten-year government bonds has remained below 2 per cent since 1998, making it the lowest among OECD member countries and limiting the government's interest payments. Indeed, the average interest rate on the public debt (total interest payments divided by government debt) fell from 5.4 per cent in 1991 to 2 per cent in 2002 (Figure 3.1). Consequently, the government's interest payments declined from 3½ per cent of GDP to 3 per cent over that period despite the sharp increase in public debt. If the average interest rate had remained at the 1991 level, an additional 26 trillion yen (5 per cent of GDP) in interest payments would have been required in 2002.

The low level of long-term interest rates is a result of exceptional circumstances. Banks have been reluctant to expand lending, focusing instead on reducing their non-performing loans (NPLs). At the same time, loan demand from households and the corporate sector has been relatively weak, as firms have pursued de-leveraging. The Bank of Japan's policy of quantitative easing has contributed to keeping the long-term interest rate at a historically low level (see Chapter 2). The abundant liquidity supplied by the

Box 3.1. **How to measure the size of the public debt properly?**

As noted above, the ratio of government gross financial liabilities to GDP is the highest in Japan among OECD countries. Gross debt is often considered to be a more appropriate indicator than net figures for several reasons. *First*, government assets are largely held by the social security system and are earmarked to future obligations. *Second*, the quality of some government assets, such as credits to Fiscal Investment and Loan Programme institutions, is doubtful. Only about a third of government assets are in the form of liquid instruments, such as bonds or cash. *Third*, gross debt may understate the government's eventual obligations, as it does not include contingent liabilities, such as government loan guarantees for quasi-government institutions.

However, the Japanese government also holds a significant amount of financial assets, amounting to half of financial liabilities in 2003. This reduces net debt to around 80 per cent of GDP, still the fourth highest in the OECD (Table 3.2). In terms of the economic burden, net debt may provide a better indicator since government assets also generate income. In 2003, about half of the interest payment on liabilities – amounting to about 3 per cent of GDP – was offset by interest receipts. Consequently, net interest payments were about 1½ per cent of GDP.

Table 3.2. **Different measures of government debt**

	2000	2001	2002	2003[3]	Growth rate
A. Trillion yen					
Gross debt	685.6	720.1	744.9	784.2	4.6
Net debt	302.4	329.6	355.9	394.1	9.2
BOJ net worth[1]	72.1	77.9	84.8	86.2	6.1
Consolidated[2]	230.3	251.7	271.2	307.9	10.1
	2000	2001	2002	2003[3]	
B. Per cent of GDP					
Gross debt	134.1	142.3	149.3	157.5	
Net debt	59.1	65.2	71.4	79.1	
BOJ net worth[1]	14.1	15.4	17.0	17.3	
Consolidated[2]	45.0	49.7	54.4	62.0	

1. Calculated by Lebow (2004).
2. General government and Bank of Japan combined.
3. OECD estimates.

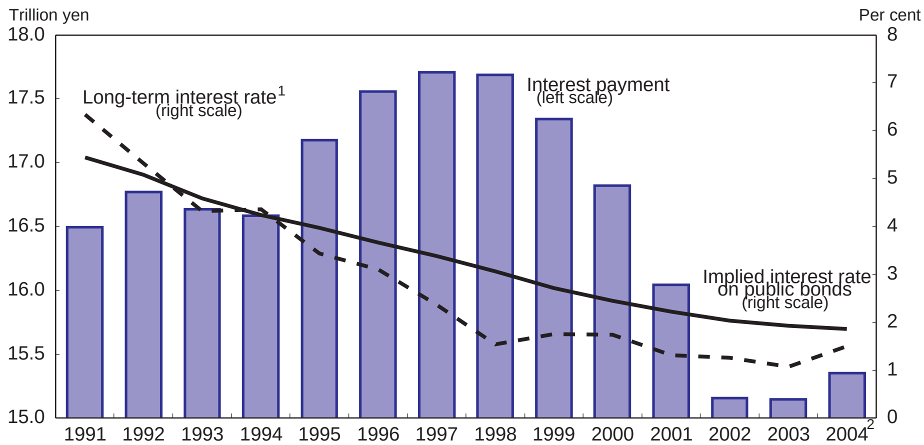
Source: Lebow (2004).

The government interest burden would be even lower if interest payments to the Bank of Japan were included as receipts. The central bank has monetised a significant portion of public debt through its purchases of public bonds. While the Bank of Japan has operational independence, there may be some justification for considering central banks as part of the public sector as they can finance public spending by monetising government debt and are subject to rules on the transfer of their surpluses to the government. With the net worth of the Bank of Japan estimated at 17 per cent of GDP in 2003 (Lebow, 2004), consolidating it with the public sector would lower general government net debt to 62 per cent of GDP (Table 3.2). The corresponding levels would be 40 per cent in the United States and about 30 per cent in the United Kingdom and Canada.

Box 3.1. **How to measure the size of the public debt properly?** *(cont.)*

While including the government's financial assets and the Bank of Japan changes the level of public indebtedness, it does not change recent trends. Indeed, net financial debt on a consolidated basis, including the Bank of Japan, has been increasing at an annual rate of 10 per cent since 2000.

Figure 3.1. **Interest payments by the government**



1. Ten-year government bonds.
2. OECD estimate.

Source: Cabinet Office and OECD estimates.

monetary authorities to the banks has helped them to purchase government bonds. Moreover, the Bank of Japan itself has been purchasing government bonds as part of the quantitative easing policy. Indeed, the amount of such purchases is equivalent to a quarter of the amount of new bond issues, boosting the central bank's holdings to 15 per cent of the outstanding stock of government debt. In sum, expansionary monetary policy and the lack of risk-taking by the private sector explain the exceptionally low rate of interest despite the high and rising level of public debt.

However, this exceptional situation is beginning to change. With the reduction in NPLs advancing in line with the government's target for 2005 and the rebound in investment, the pace of the decline in bank lending is moderating. As for monetary policy, one of the necessary conditions established by the Bank of Japan for ending quantitative easing has been partially fulfilled and the first is likely to be met during this expansion. As the private sector's appetite for risk returns and monetary policy shifts to a more standard approach, there is the risk of a sudden and sustained rise in interest rates.

The pressures for increased spending

This section will discuss two factors that are likely to boost government outlays. *First*, interest payments are likely to increase in the context of rising government debt and a normalisation of long-term interest rates from their exceptionally low level. *Second*, population ageing will tend to increase social security spending. The number of working-age persons has been decreasing since 1995 and their share of the total population will fall by around 5 percentage points during the next decade, according to government projections. Meanwhile, the share of the population over 65 would increase from 20 to 26 per cent over the same period. Given the declining birth rate, the total population is projected to begin decreasing in 2006.

The impact of higher interest rates

A substantial rise in interest rates would create a serious risk of financing strains, although the impact would be gradual as the average maturity of government debt is five years. According to an estimate by the Japanese authorities, a 1 percentage point increase in bond yields in 2004 would add 1.3 trillion yen (0.3 per cent of GDP) of debt servicing cost in FY 2005, increasing to 3.6 trillion yen in FY 2007. This would not be problematic if the higher interest rate were due to higher nominal GDP growth that also boosts tax revenue. However, given the repeated tax cuts in previous years, there is a risk that increased tax revenue would only partially offset the higher debt servicing cost. For example, while nominal GDP increased 0.7 per cent in FY 2003, personal income tax revenue fell by around 6 per cent, although special factors explain part of the decline.

Since the extent of the rise in interest payments depends on the level of interest rates, Table 3.3 presents two scenarios. In the first, the nominal long-term interest rate over the next decade is projected to average 2.8 per cent, the level for FY 2008 in the government's *Medium-Term Economic and Fiscal Perspective*, with nominal GDP growth at the same level (Table 3.4). This would double government interest payments from 3 per cent of GDP at present to 6 per cent in 2014 (Scenario A1). However, this scenario, which implies real output growth and real long-term interest rates of around 2 per cent, is slightly optimistic. The relative magnitudes of the growth rate and the interest rate may turn out to be less favourable.[6] Combining a higher interest rate with a lower rate of output growth, government interest payments would rise to nearly 10 per cent of GDP in 2014 (Scenario B1).

A more serious threat is a hike in real interest rates due to a higher risk premium as public debt rises into uncharted territory. Such an increase would not be offset by larger tax revenues. Moreover, it would further narrow the room for fiscal manoeuvre, weakening the resilience of the economy to shocks. However, there are some factors that tend to prevent such an increase in Japan. *First*, public debt is denominated in yen and 96 per cent is held domestically. *Second*, half of public debt is held by government-related institutions, including public financial institutions such as Japan Post and the Bank of Japan (Figure 3.2). *Third*, the private sector has a high saving rate and there is a strong home bias in Japanese investment, in part due to regulations. For example, pension funds are required to invest 68 per cent of their assets in Japan.

However, there are other factors that may raise concerns about financing large government budget deficits. As noted above, the end of the quantitative easing policy by the Bank of Japan and the greater appetite for risk in the private sector could result in higher interest rates. In addition, population ageing has contributed to a fall in the household saving rate to an estimated 5 per cent in 2004 and further declines might complicate the financing of government deficits. Moreover, Japan Post, which attracts a significant share of household savings and funnels it to the public sector, is to be privatised (see Chapter 5). A marked increase in interest rates would have large negative effects on the fiscal situation, financial institutions in both the public and private sectors and on the real economy. The potentially serious impact underlines the importance of addressing the fiscal problem.[7]

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Table 3.3. **Projections of government spending over the medium term**

	GDP growth rate (per cent)		Long-term interest rate (per cent)		Government spending Average annual increase in per cent between 2004 and 2014								Total government spending (per cent of GDP)[3]	
					Public investment		Social security payments[1]		Gross interest payments		Other government spending[2]			
	Real	Nominal	Real	Nominal	Growth rate	Share of GDP in 2014	Growth rate	Share of GDP in 2014	Growth rate	Share of GDP in 2014	Growth rate	Share of GDP in 2014	2014	Rise since 2004 (percentage points)
A. High growth/low interest rate[4]														
Scenario 1	2.0	2.8	2.0	2.8	2.8	4.0	3.4	23.5	10.1	6.2	2.8	7.7	41.4	4.6
Scenario 2	2.0	2.8	2.0	2.8	0.0	3.2	3.4	23.5	9.6	5.9	0.0	5.8	38.4	1.7
Scenario 3	2.0	2.8	2.0	2.8	–2.0	2.7	3.4	23.5	9.3	5.7	0.4	6.1	38.0	1.3
B. Low growth/high interest rate[5]														
Scenario 1	1.3	2.1	3.0	3.8	2.8	4.2	3.1	24.2	14.4	9.6	2.1	7.6	45.4	8.6
Scenario 2	1.3	2.1	3.0	3.8	0.0	3.4	3.1	24.2	13.8	9.1	0.0	6.2	42.9	6.1
Scenario 3	1.3	2.1	3.0	3.8	–2.0	2.9	3.1	24.2	12.5	8.1	–7.6	2.8	38.0	1.3

1. Social security payments equals social security payments in the national accounts plus government final consumption expenditure on social benefits. It grows in line with the Ministry of Health, Labour and Welfare's projection in 2004 (see Table 3.5).
2. Total government spending minus government investment minus social security payment (including government final consumption expenditure on social benefits) minus interest payment by the government.
3. On the revenue side, tax elasticities are set at 1.1 for direct taxes and 1.0 for indirect taxes.
4. The average real GDP growth rate for the period 2004 to 2014 is based on the *Medium-Term Economic and Fiscal Perspective*. The growth rate for 2005 and 2006 (2.0 per cent in real terms) is assumed to continue indefinitely. The real interest rate is the *Perspective's*"nominal long-term interest rate" deflated by the implied GDP deflator in the baseline. Similarly, the nominal interest rate of 2.8 per cent in 2008 and the rise in the GDP deflator of 0.8 per cent is assumed to continue indefinitely.
5. The potential growth rate in the OECD Medium-Term Baseline for 2004 to 2010 is assumed to continue. The real interest rate is set at 3 per cent, the average during the past 15 years.

Source: Cabinet Office and OECD calculations.

Table 3.4. **The government's *Medium-Term Economic and Fiscal Perspective***

Per cent of GDP

	FY 2002[1]	FY 2003[2]	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008
Macroeconomic conditions							
Growth rate of real GDP (in per cent)	1.1	3.2	1.8	2.0	2.0	2.1	2.1
Growth rate of nominal GDP (in per cent)	–0.7	0.8	0.5	1.4	2.1	2.5	2.9
Nominal GDP (trillion yen)	497.7	501.4	500.6	507.6	518.3	531.4	547.1
Inflation rate (per cent increase in GDP deflator)	–1.8	–2.4	–1.3	–0.6	0.1	0.4	0.8
Unemployment rate (per cent)	5.4	5.3	5.1	5.1	4.9	4.8	4.6
Nominal long-term interest rate (per cent)	1.3	1.1	1.3	1.5	1.8	2.3	2.8
Net lending (+)/Net borrowing (–) by sector							
General government	–8.2	–8.1	–7.4	–6.8	–6.0	–5.5	–5.1
Private sector	10.8	11.0	10.4	9.7	8.8	8.5	8.2
Balance with the rest of the world	–2.6	–2.9	–3.0	–2.9	–2.8	–2.9	–3.1
Fiscal conditions of central and local governments (as per cent of GDP)[3]							
Net lending							
Central government	–7.3	–6.7	–6.3	–6.0	–5.6	–5.1	–5.0
Local government	–0.7	–1.0	–0.5	–0.2	0.0	–0.1	0.0
Total	–8.0	–7.7	–6.9	–6.2	–5.6	–5.2	–5.0
Primary financial balances							
Central government	–5.8	–5.2	–5.0	–4.7	–4.1	–3.6	–3.2
Local government	0.2	–0.1	0.3	0.6	0.7	0.6	0.7
Total	–5.6	–5.4	–4.6	–4.1	–3.4	–2.9	–2.5
Debt outstanding (central and local governments in trillion yen)	604.8	639.6	674.2	706.0	736.0	764.6	791.5
(As per cent of GDP)	121.1	128.4	134.7	139.1	142.0	143.9	144.7
General government expenditures (including social security)							
Trillion yen	190.1	182.1	181.4	182.5	185.5	190.0	195.8
As per cent of GDP	38.1	36.6	36.2	36.0	35.8	35.8	35.8

1. Actual figures, except for debt outstanding.
2. Actual figures are shown for growth and level of GDP, inflation, the unemployment rate and the nominal long-term interest rate.
3. A negative number indicates a government budget deficit.

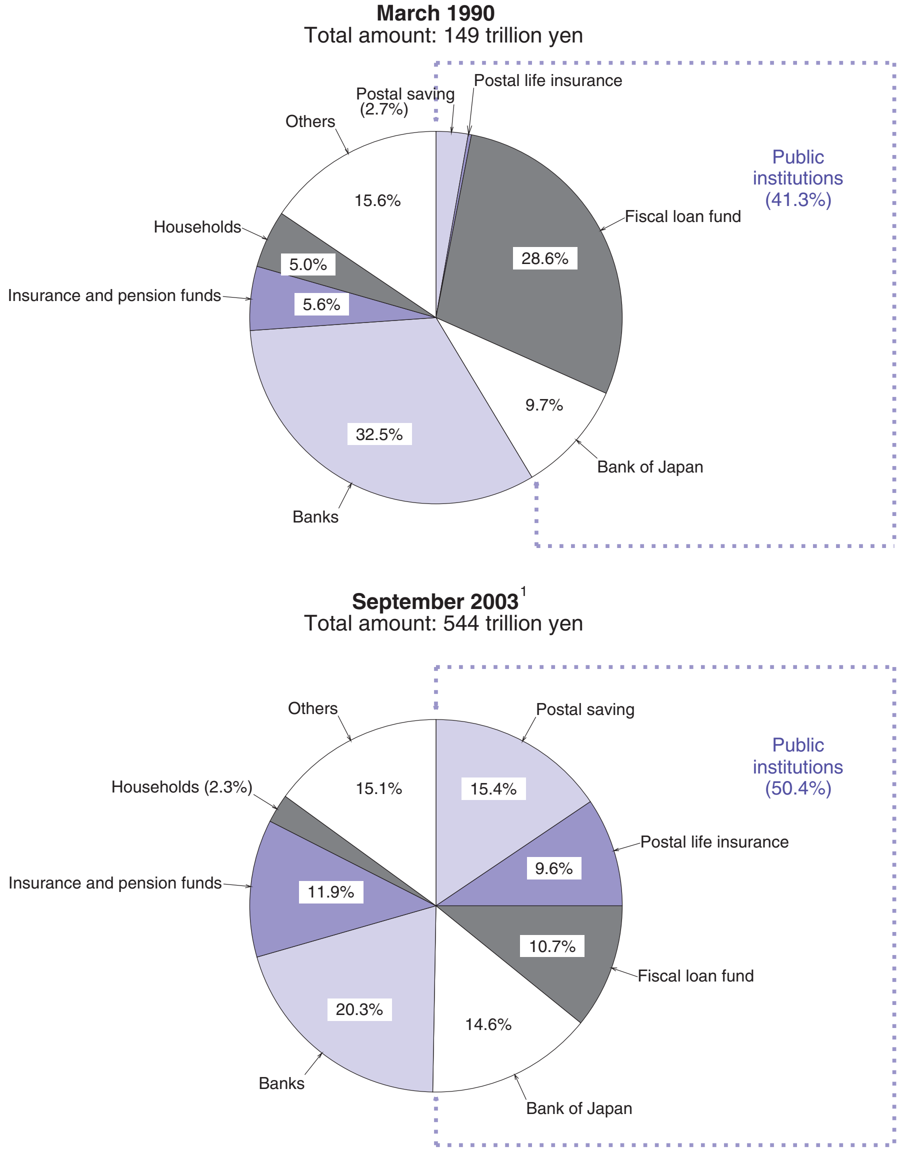
Source: Cabinet Office, Reference estimates presented to the Council on Economic and Fiscal Policy on 16 January 2004.

Rising social security expenditures

Although social security payments are relatively low compared to other OECD countries at present, they are expected to increase at a rapid pace due to population ageing. In 2002, the Ministry of Health, Labour and Welfare projected that total social security payments – pension, healthcare, welfare and long-term nursing care – would increase at a 4.2 per cent annual rate through 2010, boosting its share of GDP by 1½ per cent (Table 3.5).

The growth of pension outlays, which account for more than half of social security spending, will be slowed by the introduction of "macroeconomic indexation". In principle, pension benefits for people age 65 and over were adjusted in line with the consumer price index until 2004. However, given the negative impact of the declining working-age population and rising life expectancy on the pension system, the rise in the pension benefit will be kept below the increase in inflation. Specifically, the authorities expect the average hike in pension benefits to be 0.9 percentage points below the rate of increase in the price index over the period to FY 2025. Since the pension benefit cannot be reduced, it will thus

Figure 3.2. **Government bond holdings by sector**



1. Includes FILP bonds, which were first issued in 2001. Although they are not included in general government debt, they are indistinguishable from government bonds for purchasers.

Source: Tanaka (2004).

remain unchanged unless inflation exceeds 0.9 per cent. The initial level of benefits for newly eligible beneficiaries will also be reduced by macroeconomic indexation. This new approach will likely lead to a fall in the replacement rate from its current level of 59 per cent of the average salary, although the law requires that it remain above 50 per cent.[8] This reform is projected to keep pension spending constant at around 9 per cent of GDP through the end of the decade (Table 3.5), assuming that inflation is significantly positive.

There is likely to be a significant rise in healthcare spending, the second largest area of social security spending despite reform measures introduced in recent years. In particular, the government raised user charges, increased the eligibility age for elderly medical care[9] from age 70 to 75 and cut fees for medical services and the price of medicine. Nevertheless,

Table 3.5. **Social security spending**

	2004		2010			
			Old[1]		Revised	
	Trillion yen	Share of GDP[2]	Trillion yen	Share of GDP[2]	Trillion yen	Share of GDP[2]
Total outlays	**86**	**17.0**	**110**	**18.4**	**105**	**17.6**
Pensions	46	9.1	58	9.7	53	8.9
Healthcare	26	5.1	35	5.9	34	5.7
Welfare	14	2.8	17	2.8	18	3.0
of which: Elderly nursing care	5	1.0	8	1.3	9	1.5

1. Projections made in 2002. They have been revised due to recent reforms, such as for the pension system, and changes in demographic assumptions.
2. Assuming 2.8 per cent annual growth from 2004 to 2010.

Source: Ministry of Health, Labour and Welfare.

the government projects the amount of outlays to rise from 5.1 per cent of GDP in 2004 to 5.7 per cent in 2010 (Table 3.5), with expenditures for the elderly expected to account for more than half of the increase. Including rising expenditure for long-term nursing care, total social security spending is projected by the government to rise by 0.6 per cent of GDP by the end of the decade, even if pension outlays are kept constant as a share of GDP.

Total government expenditures

Given the expected rise in interest payments and social security expenditures, total outlays would increase significantly over the next decade even if all other categories of government spending rise in line with nominal GDP. Under the high growth and low interest rate assumption, total government spending would rise from 36½ per cent of GDP in 2004 to 41½ per cent by 2014 (Table 3.3). Slower growth and higher interest rates would boost that figure to 45½ per cent, far above the 38 per cent ceiling mentioned in the government's medium-term *Perspective*. This reflects the fact that mandatory spending for interest payments and social security is larger than discretionary outlays (public investment and other government spending in Table 3.3). Consequently, even if discretionary spending were held constant in nominal terms over the next, total spending would rise by between 1.7 and 6.1 per cent of GDP (Scenario 2).

The government's plan to achieve fiscal sustainability

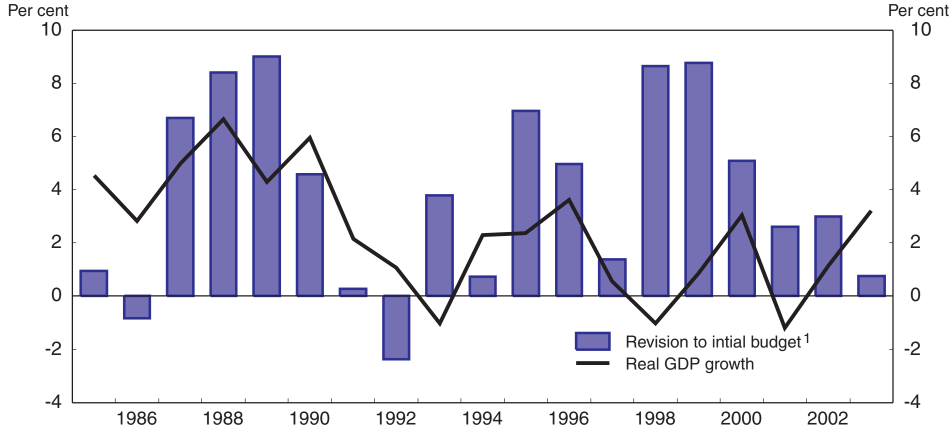
The government's *Medium-Term Economic and Fiscal Perspective*, which was first introduced in 2002 and updated in 2003 and 2004, shows a possible fiscal consolidation path based on an economic projection (Table 3.4). Although it only covers the period through FY 2008, the ultimate target is a primary budget surplus for the central and local governments by the early 2010s. To reduce the deficit, expenditures are to be limited to near the level recorded in FY 2002 – 38 per cent of GDP on a general government basis – until FY 2006.[10] The *Perspective* projects a fall in the primary budget deficit by ½ per cent a year through FY 2008.[11]

Putting the Perspective into practice

Each budget since the introduction of the *Perspective* has focused on limiting spending.[12] Fiscal policy in **FY 2003** was unique in that spending was not significantly increased by a supplementary budget. The custom in Japan has been to make fiscal plans relative to the initial

Figure 3.3. **Supplementary budgets and the business cycle**

General account, year-on-year per cent change



1. The revision is calculated as the percentage change in the final settlement budget relative to the initial budget for each fiscal year.

Source: Ministry of Finance and Cabinet Office.

budget in the preceding year. To avoid a fall in total expenditures, there is strong political pressure for a supplementary budget towards the end of each fiscal year, focused on public works. Consequently, the formulation of a supplementary budget with additional public works had been customary up until recently (Figure 3.3). In contrast, the supplementary budget for FY 2003 added only 0.2 trillion yen of central government outlays,[13] resulting in a 2.1 per cent decline in total expenditures compared to the outcome for FY 2002. Avoiding a supplementary budget also limited spending by local governments, particularly in public investment, contributing to a double-digit decline in public investment in real terms in FY 2003 on a general government basis.

The government maintained the expenditure cap in the **FY 2004** budget, limiting the initial budget to a 0.4 per cent increase from the previous year (Table 3.6). Spending restraint was accompanied by reforms to increase flexibility in the allocation of funds and to enhance the efficiency of public expenditure (Box 3.2). On the revenue side, major changes include: *i)* a hike in the pension premium for employees; *ii)* the partial abolition of the special income tax deduction for spouses; and *iii)* the end of the elderly income tax deduction and the scaling back of deductions on public pension benefits. The total impact on revenue – 1.2 trillion yen (¼ per cent of GDP) – is rather small.[14]

Following discussions at the Council on Economic and Fiscal Policy, the Ministry of Finance set guidelines for the **FY 2005** budget aimed at holding total expenditures of the central government to near the expected outcome for FY 2004. Although private-sector members of the Council insisted on the need to reduce nominal spending below the level in FY 2004, this was not accepted, given the rise in debt servicing costs and an increase in social welfare outlays due to ageing.[15] To meet the guideline, the government will cut public works by 3 per cent and other discretionary spending by 2 per cent, except those related to science and technology, which will remain unchanged. With regard to revenues, some hikes in taxes and pension contributions that were decided in previous years will take effect in FY 2005, including an increase in the employment insurance premium and the partial abolition of the special income tax deduction for spouses for local taxes. Again, the impact on revenues is very limited at 0.7 trillion yen (0.1 per cent of GDP).[16]

Table 3.6. **The FY 2004 budget**[1]

Trillion yen, general account of central government

	(A) FY 2003 initial	(B) FY 2003 final	(C) FY 2004 initial	Percentage change C/A	Percentage change C/B
Total expenditures	81.8	81.9	82.1	0.4	0.2
Debt servicing	16.8	16.1	17.6	4.6	9.2
Transfers to local government	17.4	17.4	16.5	–5.2	–5.2
General purpose spending[2]	47.6	48.4	47.6	0.1	–1.7
of which:					
Public investment[3]	8.9	n.a.	8.6	–3.3	n.a.
(excluding facilities)	(8.1)	(8.3)	(7.8)	(–3.7)	(–6.0)
Mandatory spending	33.2	n.a.	32.1	–3.3	n.a.
Discretionary spending	5.5	n.a.	6.9	26.2	n.a.
Total revenue	45.3	45.5	45.5	0.4	0.1
Taxes	41.8	41.8	41.7	–0.1	0.0
Non-tax revenues	3.6	3.7	3.8	6.1	0.8
Borrowing (public bonds)	36.4	36.4	36.6	0.4	0.5

1. Excludes social security.
2. Equals total expenditures minus debt servicing and transfers to local government.
3. The figure for public investment includes facilities for education, science and technology, social welfare, and aid for developing countries.

Source: Ministry of Finance.

Has the Perspective been effective in promoting fiscal consolidation?

The emphasis on expenditure restraint has reduced general government spending from 38 per cent of GDP in 2002 to less than 37 per cent in 2004 (Table 3.1), mainly due to large cuts in public investment. Meanwhile, revenues as a share of GDP have remained constant. With the decline in expenditures, the primary budget deficit has been reduced from 6.4 per cent of GDP to an estimated 5 per cent between 2002 and 2004, with a similar improvement in the overall deficit. The pace is thus close to the target in the *Perspective* of reducing the primary deficit by ½ per cent of GDP per year. Looking ahead to 2005, the OECD Secretariat expects the primary budget deficit to decline by ¼ per cent of GDP to 4.7 per cent, based on announced policies and projected output growth at a rate above the potential rate. Such an outcome would imply that the fiscal policy stance is broadly neutral in 2005.

The pace of fiscal consolidation since 2002 is thus in line with the government's medium-term plan. However, at the current pace, it would take a decade just to reach a primary budget balance, which may not be sufficient to stabilise the public debt to GDP ratio (Table 1.4). Instead, a primary budget surplus of up to 2½ per cent of GDP may be needed, depending on assumptions about growth and interest rates. Given the long period of continued deficits, the public debt to GDP ratio would eventually stabilise at a level significantly above the 2004 level of 163 per cent. The cost of servicing that higher level of debt could amount to as much as 2 per cent of GDP, requiring higher taxes that impose deadweight costs.

Moreover, it may be appropriate to aim at a primary surplus that is even higher than the level needed to stabilise public debt relative to GDP. Given the size of public debt, it may be desirable to reduce it – rather than simply stabilise it – as a share of GDP to smooth the financing of future ageing-related expenditures and reduce the risk of an unforeseen rise in the debt.

In addition to the higher eventual level of public debt, a gradual pace of fiscal consolidation also increases the chances of a significant rise in the risk premium on government bonds, which would cause debt to grow even faster. There is no clear empirical evidence about what level of debt prompts a rise in the risk premium and, as noted above, there are some special factors in Japan that would tend to limit such an increase. Nevertheless, a rise in the risk premium becomes a growing concern as the level of debt reaches uncharted territory.

How could the Perspective be improved?

The key to limiting the possibility of a rise in the risk premium on public debt is to develop a credible fiscal consolidation plan over the medium term. Such a plan would help sustain private demand by limiting a rise in interest rates and a fall in asset prices. As the plan is likely to extend beyond one business cycle, it should have some scope for flexibility in the face of economic downturns, while making clear the conditions that would allow policy to diverge from the plan (Nakazato *et al.*, 2003). However, the government's medium-term *Perspective* is inadequate for a number of reasons.[17]

- Its assumptions about output growth and interest rates are somewhat optimistic. The relationship between the interest rate and economic growth rate, which the government assumes to be close, could turn out differently.
- The budget figures are not binding but are presented for reference purposes only.
- It does not contain any numerical targets for revenue categories. Moreover, no changes in the tax system are specified, although tax revenue is assumed to rise (see below).
- The spending ceiling includes interest payments, which are excluded from the key objective of a primary budget surplus.
- While the plan is revised every year, there is no explicit feedback rule on how the plan will change as outcomes deviate from the path described in the plan.
- Although the ultimate target of a small primary budget surplus in the early 2010s is shown in the plan, it ends in FY 2008 and there are only a limited number of estimates beyond that point.

In sum, Japan needs a more concrete plan indicating the spending cuts and tax increases needed over a definite time frame to eliminate the primary budget deficit. It is unclear how the fiscal burden will increase in the future. The reluctance to develop a detailed consolidation plan may reflect concern that a premature fiscal tightening may undermine the economic expansion. The experience of 1997 – when a fiscal tightening of 1¼ per cent of GDP was followed by an economic downturn in 1998 – underlies this concern, although the Asian crisis appears to have been the primary cause of that recession. In addition, there is still some support for the notion that increased public investment would accelerate economic growth, thereby boosting tax revenue sufficiently to balance the budget. However, this view has been largely discredited by the current economic recovery, which occurred despite sharp declines in public investment.

The introduction of an indicative medium-term plan rather than binding objectives may also reflect the experience of the Fiscal Restructuring Law of 1997, which set numerical targets to be achieved over fixed time periods.[18] Following an economic downturn, the law was amended to allow spending increases and fiscal targets were delayed by two years. However, this proved to be inadequate and the law was suspended only a year after its introduction, creating strong scepticism in Japan about fiscal consolidation rules (Tanaka, 2002). However, this was due to the lack of a flexibility clause and the failure to reform budgeting procedures (Tsuru, 2004). Therefore, this experience should not rule out the possibility in Japan of introducing a credible medium-term fiscal plan, which has proven to be important in the case of other OECD countries.

How did other OECD countries accomplish major shifts in their budget balance?

The effort to restore fiscal balance is only at an initial stage in Japan and it is unclear what kind of expenditure and revenue reforms would be optimal. Before examining specific options, it may be useful to review the experiences of other OECD countries. For the major OECD countries, there have been large swings in budget balances during the past three decades (Figure 3.4). Table 3.7 reports the experience of OECD countries achieving a major improvement – of at least 3½ per cent of GDP – in their cyclically-adjusted primary budget balances. This suggests the following points:

- The size of fiscal consolidation necessary in Japan – 5 to 7½ per cent – is not exceptionally large. A number of countries improved their primary balances by more than 6 per cent of GDP on a cyclically-adjusted basis during the 1990s.
- The deterioration in Japan's primary budget balance over the decade from 1992 to 2002 is large at 7 per cent of GDP, but occurred at a relatively modest pace. The average deterioration phase of the 13 countries shown in Table 3.7 lasted only 3½ years.
- An average increase in the primary balance was 7 per cent of GDP, accomplished over seven years. Thus, the pace of consolidation for the 13 countries – at 1 per cent a year – is double the ½ per cent pace envisioned in Japan's *Medium-Term Economic and Fiscal Perspective*.
- The improvement in the primary balance was almost evenly divided between cuts in spending (3 per cent of GDP) and revenue increases (3.5 per cent), as shown in the bottom line of Table 3.7. Each of the 13 countries increased revenue, and all except two reduced spending.

In Table 3.8, the changes in spending and revenue by component are shown. During the fiscal consolidation phase, expenditure reductions were largest in government consumption. The sources of increased revenue (Panel B) were concentrated on direct taxes on firms and households.

Another common element of successful fiscal consolidation in the OECD area is an improvement in the budgetary system. Many countries introduced or strengthened fiscal rules, such as direct limits on expenditure or balanced budget requirements, or through debt ceilings. A notable example is the Budget Enforcement Act of 1990, which encouraged fiscal consolidation in the United States before expiring in 2002. Another feature of successful fiscal consolidation programmes is improving the cost effectiveness of government programmes through the reform of management practices and the use of market mechanisms (Joumard *et al.*, 2004). In particular, there is a need to extend planning horizons to account properly for the future costs associated with current spending programmes. For example, the Netherlands and Sweden both introduced multi-year budgeting during the 1990s. While countries used different strategies, the key common aspect of successful fiscal consolidation was a strong political commitment to this objective.

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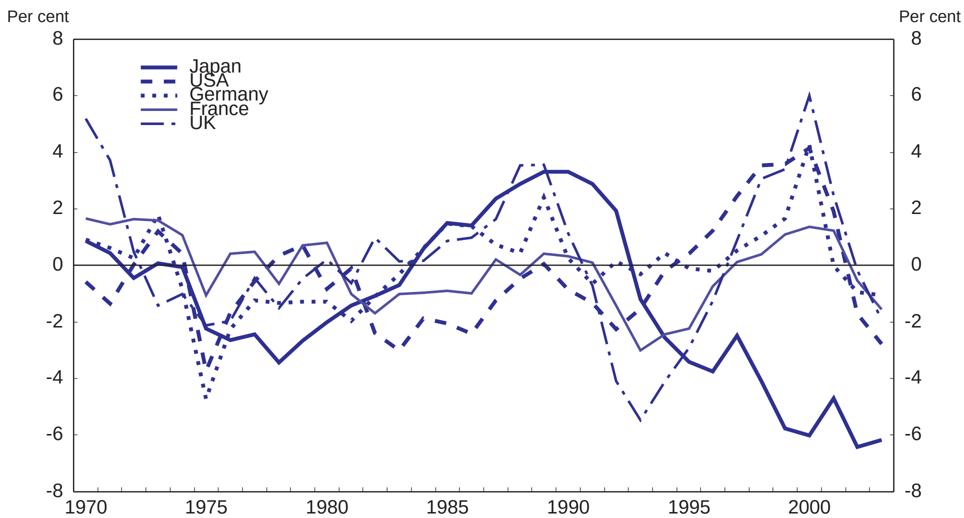
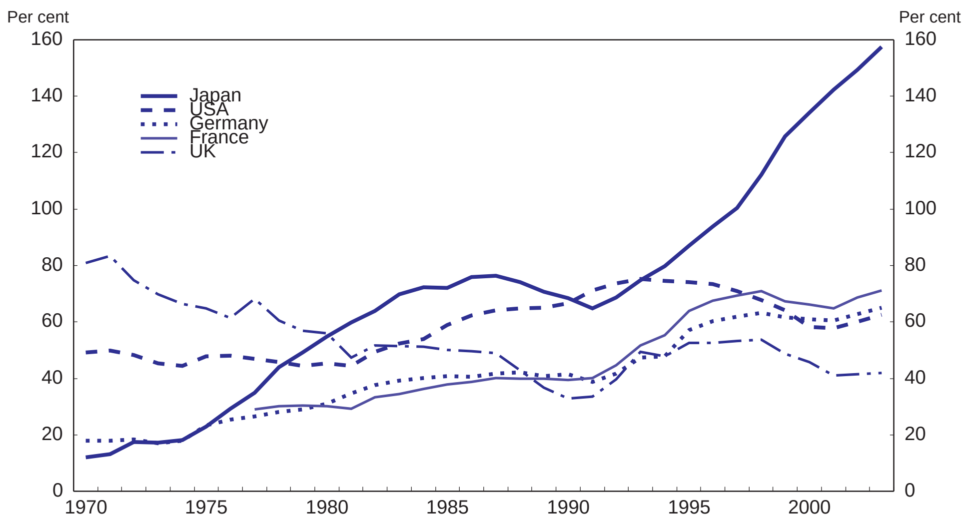
Figure 3.4. **Fiscal developments in major OECD countries**

A. Primary budget balance as a share of GDP



B. Gross government debt as a share of GDP



Source: *OECD Economic Outlook*, No. 76.

Most of the fiscal consolidation episodes were accompanied by a larger current account surplus, which increased by an average of 4 per cent of GDP (Table 3.7). However, in some countries, such as the United States, a reduced level of private saving led to a deterioration in the external position while the budget deficit was declining. The magnitude of the necessary budget reduction in Japan could also put upward pressure on its external surplus, which is already large at 3½ per cent of GDP in 2004. The emergence of large government deficits in the second half of the 1990s was accommodated by increased saving by the corporate sector, while Japan's external surplus remained steady at an average of 2¼ per cent of GDP (Figure 3.5). A reduction in government dis-saving over the next decade would need to be offset by less saving

Table 3.7. **Fiscal consolidation episodes in OECD countries**

Share of potential GDP on a cyclically-adjusted basis

	Change in primary balance	Change in current expenditure[1]	Change in public investment[2]	Total spending	Change in current revenue[1]	Residual	Change in current account balance
Australia							
1989-93	–4.9	3.1	–0.1	3.0	–1.2	–0.7	2.8
1993-99	5.4	0.3	–0.2	0.1	4.8	0.7	–2.4
Belgium							
1990-92	–0.8	0.4	0.2	0.5	0.2	–0.4	1.3
1992-98	4.2	–0.8	–0.2	–1.0	3.5	–0.3	0.9
Canada							
1990-92	–0.9	2.0	–0.1	1.9	0.9	0.0	–0.2
1992-99	7.9	–6.1	–0.5	–6.7	0.6	0.7	3.9
Finland							
1989-92	–1.9	4.8	0.4	5.2	2.3	0.9	0.2
1992-2000	7.1	–3.9	–1.0	–4.9	2.3	–0.1	12.2
France							
1987-93	–3.4	2.7	0.3	3.0	–0.3	–0.1	1.3
1993-97	3.4	–0.3	–0.6	–0.9	1.8	0.7	1.9
Germany							
1977-79	–1.4	0.0	0.1	0.1	–1.6	0.2	–1.4
1979-85	5.2	–2.9	–1.1	–4.0	0.7	0.5	3.3
Ireland[3]							
1980-94	12.8	–4.8	–3.3	–8.2	3.0	1.6	13.0
Italy							
1983-87	–1.9	1.0	–0.1	0.9	0.5	–1.5	–0.5
1987-97	9.9	1.4	–1.1	0.3	8.6	1.6	3.2
Japan							
1974-78	–3.6	3.3	0.9	4.2	–0.4	1.0	2.9
1978-89	6.2	1.1	–1.3	–0.2	7.0	–1.0	0.7
1992-2002	–6.9	6.2	–0.7	5.4	–2.8	1.3	0.0
Norway							
1986-92	–7.9	6.8	0.4	7.2	–0.3	–0.5	9.6
1992-2000	6.7	–2.9	–1.1	–4.0	3.8	–1.1	11.6
Sweden							
1989-93	–8.8	2.0	–0.2	1.8	–7.0	0.0	0.2
1993-98	9.6	–2.2	–0.6	–2.9	3.9	2.8	5.2
United Kingdom							
1989-93	–5.4	2.3	0.0	2.3	–2.4	–0.7	3.3
1993-99	7.1	–2.8	–1.0	–3.8	2.6	0.7	–0.8
United States							
1989-92	–1.5	1.4	–0.1	1.3	–0.2	0.0	1.1
1992-98	5.4	–2.2	–0.5	–2.7	2.6	0.0	–1.6
Average							
Deterioration phase	**–3.8**	**2.8**	**0.1**	**2.8**	**–0.9**	**0.0**	**1.6**
Consolidation phase	**7.0**	**–2.0**	**–1.0**	**–3.0**	**3.5**	**0.5**	**3.9**

1. Excluding interest payments and receipts.
2. Public investment is unavailable on a cyclically-adjusted basis.
3. General government data is unavailable before 1980.

Source: OECD Economic Outlook Database.

Table 3.8. **Contributions of revenue and expenditure categories in fiscal consolidation episodes**

Per cent of GDP

	Total	Government consumption	Government investment	Social security payment	Others
A. Change in expenditure (excluding interest payments)					
Australia					
1989-93	5.5	1.3	–0.1	2.6	1.7
1993-99	–3.0	–1.3	–0.2	–0.6	–0.9
Belgium					
1990-92	1.9	0.8	0.2	0.6	0.3
1992-98	–0.6	0.0	–0.2	–0.7	0.4
Canada					
1990-92	4.7	1.8	–0.1	2.6	0.4
1992-99	–9.3	–5.2	–0.5	–2.5	–1.2
Finland					
1989-92	17.1	5.2	0.4	8.8	2.7
1992-2000	–14.3	–4.7	–1.0	–5.9	–2.7
France					
1987-93	2.7	1.4	0.3	1.3	–0.3
1993-97	–0.3	–0.3	–0.6	0.2	0.3
Germany					
1977-79	–1.6	0.1	0.1	–0.8	–0.9
1979-85	–2.0	0.3	–1.1	–0.6	–0.7
Ireland					
1980-94	–5.9	–1.8	–3.3	0.4	–1.2
Italy					
1983-87	0.8	0.5	–0.1	–0.3	0.7
1987-97	–0.9	–1.0	–1.1	2.4	–1.2
Japan					
1974-78	3.1	0.8	0.9	2.4	–0.9
1978-89	0.2	–0.2	–1.3	0.9	0.8
1992-2002	7.3	4.3	–0.7	3.7	0.1
Norway					
1986-92	8.9	3.0	0.4	4.1	1.4
1992-2000	–12.2	–3.6	–1.1	–3.5	–3.9
Sweden					
1989-93	9.5	3.1	–0.2	3.8	2.8
1993-98	–12.0	–1.9	–0.6	–3.9	–5.5
United Kingdom					
1989-93	6.2	1.0	0.0	4.2	1.1
1993-99	–6.2	–2.1	–1.0	–2.6	–0.5
United States					
1989-92	2.5	0.1	–0.1	2.0	0.5
1992-98	–3.5	–2.2	–0.5	–0.6	–0.1
Average					
Deterioration phase	**5.3**	**1.8**	**0.1**	**2.7**	**0.7**
Consolidation phase	**–5.4**	**–1.8**	**–1.0**	**–1.3**	**–1.3**

Table 3.8. **Contributions of revenue and expenditure categories in fiscal consolidation episodes** *(cont.)*

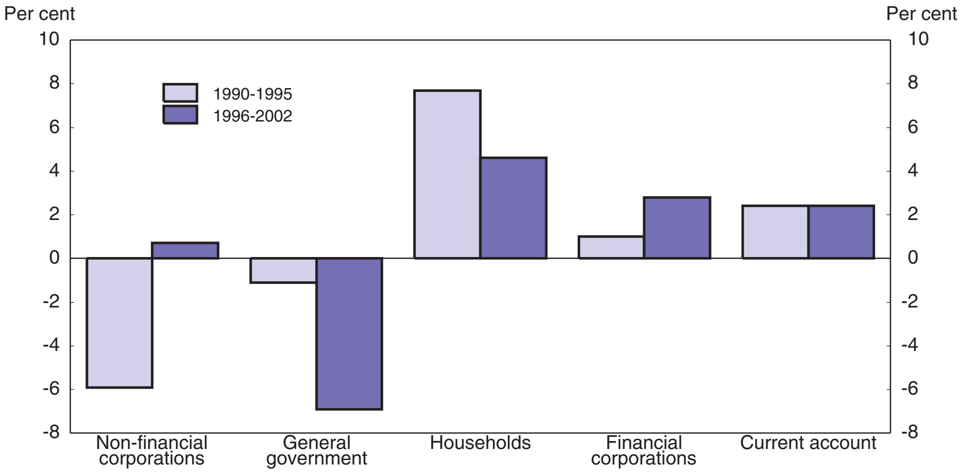
Per cent of GDP

	Total	Direct taxes on households	Direct taxes on businesses	Indirect taxes	Social security revenue	Others
B. Change in revenue (excluding interest receipts)						
Austria						
1989-93	–0.4	–1.8	–0.1	–0.4	0.0	1.8
1993-99	3.8	1.5	0.9	0.8	0.0	0.6
Belgium						
1990-92	0.1	–0.3	–0.5	0.0	0.9	0.1
1992-98	3.4	0.9	1.9	1.1	–0.4	0.0
Canada						
1990-92	1.6	–0.3	–0.4	1.0	0.7	0.5
1992-99	0.4	–0.2	2.1	–1.5	–0.3	0.4
Finland						
1989-92	4.0	–0.4	0.2	–1.0	3.1	2.1
1992-2000	1.3	0.2	4.5	–1.3	–2.3	0.1
France						
1987-93	–0.5	0.6	–0.6	–0.8	0.3	0.0
1993-97	2.8	0.6	0.6	1.3	–0.5	0.8
Germany						
1977-79	–1.5	–0.7	–0.3	0.4	–0.1	–0.8
1979-85	1.2	0.2	0.1	–0.7	0.8	0.8
Ireland						
1980-94	4.1	1.9	1.7	–0.5	1.2	–0.3
Italy						
1983-87	–0.6	–0.1	0.7	0.2	–0.7	–0.7
1987-97	9.3	1.9	1.5	3.0	1.4	1.5
Japan						
1974-78	–0.2	–0.7	–1.1	–0.1	1.5	0.2
1978-89	6.9	2.1	2.0	1.0	1.2	0.6
1992-2002	–1.1	–2.7	–1.9	0.5	1.9	1.0
Norway						
1986-92	0.0	0.8	0.2	–2.3	–0.9	2.3
1992-2000	6.1	0.0	5.4	–1.7	–2.1	4.6
Sweden						
1989-93	–6.4	–3.9	–0.7	–0.9	–1.0	0.1
1993-98	3.1	1.1	0.8	0.3	1.2	–0.3
United Kingdom						
1989-93	–2.8	–0.6	–2.1	0.1	–0.2	–0.1
1993-99	2.7	0.7	1.7	0.9	–0.2	–0.4
United States						
1989-92	0.2	–0.7	–0.3	0.4	0.2	0.7
1992-98	2.3	2.1	0.5	–0.3	0.0	0.1
Average						
Deterioration phase	**–0.6**	**–0.8**	**–0.5**	**–0.2**	**0.4**	**0.6**
Consolidation phase	**3.7**	**1.0**	**1.8**	**0.2**	**0.0**	**0.7**

Source: OECD Economic Outlook Database.

Figure 3.5. **Saving-investment balances by sector**

Per cent of GDP



Source: Cabinet Office and OECD Economic Outlook Database.

in the private sector, if the current account balance is to remain unchanged. Some of this adjustment might result from a further fall in the household sector, although it has already experienced a marked decline in saving rates. A larger share of the decline in private-sector saving might result from greater investment by the corporate sector. This underlines the importance of achieving an environment that favours private investment in Japan.

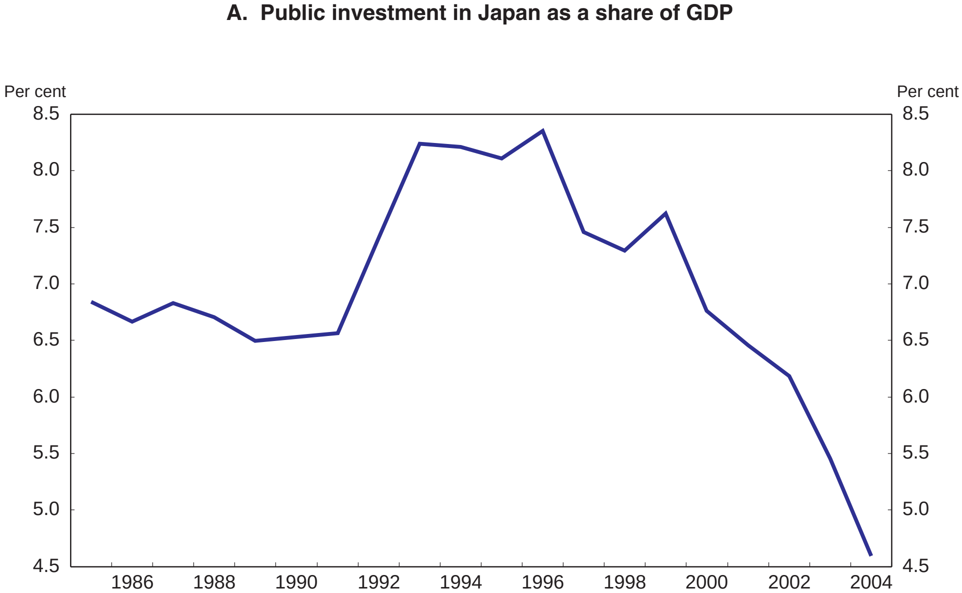
The scope for reducing public expenditures

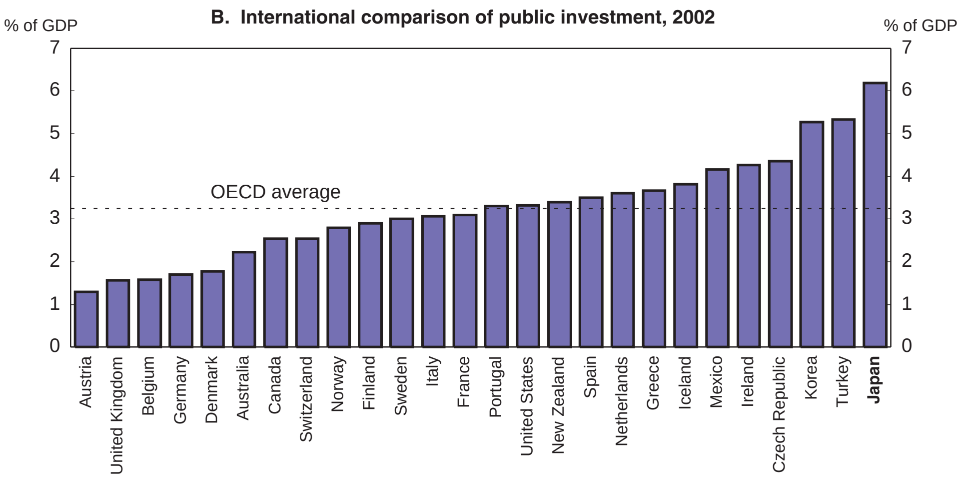
The analysis above suggests that achieving fiscal sustainability will require measures to reduce spending and to raise revenues. On the expenditure side, cutting total outlays will be difficult in light of the expected increases in interest payments and social security outlays. As noted above, freezing all other expenditure categories in nominal terms, including public investment, would be necessary to keep spending near the 38 per cent of GDP ceiling set by the *Medium-Term Economic and Fiscal Perspective*,[19] assuming that both interest rates and growth are 2.8 per cent in nominal terms (Table 3.3). Under less favourable macroeconomic conditions (Scenario B), such an approach would result in a spending increase equivalent to 6 per cent of GDP. Consequently, significant cuts in discretionary spending are likely to be necessary. This could be accomplished through reducing public investment and improving budgetary procedures to enhance the efficiency of spending programmes (Box 3.2). In addition, further reform of the social security system is necessary to limit ageing-related spending increases.

Cutting public investment to the OECD average

There appears to be scope for further reductions in public investment, much of which is characterised by low efficiency. Large cuts reduced it to below 5 per cent of GDP in 2004, down from a peak of more than 8 per cent in the 1990s following large-scale economic stimulus packages (Figure 3.6). It is projected to drop further to around 4 per cent in FY 2006 by the OECD Secretariat. Keeping the level of investment constant in nominal terms would lower its share of GDP to around 3¼ per cent – close to the average of OECD countries – by 2014 (Table 3.3). However, such a spending target will be difficult to meet, given the rising cost of maintaining the sharply expanded stock of public capital.[20] Assuming that public investment is frozen at its

Figure 3.6. **Public investment**





Source: OECD Economic Outlook, No. 76.

current level, such costs would rise by between 20 and 30 per cent between 2000 and 2020, boosting its share of total government public investment spending to around 30 per cent (Research Institute of Construction and Economy, 2001). The challenge is thus to sustain investment in productive infrastructure projects that will spur economic growth and avoiding safety problems with ageing facilities, while at the same time restraining total investment spending. It is thus essential to further improve resource allocation across sectors and regions and promote efficient procurement and management methods. This is particularly important at the local government level, given its dominant role in public investment (see Chapter 4), and in public corporations.[21]

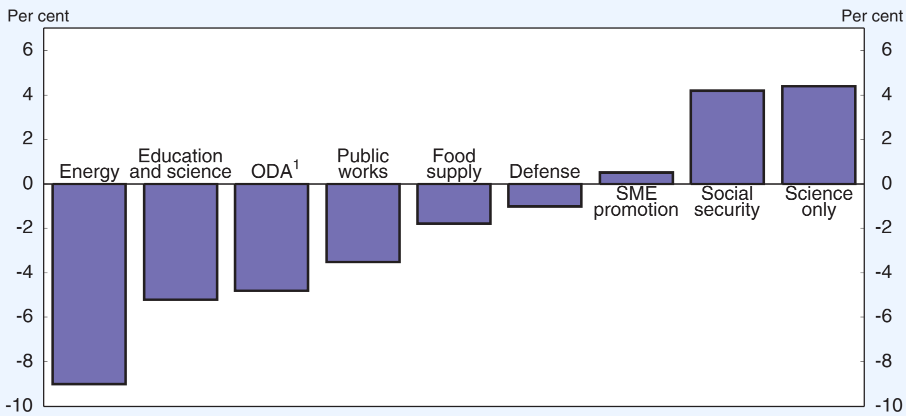
Box 3.2. **Reforms to improve the efficiency of public expenditure**

The weak impact of numerous fiscal stimulus packages on the economy over the past decade has raised questions about the effectiveness of public expenditure. Improving the performance of government programmes is more important than ever in the face of new demands for public outlays due to population ageing and the need for spending restraint to reduce the government budget deficit. In sum, meeting policy objectives and increasing Japan's growth potential while achieving fiscal consolidation will require increasing the cost effectiveness of spending.

The government has introduced some recent reforms in the public expenditure system. Beginning in FY 2003, the Ministry of Finance can approve requests by ministries for spending increases of up to 20 per cent, thus allowing greater flexibility to concentrate resources on more productive projects. As a result, priority areas such as social security and science and technology were allocated more funds, while outlays in other areas, including public works, agriculture and energy have been reduced (Figure 3.7). Prioritisation was also enhanced within each budget category. In public investment, for example, the allocation has shifted in favour of more productive projects, such as urban transport and airports, at the expense of infrastructure in rural areas. In addition, the government introduced some flexibility from the traditional approach of single-year budgeting based on spending requests from a single ministry. The single-year approach can lead to inefficiencies by encouraging ministries to use up their allotted funds before the end of each fiscal year, regardless of the merits of such outlays (Tsuru, 2004). Flexible budgeting over a multi-year period is being introduced in some pilot "model projects", in addition to allowing collaboration between ministries in "policy groups" for some projects. Ten model projects and ten policy groups were created in the FY 2004 budget and more are to be added in FY 2005. These reforms have the potential to boost the effectiveness of public expenditures, although they are still at a trial stage and the effect on the overall budget is limited.

Figure 3.7. **Flexibility in the allocation of government expenditures**

Percentage change in FY 2004 budget



1. Official Development Assistance.

Source: Ministry of Finance.

Box 3.2. **Reforms to improve the efficiency of public expenditure** *(cont.)*

Another priority is to require more rigorous assessment of spending programmes. The Ministry of Finance now insists that ministries submit evaluations of their expenditures, together with budgetary requests, in order to help it make spending decisions. It is important to establish a standardised procedure for such assessments. In particular, each should include an objective evaluation by a third party, preferably one that is a user of the service being evaluated.

Reform of special accounts, which are outside of the general account of the central government, is another important priority. Since such accounts usually have their own financial resources, there is a tendency to spend money regardless of the benefits. In addition, complex financial transactions between the main budget and the special accounts reduced transparency. The government has undertaken a number of reforms in this area, such as abolishing the special account on national schools, streamlining the Labour Insurance special account, and reducing the size of the transfer from the general account to the Petroleum and Energy special account. These are welcome steps, but a more fundamental reform should be implemented that reviews the necessity of each special account and reduces their borrowing from the general account, while increasing the transparency of their financial situation. In general, spending by the special accounts should be subject to the same scrutiny as general account expenditures.

Reforming the social security system to limit spending increases in the face of population ageing

The largest spending increase in the social security area is likely to be in healthcare and long-term nursing care (Table 3.5). To limit the rise in expenditure, it is important to allow greater private-sector participation in these "government-driven" sectors, which is a major objective of the latest Three-Year Plan for Promoting Regulatory Reform (see Chapter 5). For example, private-sector companies are not allowed to manage nursing care facilities, except in some of the special zones. In addition, private-sector companies should be permitted to enter the healthcare sector.

A number of additional reforms are needed to limit the rise in healthcare spending by the government. One factor driving up public expenditures is the low out-of-pocket fees paid by the elderly, which encourage excessive treatment and "social hospitalisation".[22] It is necessary to reform the fee for service payment system, in part by bringing it more in line with actual costs. Another key reform is to allow public insurance to apply partially in cases where non-covered and covered medical treatments are provided together, a step that may actually reduce government outlays for healthcare.[23]

Total payments under the long-term nursing care insurance, which was introduced in 2000, are increasing at a 10 per cent annual rate, suggesting that the current system is unsustainable. Half of the revenue is provided by people over the age of 40, the eligibility age, with central and local government providing the rest. A number of reform proposals to control costs, such as lowering the age when coverage begins, raising the user charge from the current level of 10 per cent to 20 or 30 per cent, and narrowing the range of services payable by the insurance, will be considered in 2005.

Regarding the pension system, the introduction of "macroeconomic indexation" in 2004, which will allow the replacement rate to fall as far as 50 per cent, was accompanied by a gradual hike in the contribution rate, half of which is paid by employers, from 13.58 to 18.3 per cent by 2017.[24] Such an increase is necessary due to ageing and the decline in the working-age population, as well as the fall in the proportion of eligible persons that participate in the pension system.[25] To compensate for increasing deficits, the government subsidy for the basic pension will be increased from a third of total outlays at present to half by 2009, financed by general tax revenue.

The 2004 reform is a step in the right direction, and appears to secure the sustainability of the pension system under current assumptions. However, more reform is necessary. Public scepticism concerning the viability of the system is still strong, as reflected in the rise in the proportion of pension contributions that are evaded from less than 15 per cent in the early 1990s to 37 per cent in 2003. Various opinion polls indicate the public believes that the system is inefficient and unfair (Nikkocitigroup, 2004). One factor is that the long-term projections for the pension system are based on relatively favourable assumptions; ageing is advancing at a faster rate than assumed, while the target rate of non-compliance is set at 20 per cent, already well below the 2003 level. The decision to raise the contribution rate is unlikely to encourage greater compliance and may have a negative impact on work incentives. Moreover, there has been no decision on how to finance the increase in the government subsidy to the pension fund beyond 2004.

Under the current pension system, there is a significant income transfer to the current generation of elderly from those presently employed, who will not receive a similar transfer after they retire. Living standards in retirement are maintained at a level similar to those of households in the 20 to 59 age range for several reasons in addition to pension benefits (see the 2003 *Survey*). *First*, the tax system favours elderly people through large age-related deductions. *Second*, the elderly have accumulated a large amount of personal savings and assets, which finance about a quarter of their consumption. The pace of the rundown in financial assets is slow, at around 2½ per cent annually, implying that they would only be exhausted after 40 years, considerably beyond life expectancy at that age. As a result, bequests are very high. In addition, the public assistance system ensures a basic level of consumption for all retirees. Overall, about 5 per cent of elderly households receive public assistance supplements to their pensions. In sum, the pension system is experiencing deficits that need to be funded by larger subsidies from the government and increases in contribution rates. The system should be reformed by setting a ceiling on contribution rates and letting benefit levels adjust to economic and demographic trends, even if the replacement rate drops more than currently envisaged.

How to increase government revenues

As shown above, controlling spending at current levels relative to GDP during the next decade is a challenging task. Nevertheless, the government should aim at this objective – or even reducing spending as a share of GDP – in order to limit the need for higher revenues. It would be unrealistic, though, to expect spending cuts to account for a large share of the 5 to 7½ per cent of GDP change in the primary budget balance that is necessary to achieve fiscal sustainability, making increases in tax revenue unavoidable. This will require broadening the tax base and raising tax rates. Continuing the present course of limiting spending to the FY 2002 level and delaying significant revenue increases will lead to an explosive rise in government debt.[26]

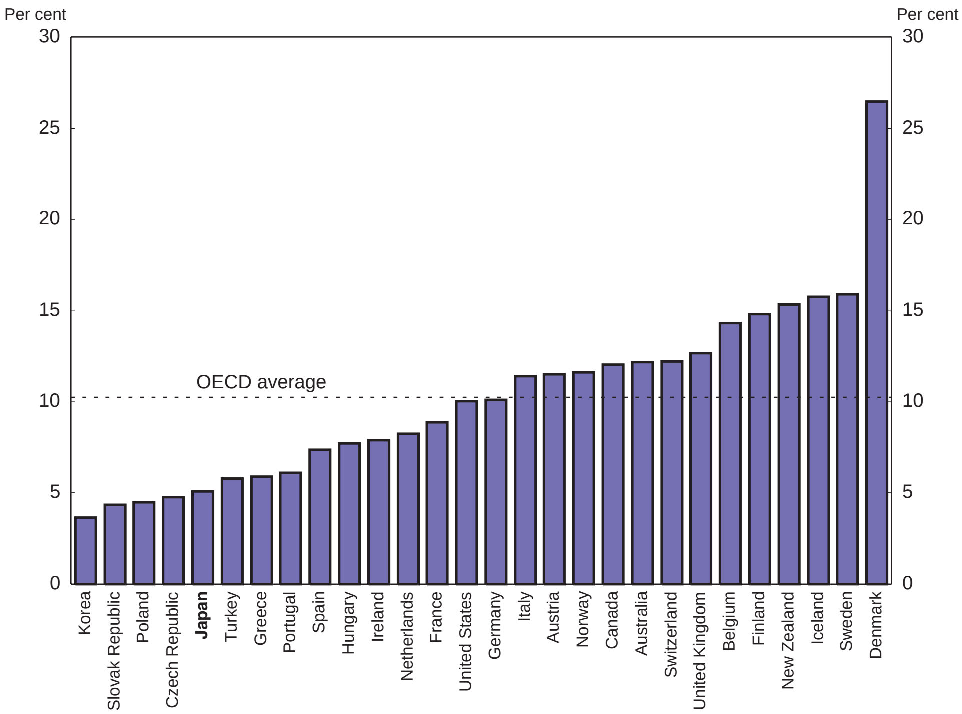
Tax base broadening needed

Empirical evidence suggests that base broadening is more effective than tax rate increases in achieving fiscal consolidation (Nakazato *et al.*, 2003). In Japan, the personal income tax base has been narrowed by various deductions. Indeed, since the 1980s, the share of household income that is taxable has stayed below 50 per cent, a relatively low level (Cabinet Office, 2002).[27] Consequently, personal income taxes, including those levied by local government, amount to only 5 per cent of GDP, half of the OECD average (Figure 3.8). Personal income tax revenues of the central government could be boosted by as much as 50 per cent, according to government estimates, by abolishing deductions for social insurance payments (2.8 trillion yen of additional revenue), the basic deduction (2 trillion yen), the deduction for dependents (1.7 trillion yen) and the basic deduction for spouses (0.7 trillion yen).

The government's effort to broaden the tax base is only at an early stage with the partial elimination of the special allowance for spouses in 2004. It should be followed by ending the basic exemption for spouses, which would also encourage female participation in the labour market (see Chapter 6).[28] Ending the fixed-rate exemption on central government income tax, which was introduced in 1999, would boost government revenue by 2.5 trillion yen (0.5 per cent of GDP).[29] This exemption reduces the amount of tax liability by 20 per cent across the board. Scaling back or abolishing this exemption is currently under consideration by the Tax Commission. Reducing deductions at the national level also broadens the tax base for the local personal inhabitant tax (a personal income tax) at the prefectural and municipal levels, thus further increasing tax revenues.

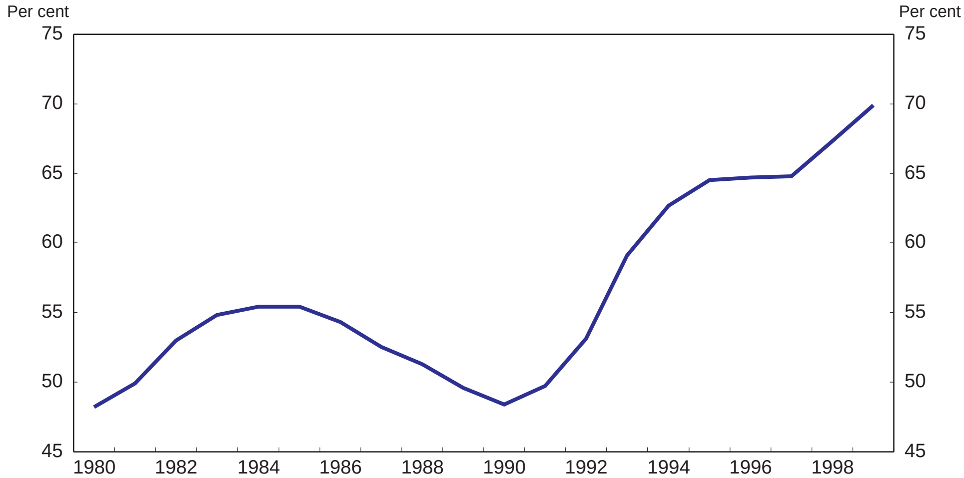
Figure 3.8. **Personal income tax revenue**

Per cent of GDP, 2002



Source: OECD Economic Outlook, No. 76.

Figure 3.9. **Proportion of firms making losses according to the national tax code**



Source: Ministry of Finance.

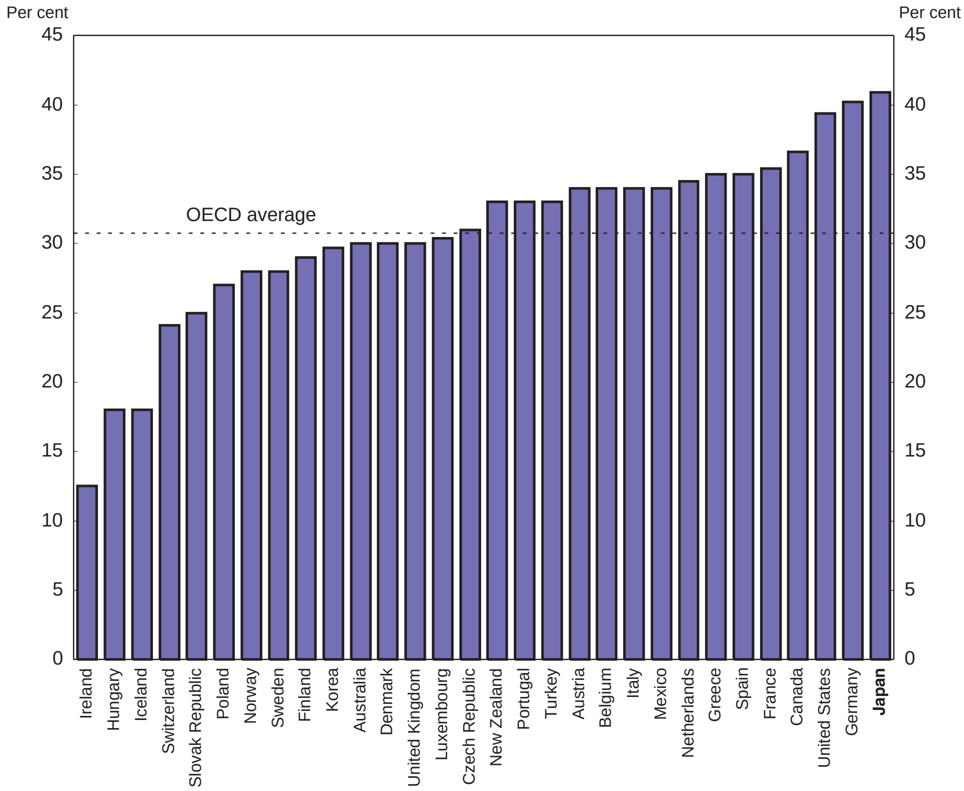
The share of enterprises making losses – as measured under the tax code – and thus not subject to corporate taxes at the national or prefectural level has risen to nearly 70 per cent in recent years, reflecting prolonged economic weakness (Figure 3.9). However, even at the peak of the bubble economy in 1990, only half of companies paid corporate taxes, implying that the definition of taxable income is too narrow. The government has introduced a pro-forma tax base for the prefectural enterprise tax, which will force loss-making companies to pay more (see Chapter 4). A more appropriate method would be to eliminate tax exemptions, such as special deductions aimed at promoting specific industries and regions. Following the introduction of an investment tax credit for R&D in 2003, the amount of revenue lost by special deductions in the national corporate income tax increased from 0.4 to 1.7 trillion yen (0.3 per cent of GDP).

Tax hikes are also necessary

While base broadening is important, the potential increase would not be large enough to fill the revenue gap. Moreover, there are strong political pressures opposing the elimination of specific tax exemptions. Increases in tax rates thus are likely to be inevitable. The personal income tax would appear to be a good candidate for higher tax rates. However, under the Trinity Reform proposal to enhance the autonomy of local governments, a reduction of grants from the central government is to be offset by increasing the taxing power of local governments (see Chapter 4). As part of the reform, the government has committed to transfer 3 trillion yen (0.6 per cent of GDP) in tax revenue from central to local governments by 2008, mainly by cutting central government personal income taxes and boosting those at the local level. The situation is further complicated by the proposal to merge the three rates in the local personal inhabitant tax into one. The complexity of the current reform programme makes it difficult to consider a rise in the personal income tax rate for the time being.

The rate of the national corporate tax, which accounts for one-fifth of total national tax revenue, was reduced from 34.5 to 30 per cent in 1999. However, including local government taxes, the rate was above 40 per cent in 2003, which is the highest in the OECD area (Figure 3.10). There is pressure from the business sector to lower the corporate tax rate so as to promote the international competitiveness of Japanese firms.

Figure 3.10. **Corporate income tax rates in 2003**[1]



1. Combined central and sub-central statutory tax rates.

Source: OECD Tax Database and KPMG's Corporate Tax Rate Survey.

Another major component of national tax revenue is the consumption tax (value-added tax), which accounts for more than one-fifth of national tax revenue. At 5 per cent, the rate is significantly lower than those in European countries. Given the limited scope for increasing direct taxes, the consumption tax appears to be the most suitable candidate for boosting government revenue. Indeed, the Tax Commission have indicated that the rate should be raised to double-digit levels in the future. Every one percentage-point rise in the consumption tax rate boosts government revenues by 2.4 trillion yen (0.5 per cent of GDP). Announcing a gradual schedule of rate increases would have a smoothing effect on consumption.

Overall assessment

The upward trend in the government budget deficit finally ended in 2002. However, given its high level, public debt is still increasing at a rapid pace. With long-term interest rates unusually low, the burden of debt-servicing costs is still modest. However, some of the exceptional circumstances supporting the fiscal situation may be approaching an end, as the private sector takes a more aggressive attitude toward risk, supported by a healthier banking sector, and the end of quantitative easing by the Bank of Japan appears to be in sight. It is thus important to address the fiscal problem during the current period of relatively strong growth before interest rates start rising.

The size of the fiscal consolidation required – around 5 to 7½ per cent of GDP – is large but has been accomplished by other OECD countries, including Japan in the 1980s. However, at the pace of deficit reduction contained in the government's *Medium-Term Economic and Fiscal Perspective*, stabilising the public debt to GDP ratio would take at least a decade, saddling Japan with a much higher level of debt at the end of the adjustment period. Moreover, there is a possibility of a jump in the risk premium during the extended consolidation period that would exacerbate the situation. In order to avoid such an outcome, two policy changes would be beneficial. *First*, the pace of consolidation should be stepped up during periods when growth is strong at rates at or above potential. *Second*, a medium-term fiscal consolidation that is more credible is necessary to support confidence in fiscal sustainability.

Such a plan should outline specific spending cuts to meet the target of a primary budget surplus. Given the pressure of population ageing, reforming social security programmes to limit spending increases is necessary. However, with interest payments and social security outlays likely to rise, even with reforms in the latter, spending reductions in other areas, including public investment, are necessary to prevent total spending from increasing as a share of GDP. Given the extent of deficit reduction that is required, it is also necessary to boost revenue, which at 30 per cent of GDP, is one of the lowest in the OECD area. The first priority should be to broaden tax bases by removing exemptions to the personal and corporate income taxes. In addition, achieving the necessary increases in revenue will require higher tax rates, notably for the consumption tax.

Notes

1. Given the ageing of the population projected through the middle of the century, stabilising the ratio of public debt to GDP over the next decade does not ensure long-run fiscal sustainability in Japan.
2. All deficit and debt numbers cited in this chapter refer to the general government – which is composed of central and local government and the social security fund – unless otherwise specified.
3. A more precise definition of long-term sustainability is the inter-temporal budget constraint, which requires that the present discounted value of future primary surpluses matches the outstanding stock of net debt.
4. Doi (2004a, 2004b) found that central and local government debt is not sustainable under the current policy stance. Atoda *et al.* (2003) and Kaino (2004) both used long-run simulations that point to further rapid increases in the debt ratio, and that faster GDP growth would not reverse debt dynamics. Dekle (2002) estimates that with unchanged policies, public debt would rise to between 700 and 1 300 per cent of GDP by 2040.
5. Standard and Poor's downgraded Japan's long-term local and foreign currency sovereign credit rating by one notch to AA– (from AA), while Fitch took the same step for Japanese government bonds in November 2002. In addition, Moody's lowered Japan's local currency sovereign credit rating by two notches in May 2002.
6. The Cabinet Office has published an estimate of potential growth of 0.9 per cent in the third quarter of 2004 (Cabinet Office, 2004).
7. The government is taking various steps to facilitate the funding of the deficit. Bonds aimed at individual investors have proven popular, with the issuance increasing from 1.6 trillion yen in FY 2003 to 6 trillion yen in FY 2004 and is expected to go as high as 10 trillion yen in FY 2005. The government also introduced inflation-indexed bonds in FY 2003, with an initial offering of 0.1 trillion yen. The nominal interest rate on these bonds does not change but the principal adjusts based on the core CPI. Such a bond can be regarded as a commitment to avoid inflation, which would boost the amount of debt to be repaid (while deflation would reduce the amount of principal).
8. Pension benefits and contributions are adjusted every five years. If the replacement rate is projected to fall below 50 per cent, the parameters would be adjusted to prevent that from happening.

9. Elderly people pay 10 per cent of their medical costs, with the remainder paid by health insurance, while younger people pay 20 to 30 per cent. The eligibility age for the lower rate is being raised from 70 in 2002 to 75 in 2007.
10. In fact, the *Perspective* shows a level of spending of around 36 per cent of GDP between FY 2004 and FY 2008.
11. The primary budget balance figures exclude social security, which had a primary deficit of 0.5 per cent of GDP in FY 2003. Including central and local governments, the general government primary deficit was 5.9 per cent of GDP that year.
12. It is more difficult to control the spending of local governments, which depends on the decisions of the 47 prefectures and more than 3 000 municipalities (see Chapter 4).
13. It included additional spending of 1.4 trillion yen for mandatory items, such as the livelihood protection programme and natural disaster recovery. At the same time, 1.3 trillion yen was cut from the initial budget.
14. The estimate of the revenue impact was made by Nikkocitigroup (2004).
15. Social security spending is to rise by 1.1 trillion yen. However, the increase is to be limited to 860 billion yen through as yet unspecified reforms.
16. The government's Tax Commission started discussion on specific items in September 2004, including whether to abolish or roll back the fixed-rate tax reductions on the personal income tax that were introduced in 1998.
17. Tanaka (2002) argues that the *Perspective* differs fundamentally from the planning systems of other countries, which place limits on individual expenditure categories based on medium-term macroeconomic and fiscal forecasts with clear policy objectives and targets.
18. Numerical targets included: 1) limiting the fiscal deficit of the central and local governments to 3 per cent of GDP; 2) phasing out the issuance of non-investment bonds and reducing the debt to spending ratio through FY 2003; and 3) imposing spending caps in specific categories, including –10 per cent on Official Development Assistance and grants to local governments, –7 per cent for public works, +2 per cent for social welfare and +5 per cent for science and technology.
19. As noted above, the 38 per cent ceiling only applies until FY 2006. Although the ultimate target is a primary budget surplus, the spending ceiling in the *Perspective* includes interest payments.
20. In terms of national accounts, part of maintenance costs is included in government consumption of intermediate inputs.
21. The amount of expenditure on a contract basis was 2.4 trillion yen by the central government, 8.6 trillion yen by local governments and 1.7 trillion yen by public corporations in FY 2003.
22. The number of beds in hospitals per population is three times more than that in the United States and the United Kingdom and 1.5 times more than that in Germany and France. Also, the length of stay in hospitals is three to four times longer compared to other countries.
23. At present, if treatment includes any non-covered services, none of the cost is covered by public insurance. Allowing insurance to pay for the covered services in such cases might reduce total government healthcare costs for several reasons. *First*, it would encourage patients to choose more non-covered treatments, reducing the number that are reimbursed by health insurance. *Second*, it may slow the upward trend in the number of treatments that are covered by health insurance. In any case, this reform would enhance consumer choice and welfare.
24. Pension contributions of those who are not employees will be increased gradually from 13 300 yen per month to 16 600 yen in 2017.
25. A decrease in the number of employees due to corporate restructuring is the main reason for the drop in the number of contributors. At the same time, many companies are reportedly increasing the share of part-time workers in order to avoid paying the employers' share of pension contributions.
26. Nippon Keidanren, the leading business group in Japan, recently released a simulation on the sustainability of public finance. According to their "no reform case" (spending to GDP ratio constant, no tax hike, government scenario on social welfare policy), the primary budget deficit would be 34 trillion yen in 2025 (4½ per cent of GDP) assuming 2 per cent nominal output growth over the next two decades, leading to an explosive rise in debt. On the other hand, by implementing drastic cuts in spending – reducing government spending in 2025 to half of that in the non-reform case – would achieve a primary balance in 2013 while achieving even higher economic growth compared to the non-reform case (Nippon Keidanren, 2004).

27. The share of income that is taxable for a household earning 10 million yen (about $100 000) is 46 per cent in Japan, compared to 77 per cent in the United States and 92 per cent in the United Kingdom.
28. A survey by the government shows that nearly 27 per cent of female employees working part-time limit their hours in order to receive favourable treatment by the income tax system (Ministry of Health, Labour and Welfare, 2002).
29. Personal income tax receipts at the central government level amounted to 14 trillion yen in FY 2003. The full 20 per cent exemption is not allowed to high-income earners.

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Chapter 4

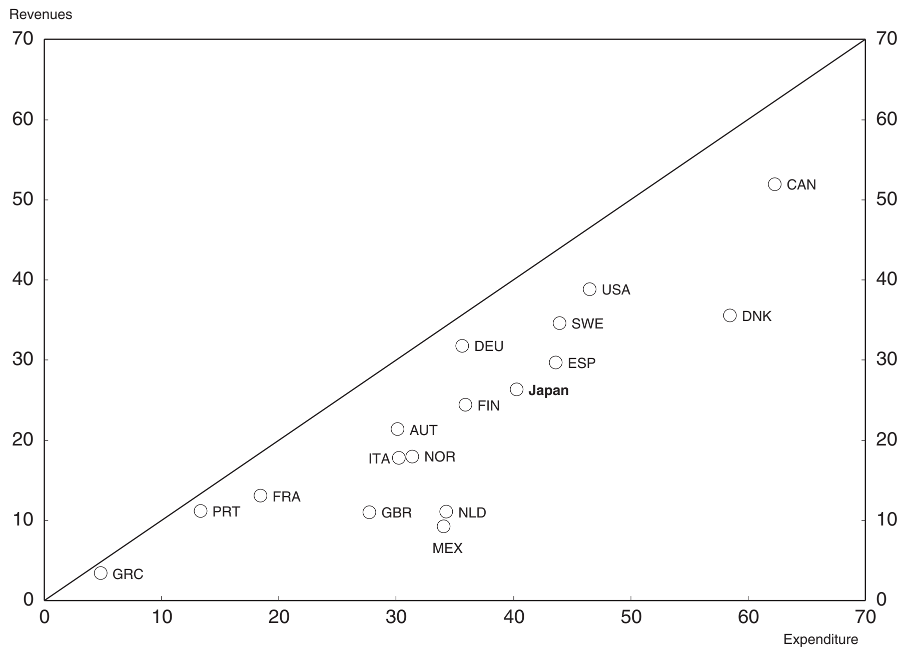
Getting the most out of public sector decentralisation

This chapter discusses policies to improve fiscal relations between levels of government so as to better meet the needs of citizens while increasing the fiscal discipline of local authorities. It analyses a number of problems, including regulations that limit innovation and accountability at the local level, the inefficient system of intergovernmental grants and the complex structure of local taxes. The chapter concludes that it is essential to improve local governments' ability and incentives to provide public services efficiently, in part by reducing reliance on earmarked grants, an objective of the "Trinity Reform". It is necessary to go further by removing barriers to the effective use of sub-national governments' taxing power and making the tax system more neutral. The framework for fiscal federalism and fiscal discipline should be strengthened through rules and market instruments, which in turn requires a clear signal that the central government will not bail out local governments.

Government in Japan is unitary with a relatively high degree of decentralisation but the benefits of decentralisation have not been fully exploited while some of its potential risks have materialised. On the spending side, local governments accounted for over 40 per cent of general government outlays in 2002 (Figure 4.1), a relatively high share among OECD countries and above those in several federal countries (including Austria, Germany and Mexico). The fragmentation in the provision of publicly-funded services, however, has made it difficult to exploit scale economies, with many municipalities too small to be efficient. In addition, strict rules and regulations imposed by the central government have severely limited local governments' ability to innovate and to tailor services to match citizens' needs. On the revenue side, the local government share is smaller but remains high by OECD standards and the right to set local tax bases and rates is broader than in

Figure 4.1. **Sub-national government share in general government revenues and expenditure**

Percentages, 2002[1]



Note: Revenues include direct and indirect taxes as well as non-tax revenues received by regional and local governments and are expressed as a share of revenues received by the general government. Expenditure corresponds to total expenditure by regional and local governments expressed as a share of general government expenditure. Transfers between governments are netted out. The country ranking in this figure does not necessarily correspond to the comparative fiscal autonomy of sub-national governments.

1. Or latest year available: 2000 for Japan and Mexico, 2001 for Portugal.

Source: OECD, National Accounts database; Statistics Norway; Statistics Canada; US Bureau of Economic Analysis.

some other OECD countries. The effective use of this taxing power has been rather limited until recently and, when used, it has sometimes increased the complexity of the tax system without serving to discipline local government fiscal behaviour.

Ballooning local government debt, from less than 15 per cent of GDP in the early 1990s to 40 per cent in FY 2003, is another sign of a malfunctioning in fiscal relations across levels of government. Rules on local government budget balances are indeed rather lenient by international standards. Budget constraints have been further softened by the design of the intergovernmental grant system and by the heavy intervention of public bodies to finance local public spending and stabilise the economy, in particular in the 1990s. In this context, local government accountability and incentives to produce services in a cost-effective manner have been weakened.

This chapter identifies policy options to improve fiscal relations across levels of government. The first section reviews the economic and political context as well as the forces shaping fiscal relations across levels of government. The following three sections present the main issues related to current spending, revenue assignments and existing instruments to secure fiscal discipline. The final section provides conclusions and policy recommendations.

Forces shaping fiscal relations across levels of government

Restoring fiscal sustainability

Faced with a gross debt amounting to 157 per cent of GDP in 2003, a continued large deficit and significant spending pressures stemming from the rapid ageing of the population, Japan has to take bold steps to restore fiscal sustainability. Revamping fiscal relations across levels of government is of paramount importance in this regard. In particular, achieving the objective of keeping general government spending fixed as a share of GDP, while promoting economic growth, requires improving the cost-effectiveness of local public spending programmes. There is growing recognition that past programmes to stimulate local government spending, and in particular public works, through the grant and local bond systems have had a very limited impact on the growth potential of the Japanese economy. Although the large increase in local public investment during the first half of the 1990s has been largely unwound, further cuts in grants targeted at local public works may be needed, as recognised in the FY 2004 budget, forcing a reallocation across projects and spending areas.

As foreshadowed in the government's *Medium-Term Economic and Fiscal Perspective*, restoring fiscal sustainability will entail increasing tax revenues. While the *Perspective* does not specify any change in the tax system, an important consideration should be how to assign tax bases and share revenues across levels of government. The Tax Commission and the 2003 *OECD Economic Survey of Japan* have both suggested broadening the personal income tax base. Since this alone will not be sufficient to balance the budget, even in the event of significant expenditure cuts, the OECD has also recommended that the consumption tax (VAT) rate be raised at some point. From FY 2004, local governments have been granted a share of personal income tax as a temporary measure until a full-scale transfer of tax resources is implemented. However, this measure and any increase in the consumption tax rate cannot be expected to raise local governments' effective revenue-raising autonomy, and thus accountability, since they have no right to set either the base or rate of these two taxes.

Coping with demographic pressures

Population ageing will change demand patterns for local public services, across both spending categories and jurisdictions. A reallocation of public funds is thus needed to contain spending pressures and to avoid unwarranted disparities in citizens' access to local public services across jurisdictions. The share of the population over the age of 65 is expected to rise from 17.4 per cent in 2000 to 22.5 per cent in 2010 and to 29 per cent in 2025. The government estimates that social welfare expenditures, including pension, medical care and other welfare programmes, will increase from 86 trillion yen in 2004 (17 per cent of GDP) to 105 trillion in 2010, despite recent reforms.[1] Pensions would account for about a third of the increase. As employers, local governments' contribution to the pension system amounted to 0.7 per cent of GDP in 2002 and will likely rise significantly over the coming decade, reflecting the pay-as-you-go nature of the system. In addition, since outlays on healthcare and other welfare programmes are largely under local government responsibility, pressure on local spending will be intense. On the other hand, the impact of population ageing could be partially offset by a decline in expenditures on education, which is mainly a local government responsibility. However, while the decline in the number of pupils in primary and lower secondary schools led to the closure of 2 125 schools over the past ten years, spending per pupil increased by 20 per cent between 1995 and 2001, keeping overall public expenditure on education constant as a share of GDP. This indicates that, at least until recently, the reallocation of funds has not been sufficient to limit the rise in local spending.

Ageing and internal migration flows will affect individual local governments differently, reinforcing demands on equalisation schemes. The share of the population over the age of 65 varies significantly across prefectures, from 25 per cent in Shimane to 13 per cent in Saitama. The share even reaches 40 per cent in some municipalities, with a clear urban/rural cleavage.[2] At the same time, the increase in the number of elderly people with no family ties is likely to be more rapid in urban centres. In addition, the mobility of citizens across municipalities has increased, resulting in greater divergence between the number of residents and the number of people using local public services and infrastructure, while equalisation schemes are largely based on residents. All of these considerations may call for a reassessment, and possibly a strengthening, of fiscal equalisation schemes across jurisdictions, in particular so as to allow them to provide a certain standard of services for the elderly in rural areas and to avoid infrastructure shortages in urban centres.

Bringing government closer to people

There is increasing concern about inefficient spending decisions by the central government (in particular for local public works) and the excessive regulations and uniform standards it imposes on local representatives. With the economy and society maturing, it has become clear that the "one-size-fits-all" approach, used to re-build the country since the Second World War, has increasingly failed to deliver an optimal basket of public goods for local citizens. Distrust of central government bureaucrats has been reinforced by a series of political and corruption scandals. Interestingly, in Japanese elections, the lower the level of government, the higher the rate of voter turnout (OECD, 1997). At this juncture, the transfer of responsibilities to local governments is increasingly seen as a strategy to bring government closer to people so as to respond more quickly and effectively to their demands.

Issues in the allocation of spending responsibilities

Local governments typically face difficulties in efficiently providing public services that are characterised by scale economies, are redistributive by nature and may affect residents from other jurisdictions. In Japan, their core spending items include: education, social welfare, healthcare and a large amount of public works by international standards (Box 4.1 and Figure 4.2, Panel A). More than half of total public spending on health, education and social welfare (excluding basic pensions) originates from local governments (Panel B). To exploit scale economies and minimise the risk of a sub-optimal provision of services that are redistributive by nature or whose benefits are shared across several jurisdictions, Japan has relied on three main strategies: promoting amalgamations of municipalities, imposing minimum standards and supporting local spending through generous earmarked grants. This section assesses the benefits and limits of these strategies, largely drawing on experiences in the education sector and public works since they both account for large shares of total local public spending.

Exploiting scale economies by redesigning the geographical coverage of local public services

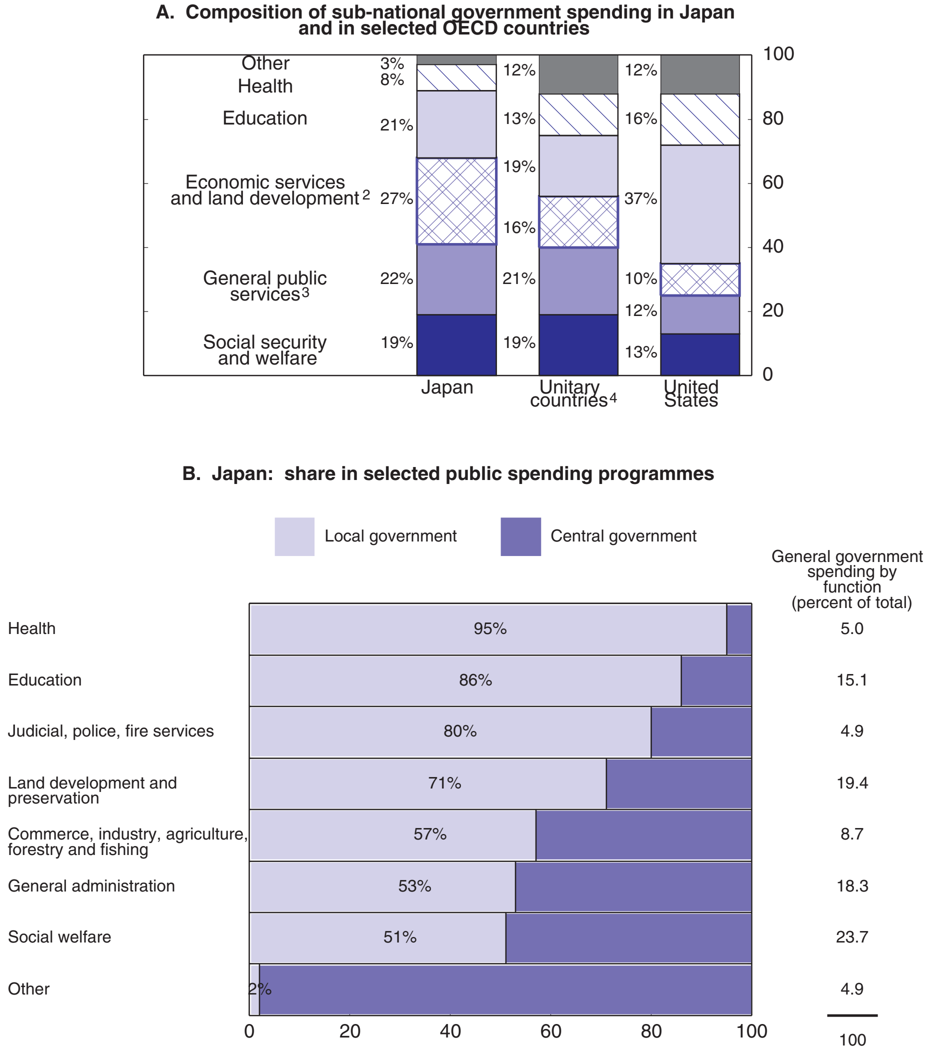
The small size of municipalities has made it difficult to secure cost-effective local public services. Some empirical studies have revealed the existence of diseconomies of scale for small municipalities and congestion costs for the largest ones, which have high population density. Hayashi (2002) found that the unit costs of local public services follow a U-shaped curve: they are high for the smallest municipalities, tend to decrease until around 120 thousand inhabitants, and increase as municipalities grow beyond this

Box 4.1. **The system of local government in Japan**

There are two levels of local government. The upper tier consists of 47 *prefectures*, with population ranging from over 12 million (Tokyo metropolitan government) to 0.6 million (Tottori prefecture). Under the prefectures, there are 2 929 municipalities comprised of 712 *cities* and 2 220 *towns* and *villages* (as of December 2004), with large variations in terms of population and area size. Despite these variations, all municipalities are basically in charge of the same spending responsibilities and are funded under the same principles. The same applies to the prefecture level.

Total spending by prefectures and municipalities were broadly equal in FY 2002, each amounting to 50 trillion yen (10 per cent of GDP). Local government spending responsibilities include: education, social services (public financial assistance, child welfare, services for the elderly), healthcare services, waste collection and disposal, infrastructure (roads, river management, sewers), public housing and police and fire services. In addition, the National Health Insurance is operated by municipalities. In many of these areas, however, the central government imposes rather strict standards and norms on local government services. Prefectures perform tasks covering wider geographical areas than municipalities but the actual responsibilities often overlap. For example, in the education sector, prefectures are primarily responsible for upper secondary schools while municipalities are responsible for lower secondary and elementary schools. However, most of the teachers' salaries for lower secondary and elementary schools are paid by prefectures and the central government. In the field of waste, municipalities collect and process home garbage while prefectures take the initiative in the disposal of industrial waste.

Figure 4.2. **Sub-national expenditure by function**[1]



1. FY 2002 for Japan; 2002 or latest year available for unitary countries; 2000 for the United States.
2. Covers general economics, commercial and labour affairs, agriculture, forestry, fishing and hunting, transport, communication. mining, manufacturing and construction, housing and community amenities, etc.
3. Including judicial, police and fire services.
4. Non-weighted average. Includes Denmark, Finland, France, Greece, Italy, Luxembourg, Netherlands, Norway, Spain, Sweden and the United Kingdom.

Source: Ministry of Internal Affairs and Communications (2004), *White Paper on Local Public Finance*.

threshold. Similar results are obtained by Yoshida (2003), who shows that per capita expenditure is the lowest for municipalities with around 125 thousand inhabitants. In 2003, 93 per cent of municipalities had less than 100 thousand inhabitants and almost half had less than 10 thousand. The small size of municipalities has been at the root of other problems. In healthcare, for instance, it has been identified as one barrier to strengthening the role of municipalities as paying agents and pooling risks effectively (Imai, 2002).

The central government has promoted the amalgamation of municipalities

The central government has long promoted amalgamations so as to ensure that municipalities have sufficient capacity to deliver key public services and exploit scale economies. The number of municipalities was reduced by almost two-thirds during the 1950s (Table 4.1). The stance in favour of mergers has been strengthened since the end of the 1990s and the ruling parties agreed in July 2000 on a target of reducing the number of municipalities from 3 thousand to 1 thousand, though they did not set a precise timetable.

Table 4.1. **Municipalities: number and disparities in size**

	Number of municipalities
1945	10 520
1953	9 868
1961	3 472
1995	3 234
1999	3 229
December 2004	2 929
Percentage of municipalities in April 2003 with:	
Less than 10 thousand inhabitants	47.3
Between 10 and 100 thousand inhabitants	45.5
Between 100 and 500 thousand inhabitants	6.5
Over 500 thousand inhabitants	0.7
Memorandum items:	
Number of municipalities considering formally an amalgamation as of April 2004	1 855[1]

1. At present, there are 580 Statutory Councils on amalgamation, covering 1 855 municipalities. If all of the amalgamation proposals are approved by the Councils, 580 new municipalities would be created from the 1 855 (the process is expected to be completed in March 2005). A large number of other municipalities have taken less formal steps to examine amalgamation opportunities: as of October 2004, 193 had set up a Study Group composed of mayors and chairpersons of local assemblies and 71 had set up a Voluntary Council composed of the members of the Study Groups as well as business representatives, academics and citizens.

Source: Ministry of Internal Affairs and Communications.

The amalgamation process has been supported by several political and financial measures. The Special Law for Municipal Mergers was revised in 1999 to allow residents to take the initiative in proposing mergers. Municipal assemblies should decide whether to organise a council to consider amalgamation if at least 2 per cent of eligible voters in a municipality sign a petition favouring such a step. To limit opposition by members of municipal councils, the number of seats in the first election following the merger can be up to twice the number allowed by law. On the financial side, adjustments in the grant system were made so as to reduce disincentives to amalgamation, thereby strengthening the incentives for merging small units that are inefficient.[3] In addition, the central government allows local governments to issue "special amalgamation bonds" for projects related to amalgamation, with 50 to 70 per cent of the redemption costs covered by the central government through the grant system. As a result, 144 municipalities merged to form 42 municipalities between April and October of 2004, 1 855 municipalities organised councils to consider amalgamation and 264 others were considering mergers as of October 2004.

Amalgamation may not always be the best option to exploit scale economies since both the optimal size and functional areas differ from service to service (*e.g.* water supply *versus* education). Co-operative arrangements have the advantage of being more flexible in this respect – they can be single-purpose or cover several services. In addition, by reducing the number of local governments, amalgamations may weaken competitive pressures and the local democratic process – two of the most well recognised benefits of fiscal devolution, although the optimal size of a municipality in these respects is difficult to determine.

Co-operative approaches have received less attention

The potential benefits of co-operative approaches for providing public services have not been fully exploited. One main form of co-operative agreement is the joint provision of one or several services by a body regrouping a number of local governments on an *ad hoc* basis. Local governments in Japan, as in a number of other OECD countries, sometimes jointly provide specific public services (*e.g.* elderly care, waste disposal, fire services, water provision and treatment).[4] They have not always been efficient. In a number of cases, local public enterprises or the so-called "third-sector companies" (jointly owned by the public and private sectors) have been instrumental in managing these tasks. They have, however, often recorded large losses and associated liabilities that may have to be eventually absorbed by local governments.[5] Akai (2003) provides evidence that the profitability of these third-sector companies declines when local governments' participation is fragmented. Contributing to this situation is the lack of a clear accountability framework and, in particular, the absence of strict rules for risk-sharing in joint venture projects between the public and private sectors.

Other forms of co-operative arrangements that may spur competition across providers, and thus cost effectiveness in local public spending, while mitigating accountability concerns, have received less attention. The "Swiss model", which relies on a purchaser/provider split, is of particular interest.[6] Under this approach, the supply of services is concentrated in certain jurisdictions – thus allowing scale economies – while providers receive some compensation from other jurisdictions which use these services, so as to mitigate the risk of under-provision. Non-providing jurisdictions can buy services from different providers/jurisdictions (local citizens can also be given the choice of providers through an implicit voucher), thus introducing competition. One disincentive to this approach in Japan, however, is the grant formula which bases entitlements on several criteria, including the number of providers (in particular the number of schools). A local government that decides to stop supplying a specific service while giving its citizens the ability to buy it from another jurisdiction or private provider would thus suffer from a cut in grants.

Norms and regulations imposed on services provided by local governments

Norms and regulations have been used extensively to secure equity and promote national objectives

While the local government share in total public spending is high by international standards, decision-making authority has tended to rest with the central government, at least until recently. Major local government public spending programmes (including education, social welfare and public works) are formulated by national ministries and largely financed through earmarked grants. Norms and regulations have often been used to secure minimum standards of public services throughout the country so as to promote equity. For most welfare benefits provided by local governments, eligibility criteria and benefit levels are set by the Ministry of Health, Labour and Welfare. The Livelihood Protection Law even forbids local governments to set benefit levels above the standard level. In the education sector as well, full equality of opportunities has long been the *credo* of the Japanese system. A uniform system was legislated after the Second World War with strict standards for school curriculum, textbooks and teacher qualifications. This has resulted in a rapid and broadly-based rise in the educational level of the population, providing a solid base for the rapid economic growth of post-war Japan.[7]

Norms and regulations have made it difficult for local governments to respond to local citizens' needs and introduce innovative managerial approaches in some areas. The excessive uniformity of schooling has been a cause of concern, including for the central government (OECD, 2001), since it may hinder the diversification of the economy and the innovation process. Although local governments are responsible for appointing teachers, flexibility in setting wages is rather limited because a law instructs local governments to set wages for teachers above the level for other local government employees. The reliance on norms to promote equity has reached its limits. The share of pupils enrolled in private institutions is high by international standards – 27 per cent in 2003, compared to below 10 per cent in Canada, Italy and the United States. With tuition fees for these schools being much more expensive than for public schools, experience in other OECD countries shows that there is a risk of social segregation in the education system.

Recent deregulation initiatives have yet to yield their full benefits

Several commendable deregulation initiatives – giving local governments more autonomy in designing and managing their spending programmes – have been launched since the mid-1990s. The Omnibus Decentralisation Act in 1999 aimed at clarifying the respective roles of central and local governments and reducing central government involvement in the provision of public services. In the education sector, efforts have aimed at ensuring that schools work more closely with their local communities and at promoting creativity, diversity and flexibility so as to give Japan a competitive edge in the globalisation process. Central government regulations regarding school hours and curriculum were loosened (OECD, 2001 and Shimizu, 2001).[8] Local boards of education were also allowed in 1997 to expand the opportunities for children to register in schools outside their designated catchment areas in order to take account of parental preferences.

The Special Zone initiative begun in 2002 (see Chapter 5) has given local governments new opportunities to lower the regulatory burden and tailor their actions to better suit citizens' preferences. In the education sector, it allows local governments and the private sector to offer new types of schools and several municipalities have already announced plans to launch schools that prioritise teaching English. Of the 1 695 proposals for special zones made through November 2003, 209 concerned the education sector. However, experience with the Special Zone initiative has not only demonstrated that there are a large number of regulatory constraints on growth identified by the local authorities but has also revealed that local governments often lack appropriate information on regulations, since some have asked to be exempted from regulations which did not exist.

Several local governments have exploited their new discretionary powers. The education board of Shinagawa ward in Tokyo has been one of the most active in this respect. It introduced school choice in its public elementary schools in 2000 and in its lower secondary schools in 2001 and reformed personnel management rules. In many other local governments, however, there is a strong tendency to wait for instructions from the Ministry of Education (Muta, 2000).[9] Time may help, as local public employees learn by doing and citizens fully understand where responsibilities lie and seize the opportunity to voice their preferences. The lack of expertise in the smallest jurisdictions may, however, need to be tackled, for example through amalgamations (see above).

An extensive use of earmarked grants

Earmarked grants have been used extensively to steer local government spending decisions. They amounted to 40 per cent of intergovernmental transfers in FY 2002 (over 2.6 per cent of GDP) – a high share compared to many other OECD countries.[10] In principle, these grants have two main objectives: to minimise the risk of a suboptimal provision of public services when their benefits extend beyond a jurisdiction's boundaries (spillover) and to secure minimum standards for specific services (Cabinet Office, 2001). In practice, however, these grants have been extensively used for macroeconomic stabilisation and for regional redistribution purposes, which can create conflict between objectives – the case of local public works being a case in point (see below). In addition, rigidities in the allocation process and the lack of proper cost-benefit analysis have limited the effectiveness of these grants in addressing spillover effects. Indeed, almost 60 per cent of the earmarked grants aiming to promote specific activities were established before 1980 (Table 4.2). The flexibility in allocating resources across sectors has increased somewhat since 2000. In particular, the FY 2003 budget introduced a mechanism to facilitate the shift of discretionary spending toward priority areas by enabling the Ministry of Finance to approve requests from other ministries for spending increases of up to 20 per cent. More progress is, however, needed as recognised in the Structural Reform Evaluation Report by the Cabinet Office in 2004.

Table 4.2. **Earmarked grants, date of introduction and cost-sharing**

Billion yen[1]

Time of introduction	Central government contribution rate to total costs				Total	*Memorandum item:* Share (per cent)
	Less than 1/3	1/3 or more but less than 1/2	1/2 or more but less than 1	1		
Before 1954	7.2	121.6	283.1	59.2	471.1	11.7
High economic growth period (1955-73)	37.4	263.1	401.8	561.2	1 263.5	31.4
Oil shock period (1974-79)	0	163.2	208.4	215.3	586.9	14.6
1980-90	0	98.3	86.4	823.8	1 008.5	25.1
Since 1990	59.1	336.4	234.6	61.3	691.4	17.2
Total	**103.7**	**982.6**	**1 214.3**	**1 720.8**	**4 021.4**	**100.0**
Memorandum item:						
Share (per cent)	2.6	24.4	30.2	42.8	100.0	

1. The data presented here are for the so-called "national financial subsidies" whose main objective is to promote specific projects. In FY 2000, public works accounted for 40 per cent of the total, social welfare for 25 per cent and 10 per cent was devoted to education and science promotion. The amounts are those set in the initial budget for FY 2000.

Source: Cabinet Office, 2001.

These grants are not only earmarked to specific areas (*e.g.* public works, education or social welfare) but they are made conditional on local governments complying with strict and detailed operational standards. For instance, local government officials have reported difficulties in using grants earmarked to pay teacher wages for part-time teachers.[11] Under the Law on State Subsidies on Expenditure on Facilities for Compulsory Education, half of the construction costs of school buildings are paid by the central government if the recipient complies with rather strict conditions such as floor size, availability of various rooms (science room, visual room, consulting room, etc.), equipment and distance from the students' homes. Mihaljek (1997) also noted that in the case of public construction work in general, even the brands of construction materials and parts were sometimes specified by the central government. With various ministries and public agencies involved in the allocation process and detailed operational conditions, earmarked grants do not allow spending programmes to properly reflect local needs. In addition, applying for and managing earmarked grants tends to be cumbersome and costly for local government (Cabinet Office, 2001).[12]

The case of public works

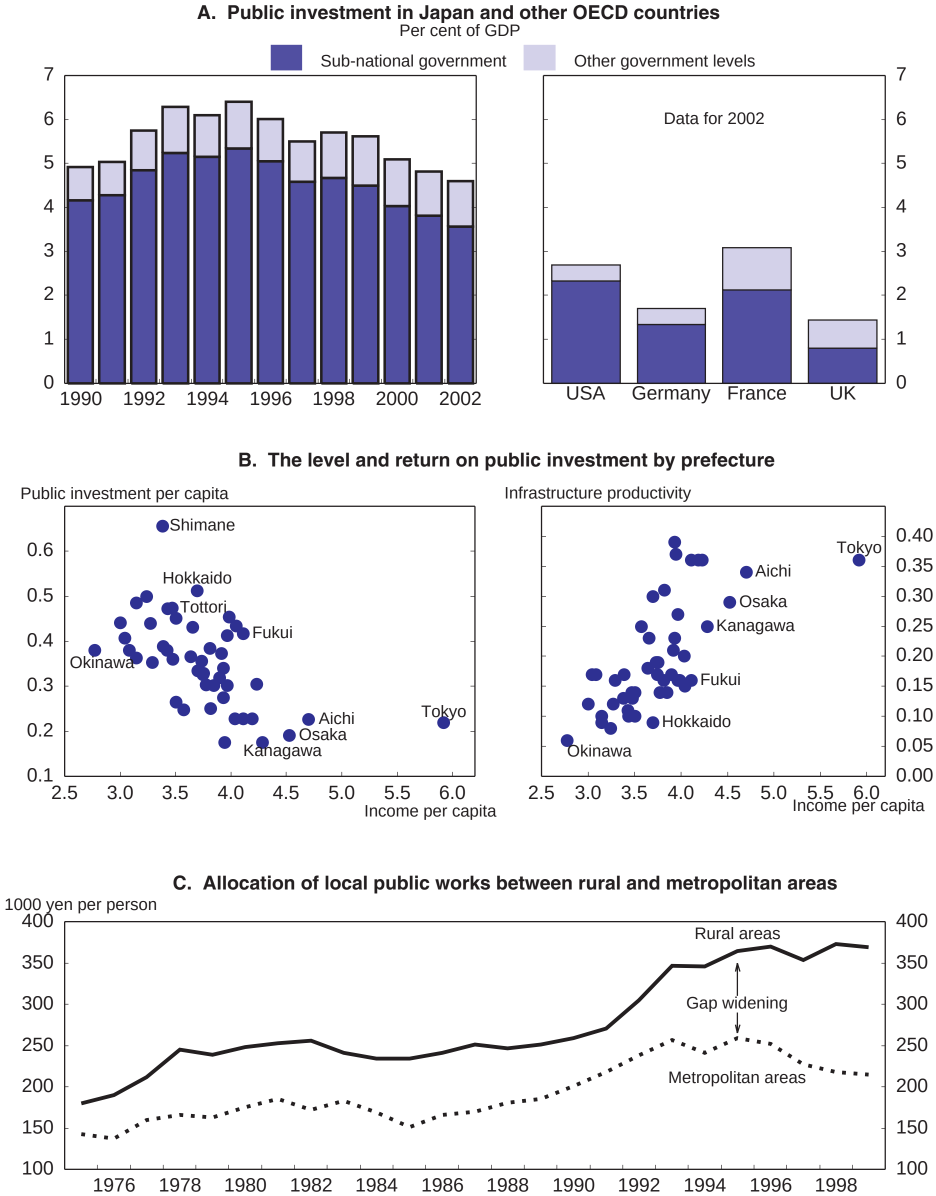
Public works have absorbed a significant share of earmarked grants. Local government spending on public works has declined somewhat since the mid-1990s but remains very high by OECD standards (Figure 4.3, Panel A), reflecting generous support from the central government. Past investment has not, however, fully filled the gap with some OECD countries, at least for some categories of infrastructure. There is evidence suggesting that infrastructure endowments in Japan stood below those in the United States and many continental European countries in 2000 (Nicoletti *et al.*, 2003). Although bottlenecks in infrastructure partly reflect topographic and historical factors, an inappropriate allocation of public works across both regions and sectors has likely played an important role (Ministry of Finance, 2001 and 2002).[13]

Central government support of local public works has been driven by multiple objectives. Stimulating the economy during recession periods has been an important goal of the central government, in particular in the early 1990s. Reducing dispersion in regional income has also long been a major factor in the allocation of public investment (Kamada *et al.*, 1998). Per capita investment in low-income prefectures was twice that in high-income areas in 1998 despite a much higher rate of return in the latter (Figure 4.3, Panel B). The bias in favour of low-income/rural regions, which increased in the late 1990s (Panel C), resulted in part from features of the Japanese political system and the lobbying activities of local interest groups (Doi and Ihori, 2002; Robaschik and Yoshino, 2004). The high level of investment in poorer areas has not stimulated self-sustaining growth as hoped, as the areas simply became highly dependent on public works and construction companies in rural areas captured most of the rent (Yoshino and Sakakibara, 2002). Several empirical studies show that the impact of public investment on the country's potential growth has declined substantially since the early 1990s to a low level, suggesting that generous central government support to local public works has substantially exceeded territorial spillover effects.[14]

Deficiencies in the use of cost-benefit analysis have also been identified. Although such analysis has been mandatory since FY 1999, it is still made by the relevant spending ministries, in contrast with the promising reform recently implemented in Korea.[15] The underlying assumptions for estimating potential benefits have often been arbitrary and excessively optimistic. The study group on cost-benefit analysis for public investment of the Ministry of Finance recommended in 2002 that the analyses review assumptions on macroeconomic developments and infrastructure targets set by spending ministries and make public the information and methods used. Following the recommendation, the Ministry has been promoting more effective use of cost-benefit analysis in the budget formulation process.

The central government provided increasingly generous financial incentives to support local public works over the 1990s. This support has been channelled through the grant system as well as by permitting local governments to issue bonds with the implicit guarantee and subsidisation from the central government. There are two main categories of public works – the so-called "subsidised" and "independent" projects. While earmarked grants are

Figure 4.3. **Local government investment: main features**



Source: Cabinet Office, *Annual Report on Prefectural Accounts*, Ministry of Finance, Ministry of Internal Affairs and Communications, Population Census of Japan, and *OECD National Accounts*.

a key financing source of subsidised public works, their share fell from 51 per cent in FY 1999 to 43 per cent in FY 2002 (Table 4.3). As a result, local governments have increasingly relied on local bonds to finance both subsidised and independent projects (the latter being ineligible for earmarked grants). Local bonds also involve substantial financial support from the central government. *First*, debt service and the actual endowment in infrastructure (*e.g.* length of roads, bridges, etc.) enter in the calculation of local governments' entitlements to the main block grant (the Local Allocation Tax, see below). *Second*, local government debt is implicitly guaranteed by the central government, which thus carries much of the costs in term of the risk premium.

Table 4.3. **Financing local public works**

Percentage shares

	"Subsidised" public works			"Independent" public works		
	FY 1990	FY 1999	FY 2002	FY 1990	FY 1999	FY 2002
Earmarked grants from the central government	40.6	51.1	42.7	0.0	0.0	0.0
Local government bonds	27.9	36.0	44.3	21.3	45.4	40.8
Local government general revenues (including block grants)	26.1	7.5	7.7	65.9	41.5	44.5
Others	5.4	5.4	5.3	12.8	13.1	14.7
Memorandum item:						
Local public works as a share of GDP	1.9	2.3	1.9	2.9	2.5	2.0

Source: Ministry of Internal Affairs and Communications.

Generous financial support has dulled incentives to minimise the costs of local public works. The lack of competition in public procurement has been an important cause of concern.[16] The *OECD 2000 Economic Survey of Japan* reported on the possibility of widespread bid-rigging (*dango*) in public procurement at the local government level. In addition, a vast majority of municipalities have pursued the favourable treatment of local companies and locally produced goods as a policy goal. Overall, it was estimated in 2000 that improvement of the public procurement system could reduce costs by 15 per cent. The Law for Bidding for Public Works Projects adopted in 2000 aimed at improving the transparency and fairness of the bidding process. Industry sources, however, still complain of problems with securing public procurement contracts at the local government level, including lack of transparency, unclear procedures and close ties between commissioning entities and incumbent firms.[17] The large degree of regional variation in requirements and processes further contributes to the arbitrary operation of the tendering process.

Issues in local government funding

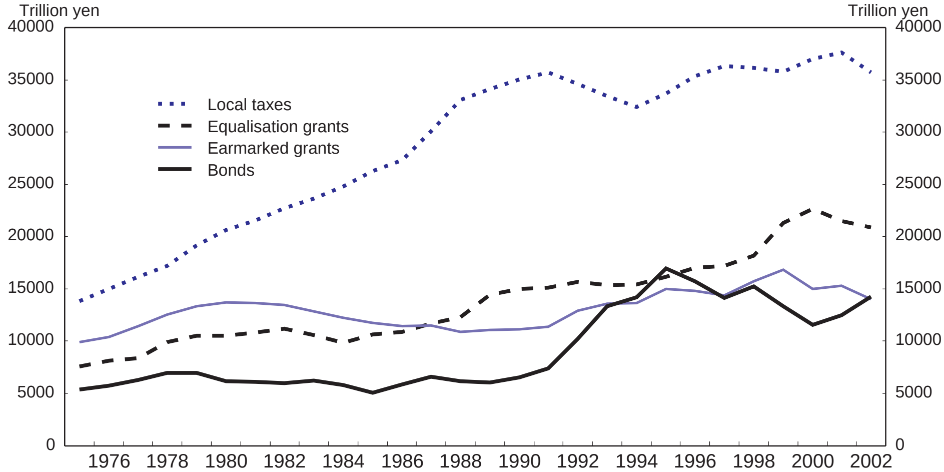
With large spending responsibilities at the local level, the main challenge on the funding side is to provide local governments with sufficient revenue-raising autonomy to make them accountable to local citizens, while ensuring that all have enough capacity to raise revenue to provide a certain level of core public services. Local governments have long relied on local taxes, in particular income taxes. The economic slump, however, has been reflected in a stagnation in local tax revenues in real terms since the early 1990s (Figure 4.4). Meanwhile, local financing needs increased since local spending was promoted by the central government, at least until the late 1990s, in part to cushion the sluggishness of other demand components. Block grants and local bonds have thus played an increasing role in filling local government financing gaps.

A complex system of local taxes

Local taxes are numerous but their revenues fall short of local government spending by a considerable amount. The Local Tax Law – a national law – defines the tax bases and standard rates for 13 main prefectural taxes and for ten municipal taxes.[18] This contrasts with a much leaner local tax system in Nordic countries – at most four local taxes in Finland, Iceland, Norway and Sweden – which are, like Japan, unitary countries with a high share of local government in total public spending. This rather complex local tax system results in some duplication and overlapping of tax bases – corporate income, for instance,

Figure 4.4. **Main financing instruments of local governments**

At 1995 constant prices, using the GDP deflator



Source: Cabinet Office and Ministry of Internal Affairs and Communications.

being subject to the two inhabitant taxes on corporations (at the municipal and prefectural levels) and to the prefectural enterprise tax (Box 4.2).[19] The proliferation of deductions and exemptions, which has also plagued some of the central government taxes, has damped local government revenues. As an indication, only 30 per cent of companies paid the prefectural enterprise tax on profits in FY 2001. The prefectural and municipal inhabitant taxes on individuals also contain many allowances, with about a quarter of the workforce not paying any income tax (Nagaosa, 2003).[20] Furthermore, the value of land for tax purposes in the immovable property tax is set at 60 to 70 per cent of the reference price provided by the Ministry of Land, Infrastructure and Transport. Local governments can, and do to a limited extent, increase rates for a number of taxes, thus compensating for some of the loss in revenue resulting from undervaluation or exemptions. This strategy may, however, meet fierce political resistance (in particular for one of the most visible taxes, the property tax) and raise serious economic concerns.

The high volatility of local tax revenues and regional imbalances

Revenues of some of the main local taxes have fluctuated sharply over the economic cycle. Business taxes amounted to 20 per cent of local government tax revenues in 2001, which is a very high share by international standards (Figure 4.5), and have been the most volatile component over the past 15 years (Table 4.4). The 2004 reform of the enterprise tax is expected to reduce this volatility by lowering the income component and introducing an asset component – similar to those used for the prefectural and municipal inhabitant taxes on corporations – and a value-added component (see Box 4.2). It should, however, be noted that the prefectural inhabitant tax on corporations has been rather volatile in the past.

While the reformed enterprise tax is expected to yield more stable revenues for local government, it also raises a number of concerns which have led some OECD countries to abolish or reform drastically similar business taxes (Box 4.3). *First*, they may discourage employment creation and business investment by imposing a heavy burden on newly-created companies with little or no profits. The exclusion of new and small companies (assets up to 100 million yen) from the new Japanese enterprise tax will mitigate this risk.

Box 4.2. **Local taxes on businesses in Japan**

Companies are subject to three or four main local business taxes according to the size of the municipality in which they are located.

The *municipal inhabitant tax on companies* comprises two components. The first is a tax on business income, calculated as a flat surcharge on the national corporate income tax. The Local Tax Law sets the standard rate at 12.3 per cent and gives local governments the possibility to increase the rate up to 14.7 per cent. The second component is a tax on companies' assets (own capital), with tax liabilities increasing in line with the value of assets.

The *prefectural inhabitant tax on companies* is broadly similar to the municipal one and uses the same tax base for the business income component. The standard rate is set at 5 per cent with a ceiling of 6 per cent. Tax liabilities for the asset component are calculated somewhat differently than at the municipal level since they increase with both the number of employees and the value of the company's assets.

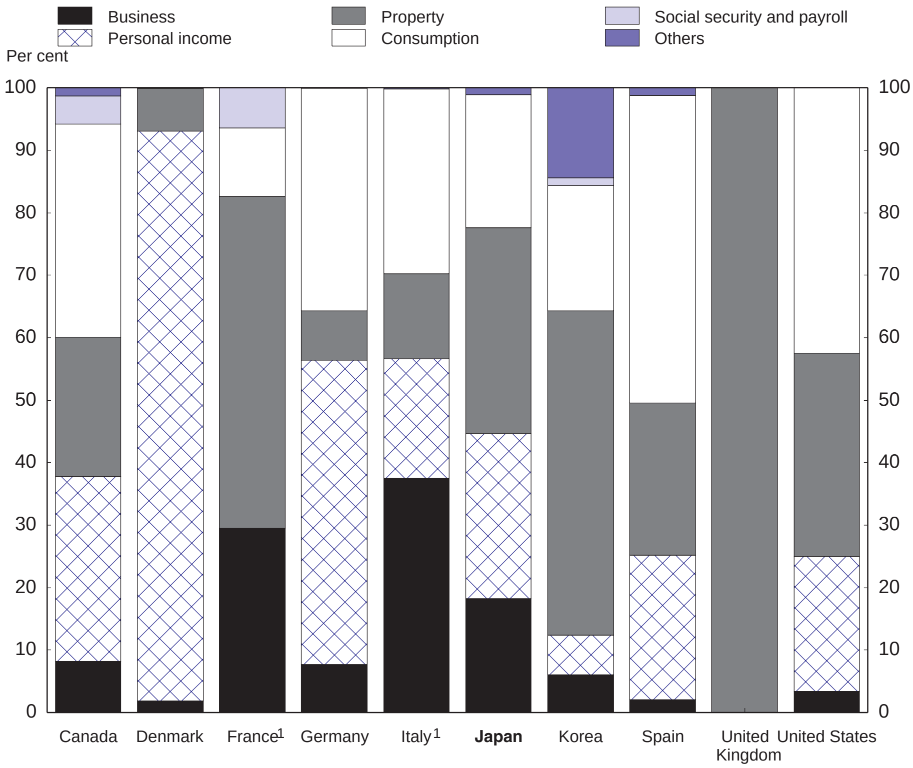
The *prefectural enterprise tax* was, until April 2004, a pure income tax based on a similar definition of the company's income to that used for the national corporate income tax. Standard tax rates were progressive relative to the company's income (from 5 to 9.6 per cent). The enterprise tax was reformed in FY 2004 for large companies (*i.e.* own capital above 100 million yen) so as to secure more stable revenues for prefectures and to implement the principle of benefit taxation – every company using local public services should pay taxes whether or not it makes profits. For these companies, the enterprise tax now has three components: *i)* an income component taxed at a reduced rate compared with the previous system (3.8 to 7.2 per cent depending on the company's income); *ii)* a 0.48 per cent tax on the company's value-added (defined as the sum of employee compensation, net interest payments, rents and profits or losses); *iii)* a 0.2 per cent tax on the company's assets. As with the previous enterprise tax, prefectures are permitted to raise the tax rate up to 20 per cent above standard rates. When firms operate in more than one prefecture, tax revenues are shared across them taking into account the number of employees and the value of fixed capital.

For companies located in large cities (*i.e.* with a population of more than 300 thousand), a *municipal enterprise tax* is imposed. The first component is based on the size of the company's building (600 yen per square metre) and the second component is a tax on the wage bill (0.25 per cent of the total). Municipalities have no right to alter the tax base or rates of the municipal enterprise tax.

However, this deviates from the principle of benefit taxation – that every company using local public services should pay taxes, whether or not it makes profits – a principle supported by the Japanese government. It also introduces new tax distortions since small and large businesses will not be treated equally and the new tax may also favour sub-contracting as opposed to in-house provision (a problem that emerged in Hungary). *Second*, taxes on business assets and value-added may exacerbate enterprise failures during economic downturns by transferring the cyclical risk from local governments to companies. The business community has indeed opposed the reform, although it has been designed to be revenue-neutral.[21]

Figure 4.5. **Composition of sub-national government tax revenues**

2002



1. Including other taxes paid solely by business (*Taxe professionnelle* in France and IRAP in Italy).

Source: *OECD Revenue Statistics*, 1965-2002.

Revenue bases of local government taxes are unevenly distributed across regions, calling for extensive equalisation schemes if the ability to provide certain standards for local public services is to be achieved throughout the country. Tax bases for local taxes on businesses are highly concentrated in urban areas. Illustrative is the fact that tax revenues per capita in Tokyo are almost six times higher than in the poorest prefecture.[22] Regional

Table 4.4. **Geographical dispersion and volatility of main local taxes**

Main prefectural and municipal taxes	Geographical dispersion[1] FY 2002	Volatility over time 1985-2002[2]
Inhabitant tax on individuals	0.27	0.09
Inhabitant tax on companies	0.40	0.21
Enterprise tax	0.49	0.26
Local consumption tax (VAT)	0.16	0.07
Property tax	0.19	0.13
Total local taxes	0.22	0.05

1. Geographical dispersion is measured by the coefficient of variation of the revenue per capita in each of the 47 prefectures from each local tax.
2. Volatility over time is measured by the coefficient of variation for the ratio of local tax revenues to GDP over the period 1985-2002, except for the local consumption tax. To adjust for the change in the local consumption tax rate in 1997, volatility has been calculated by averaging the volatility over the periods 1991-96 and 1998-2002.

Source: Calculations based on data from OECD Revenue Statistics and from the Ministry of Internal Affairs and Communications.

Box 4.3. **Problems with sub-national taxes on business value-added or assets in OECD countries**

Sub-national governments in several European countries rely on a business tax based on the value of the company's inputs, its assets or value-added. Such taxes have raised a number of concerns and some have been reduced recently.

In **France**, companies engaged in business activities are subject to a local business tax (*Taxe professionnelle*). The taxable base has long consisted of the company's rental value of equipment and buildings and its wage bill. This tax had been criticised for its adverse effect on employment creation and has been reformed. The taxable base has been narrowed substantially over the past decade, with the removal of the tax on the company payroll: until 1997, 18 per cent of wages paid were subject to this tax but this share was gradually reduced thereafter and abolished altogether in 2003. The loss of tax revenues for local governments has been offset by increased central government transfers. The taxable base now only consists of the rental value of commercial and industrial buildings and equipment. Early in 2004, President Chirac announced that the *taxe professionnelle* will soon be significantly revamped.

In **Germany**, the local business income tax (*Gewerbesteuer*) is a tax on a company's inputs, though the base is wider than the French *taxe professionnelle*. Originally, this tax was conceived as a value-added tax, with the tax base consisting of the income of all production factors. The tax base has, however, been gradually narrowed over the past decades. The payroll component was abolished in 1980 and since 1984 only 50 per cent of interest payments on long-term debt are taxable. The imputed value of buildings and equipment was also excluded in 1997 with the loss of revenues for the municipalities compensated by tax-sharing arrangements on the VAT. A reform is under discussion in the Commission for Reforming Municipal Finances set up by the Federal Government. One key issue is whether the local business tax should be more profit-oriented (an option preferred by businesses since it would better reflect their true income) or more "input-oriented" (preferred by municipalities since it would ensure more stable tax revenues).

In **Hungary**, the local business tax is by far the most important source of tax revenue for local government at over 70 per cent. It is levied at a locally-determined rate of up to 2 per cent on a base that resembles value-added (sales revenue, excluding VAT, plus interest income less the acquisition cost of goods sold, material cost and the cost of sub-contractors). It is widely criticised for being biased by discretionary exemptions and for creating a bias in favour of sub-contracting (as opposed to in-house provision). Until 2003, local governments could grant exemptions from the local business tax at their discretion, which could create a problem in localities where links between local business and local officials are strong. A high reliance on the local business tax also creates undue imbalances in the resources available for local public goods as proceeds tend to be highest in the richest regions. The Finance Ministry's initial plans for the 2004 budget envisaged changes to the local business tax but these were not included in the final budget submission.

In **Italy**, a regional tax on productive activities (IRAP) was introduced in 1998 to replace a number of taxes, including the local income tax. The tax base includes profits, interest payments, labour costs and other components of value-added. Depreciation allowances and intermediate inputs are not taxable. Although when introduced it was considered as a major step towards greater regional autonomy, there is concern about the effective degree of fiscal autonomy in poorer regions where the tax base is small and about the relatively high tax burden on the self-employed and small companies. Reforms are under consideration to replace the unpopular IRAP with another tax for the regions.

Box 4.3. **Problems with sub-national taxes on business value-added or assets in OECD countries** *(cont.)*

In **Spain**, as from 2003, businesses with a turnover of less than 1 million euro are exempted from the *Impuesto sobre las Actividades Economicas* (IAE). The central government has estimated that 93 per cent of businesses which were liable to pay this tax in 2002 would qualify for an exemption. This tax is based on fixed elements such as the surface area of the premises and electricity consumption (the number of employees criteria was abolished recently).

imbalances are slightly less pronounced for the inhabitant tax on individuals but remain high. On the other hand, revenues from the prefectural consumption tax (VAT) and property tax are much more evenly distributed. Proceeds from these two taxes are also relatively stable over the economic cycle – an important criterion when discussing optimal tax assignment across levels of government. It should, however, be kept in mind that local governments have no discretion in setting consumption tax rates or base and that giving local government discretionary powers may entail high compliance and administrative costs and create distortions in trade between jurisdictions.

Taxing powers of local governments have not been used effectively

Local governments have some flexibility in setting the rates and bases of several taxes but have so far only rarely used it, or in a surprising manner. As in most other OECD countries, several of the so-called local taxes are in fact tax-sharing arrangements. Bases and rates are set by the central government, which is also responsible for collecting them (*e.g.* the prefectural consumption tax or the local share of the personal income tax – the so-called local transfer tax of the personal income tax – introduced in FY 2004). Tax proceeds are redistributed across jurisdictions according to objective criteria. For instance, for the local transfer tax of the personal income tax, the number of residents is used. For the road and hydrocarbon taxes, the criterion is the length of roads. In some cases, uniform tax bases have been instrumental in limiting tax evasion and avoidance and/or in keeping collection and compliance costs relatively low (*e.g.* for the prefectural surcharge on the consumption tax). For a number of other taxes, however, the Local Tax Law allows some flexibility in setting rates below, or above, standard levels. In particular, local governments can decide on the rate of the prefectural and municipal inhabitant taxes on individuals and on corporations, of property taxes and of the enterprise tax. This flexibility has been enhanced by the removal of the ceiling on the municipal inhabitant tax on individuals in 1998 and of the maximum property tax rate in April 2004. Overall, Japanese local governments' discretionary taxing powers are higher than in Austria, Germany, Italy and, until recently, Belgium and Spain (Table 4.5).[23]

Local government autonomy in setting rates has so far failed to promote tax competition and fiscal discipline. Despite the flexibility offered by the law, most local governments have applied standard rates for the inhabitant tax on individuals and the property tax (Table 4.6). More surprisingly, all prefectures but one, as well as many municipalities, apply a rate above the standard one for the inhabitant tax on corporations. These outcomes seem to conflict with

Table 4.5. **Sub-national government taxing powers in selected OECD countries**[1]

1995

	Sub-national government taxes relative to:		Discretion to set taxes[2]	Summary indicator of taxing powers[3]
	Total taxes	GDP		
Sweden	32.6	15.5	100.0	15.5
Denmark	31.3	15.5	95.1	14.7
Switzerland	35.8	11.9	92.4	11.0
Finland	21.8	9.8	89.0	8.7
Belgium	27.9	12.4	57.9	7.2
Iceland	20.4	6.4	100.0	6.4
Japan	**24.2**	**6.8**	**90.3**	**6.1**
Spain	13.3	4.4	66.6	2.9
New Zealand	5.3	2.0	98.0	2.0
Germany	29.0	11.1	12.8	1.4
Poland	7.5	3.0	46.0	1.4
United Kingdom	3.9	1.4	100.0	1.4
Netherlands	2.7	1.1	100.0	1.1
Austria	20.9	8.7	9.5	0.8
Portugal	5.6	1.8	31.5	0.6
Czech Republic	12.9	5.2	10.0	0.5
Hungary	2.6	1.1	30.0	0.3
Norway	19.7	7.9	3.3	0.3
Mexico	3.3	0.6	11.2	0.1

1. The countries are ranked in descending order according to the value of the summary indicator of taxing powers.
2. The figures show the percentage of their total taxes for which sub-national governments hold discretion over the tax rate, the tax base or both the tax rate and the tax base. A value of 100 designates full discretion.
3. The summary indicator is the product of the ratio of sub-national government taxes to GDP and the degree of discretion to set taxes. Thus, it measures sub-national government taxes with full discretion as a percentage of GDP.

Source: OECD, *Taxing Powers of State and Local government*, 1999 and *Revenue Statistics 1965-2001*, 2002.

the fiscal federalism literature and the situation in several other OECD countries. Since companies are more mobile than households or properties, one would expect enterprise taxes to be more subject to tax competition.

Several factors could play a role in explaining this apparent absence of tax competition for companies. *First*, local enterprise taxes and property taxes are deductible from the central government tax base. Thus, a cut in local tax would not be reflected *pari passu* in a lower tax burden on local businesses since it would be offset, at least partly, by higher central government taxes. Symmetrically, an increase in local tax rates would not correspondingly reduce the attractiveness of a region since it would be partly offset by lower central government taxes. This may explain the tendency to apply rates above standard levels. *Second*, conditions and subsidies attached to local bond issuance make it unattractive to cut taxes. Indeed, a local government that cut taxes would no longer be allowed to issue bonds to finance local public works (Mochida, 2001). *Third*, since central government support is to some extent discretionary (*e.g.* in the allocation of earmarked grants), local governments may fear that cutting taxes could result in lower support – a mechanism identified in other OECD countries, including Korea and Norway.[24] *Fourth*, there are various regional development policy packages that allow local governments to introduce specific tax rebates so as to attract businesses and compensate them for the decline in tax revenue through higher grants (LAT). In this context, local governments tend to apply for such packages rather than lower rates across the board.

Table 4.6. **Local government discretionary powers in setting taxes and their effective use**

	Discretion in setting the tax base	Discretion in setting tax rates	Effective tax rates Number of local governments setting tax rates (FY 2003):			Rates as set in the law	Maximum rate[1]	*Memorandum item:* Share in prefectural tax revenues (FY 2002)
			Below standard rate	At standard rate	Above standard rate			
Main prefectural taxes								
Inhabitant tax on individual								16.8
On "normal" income	No	Yes[4]	0	47	0	2 and 3% (depending on the level of income)	No limits	
On a per capita basis	No	Yes[4]	0	46	1	1 000 yen per person	No limits	
Inhabitant tax on corporation								5.3
On "normal" income	No	Yes[4]	0	1	46	5%	6%	
On a per capita basis	No	Yes[4]	0	45	2	20 to 800 thousand yen per company (depending on the type and own capital of the company)	No limits	
Inhabitant tax on interest	No	No	0	47	0	5%	n.a.	2.9
Enterprise tax			0	40	7			26.6
On corporations' income and liquidation income	Yes[3]	Yes[4]	0	40	7	3.8 to 7.2% (depending on the level of income)[5]	20% above standard rates	
On corporations' value added	No	Yes[4]	0	40	7	0.48%	20% above standard rates	
On corporations' capital	No	Yes[4]	0	40	7	0.2%	20% above standard rates	
On private unincorporated enterprises' income	Yes[3]	Yes[4]	0	47	0	3 to 5% (variable with type of business)	10% above standard rates	
Local consumption tax (VAT)	No	No	0	47	0	1%	n.a.	17.6
Real property acquisition tax	No	No	0	47	0	3%	n.a.	3.8
Tobacco tax	No	No	0	47	0	969 yen per 1 000 cigarettes	n.a.	2.0
Automobile tax	No	Yes[4]	0	46	1	Variable with displacement of the car	20% above standard rates	12.8

Table 4.6. **Local government discretionary powers in setting taxes and their effective use** *(cont.)*

	Discretion in setting the tax base	Discretion in setting tax rates	Effective tax rates Number of local governments setting tax rates (FY 2003): Below standard rate	At standard rate	Above standard rate	Rates as set in the law	Maximum rate[1]	*Memorandum item:* Share in prefectural tax revenues (FY 2002)
Main municipal taxes								
Inhabitant tax on individual								30.1
On "normal" income	No	Yes[4]	0	3 191	0	3 to 12% (increasing with profit level)	No limits	
On a per capita basis	No	Yes[4]	0	3 173	18	3 000 yen per person	No limits	
Inhabitant tax on corporation								9.6
On national corporate tax	No	Yes[4]	0	1 765	1 426	12.3%	14.7%	
On a per capita basis	No	Yes[4]	0	2 617	574	50 thousand yen to 3 million yen per corporation (variable with the number of employees and level of own capital)	20% above standard rates	
Property tax	No	Yes[4]	0	2 918	273	1.4%	2.1%[2]	46.3
Light vehicle tax	No	Yes[4]	0	3 162	29	Variable with type and displacement of the vehicle	20% above standard rates	0.7
Tobacco tax	No	No	0	3 191	0	2 977 yen per 1 000 cigarettes	n.a.	4.2
Enterprise tax								1.7
On floor size	No	No	0	69	0	600 yen per square meter	n.a.	
On total salary	No	No	0	69	0	0.25%	n.a.	

1. n.a. stands for non-applicable (*e.g.* when local governments have no rights to set tax rates).
2. The upward ceiling was removed in FY 2004.
3. Capital amount, sales amount, floor size or price of building, size or price of land, number of employees etc. can be used as a tax base instead of, or combined with, a tax base consisting of income and liquidation income (income from the sales of assets during the liquidation process). However, the tax base should be set so as to keep the balance from the standard case.
4. If "fiscal and other needs" income from sales of assets, etc. during liquidation process are recognised, local governments can set tax rates above or below standard rates.
5. Corporations with own capital below 100 million yen are subject to a rate which varies between 5 and 9.6 per cent but are not taxed on their value added or assets.

Source: Ministry of Internal Affairs and Communications.

Local government tax autonomy also includes the right to grant special rebates to the taxes prescribed by the Local Tax Law and to introduce new local taxes. Local governments can introduce a large variety of tax exemptions without getting approval or even informing the central government. There are numerous examples of local governments using special tax rebates for attracting businesses (usually in industrial parks), although the central government has repeatedly expressed some concerns.[25] One obvious risk of this form of tax competition is to make the tax system overly complex and reduce its neutrality. The tax autonomy of local governments has been further enhanced by the 2000 Amended Local Taxation Act which enables them to introduce "supra-legal taxes" (*i.e.* taxes not stipulated in national laws) after consultation with the Ministry of Internal Affairs and Communications (MIC).[26] Many sub-national governments, both prefectures and municipalities, have introduced new taxes, including some on nuclear or industrial waste, hotel stays, or fishing. A number of concerns have, however, been voiced, in particular: *i)* these taxes fail to discipline local authorities since they often fall on non-residents or can be shifted on to them (tax exporting); *ii)* revenues are in many cases low, while collection costs may be high; *iii)* opportunities to introduce such taxes are extremely limited in rural jurisdictions compared to metropolitan ones, thus contributing to increasing regional imbalances (Kitamura, 2002 and Doi, 2004).

Extensive equalisation schemes

Equalisation schemes have made it possible to provide high-quality public services throughout the country but they have absorbed an increasing amount of fiscal resources over the past decades and created significant adverse incentive effects, thus prompting calls for reforms. The need for equalisation in Japan stems mainly from the fact that the capacity to levy taxes differs across regions while local spending is partly of a redistributive nature (*e.g.* with a significant share of spending devoted to welfare benefits). The Local Allocation Tax (LAT) – a block grant – is the main equalisation scheme. Similar to those in Australia and the Nordic countries, it is based on criteria related to both financial capacities and needs/costs (Box 4.4 and Figure 4.6, Panel A).[27] Earmarked grants have added to the already strong equalising power of the LAT, with low income/rural prefectures often receiving more than wealthier ones on a per capita basis (Panel B), in particular for public work projects (see above). Overall, some poor and/or remote jurisdictions end up having more financial resources than those available in the richest ones. The most striking examples are the prefectures of Kochi, Shimane and Tottori as against those of Aichi, Kanagawa and Osaka (Panel C).

Aside from intergovernmental grants, several factors have redistributed income across jurisdictions. *First*, central government income taxes take more from local governments with profitable companies and wealthier inhabitants.[28] *Second*, the different financial conditions set for local government borrowing has also had some equalising effects (see below). On the other hand, social insurance schemes provide for less inter-regional redistribution than in many other OECD countries. In particular, national health insurance contributions vary by a factor of seven across jurisdictions for individuals with similar income, since they partly reflect past healthcare costs in the jurisdiction (Imai, 2002).

The coverage and costs of fiscal equalisation schemes have increased over the past decades

The fiscal cost of equalisation schemes has edged up in recent years while pre-transfer disparities between jurisdictions have narrowed and, by international standards, are

Box 4.4. **Basic principles governing the Local Allocation Tax**

The Local Allocation Tax (LAT) system was introduced in 1954 and its basic framework has not changed much since. It serves two main functions: *i)* compensating for disparities in fiscal resources and needs; *ii)* filling the fiscal gap for local governments since their spending responsibilities significantly outpace their revenue-raising powers.

The demand for LAT transfers is derived from a formula based on the standard financial needs and revenues of each local authority. If needs exceed revenues, the jurisdiction is entitled to the LAT. If revenues exceed needs, the jurisdiction does not receive a LAT transfer, nor does it contribute directly to the equalisation scheme. In FY 2003, all prefectures except Tokyo and 96 per cent of the municipalities received it.

Standard fiscal needs of local authority i (SFN_i) are calculated using the following formula:

$SFN_i = \sum_k F_{ik} * U_{ik} * M_{ik}$, where:

F_{ik} is a measurement unit specified for each public service k (*e.g.* the number of students, teachers and schools for education services; the size of the population for fire, sewage, garbage services as well as social assistance; length of roads for public construction, as well as local bond repayment costs);

U_{ik} is a unit cost for service k. It is calculated by MIC using a "model" prefecture with a population of 1.7 million and a "model" municipality with 100 000 inhabitants (Council of Local Authorities for International Relations, 2002). It is uniform across local governments.

M_{ik} is a modification coefficient reflecting region-specific circumstances (such as population size, density, climate, etc.). Since the mid-1980s, modification coefficients also account for bond repayment costs when certain kinds of "local independent projects" have been financed through local bonds (Akai *et al.,* 2001 and Nakano, 2002).

Standard fiscal revenues of local government i (SFR_i) are calculated as the sum of local transfer taxes (LTT_i), collected nationally but redistributed according to a prescribed formula, and 75 per cent of the revenues from local taxes that a local government would get if it applied standard tax rates (t_j) on its estimated jth "potential" tax base B_{ij}.

$$SFR_i = 0.75 * (\sum_j B_{ij} * t_j) + LTT_i$$

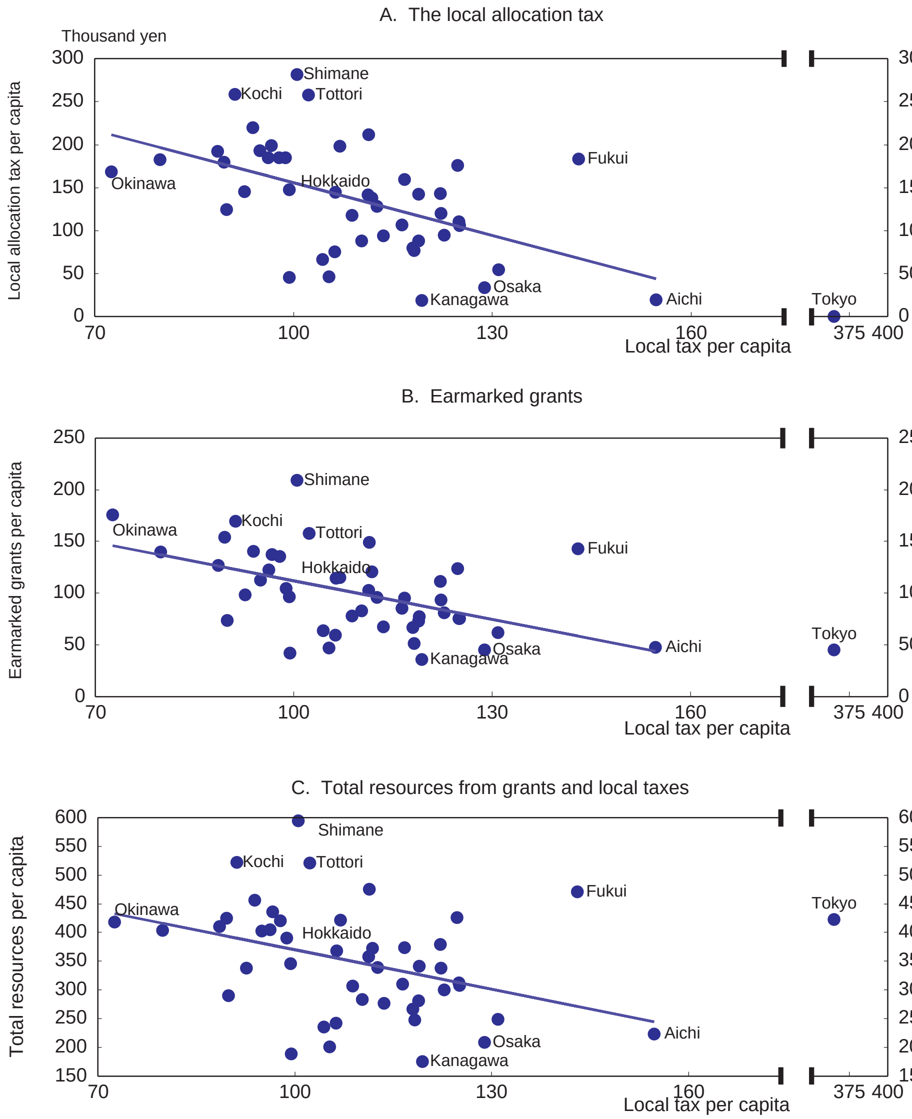
The 0.75 factor is called a "reservation ratio". It is regarded as an allowance for the uncertainty of estimation and an instrument to retain incentives for increasing the local tax base.

The amount of money made available for the LAT is a pre-specified share of revenues from five central government taxes (32 per cent of the personal income tax and the liquor tax, 35.8 per cent of the corporation tax, 29.5 per cent of the consumption tax and 25 per cent of the tobacco tax in FY 2004).

Solving imbalances between the demand and the availability of funds for the LAT. There is no reason why the demand and availability for LAT transfers should match. The past decade of economic stagnation has reduced the resources available for the LAT while increasing demand. Adjustments have included: an increase in the share of national tax revenues (*e.g.* the share of the corporate tax increased from 32 to 35.8 per cent between FY 1998 and FY 2003); transfers from the central government to the LAT account and borrowing from the LAT Special Account (associated debt edged up to 50 trillion yen in FY 2003, about 10 per cent of GDP, up from 0.1 per cent in 1990).

Figure 4.6. **The equalisation power of intergovernmental grants received by prefectures**[1]

FY 2001 settlements



1. Regressions based on all 47 prefectures excluding Tokyo.

Source: Ministry of Internal Affairs and Communications, *Annual Statistics of Local Public Finance FY 2003* and *2000 Population Census*.

relatively low.[29] LAT transfers amounted to over 4 per cent of GDP in the early 2000s, up from 2¾ per cent in the mid-1980s, and most local governments are now eligible for this grant. Several factors have contributed to the upward pressures on the grant system. *First*, the LAT system has been asymmetric in adjusting for the business cycle. The money available for the LAT – a fixed share of central government tax revenues – increases during upswings. Cyclical tax windfalls have made it possible to upgrade minimum standards for local public services. During downturns, however, it has been difficult to cut back these transfers. The decline in funds available for the LAT has largely been compensated by borrowing from the LAT special account or by encouraging local governments to issue bonds whose future repayment costs are partly accounted for in the calculation of entitlements to the LAT, thus creating upward pressures on future LAT transfers. *Second*, several observers have argued that the vague definition of public services included in the standard fiscal needs formula, which the LAT equalises, has contributed to ballooning demand for transfers. Concerns have been expressed that the rapid expansion of standard fiscal needs over the past decades reflects efforts to stimulate the economy through specific incentives (in particular public works), as well as political lobbying, rather than equalisation needs.[30] On the other hand, the LAT formula may fail to properly account for the specific situation of large urban centres since the number of residents is much lower than the number of users of local public services, in particular for inner city transport facilities.[31]

Efficiency/equity trade-offs

Similar to several other OECD countries, concerns have been raised that equalisation schemes may fail to promote public sector efficiency and, by creating poverty traps, hinder the catching-up process of poor jurisdictions. The LAT formula displays some attractive features which should limit moral hazard problems. By being based on "standard" tax revenues, it ensures that a change in local tax rates or the introduction of local tax rebates has no direct effect on the amount of equalisation grant received – a local government will not receive higher (lower) LAT if it cuts (increases) local tax rates. In addition, by excluding 25 per cent of local tax revenues – the so-called reservation ratio – from the equalisation scheme, it preserves some incentives to develop the local tax base. This is, however, considered to be too low to avoid poverty traps and convergence between richer and poorer regions could be slowed.[32] Faced with an implicit 75 per cent marginal tax rate on their revenues, local policymakers may have low incentives to implement growth-oriented policies even if they focus on maximising votes.[33] In addition, measuring the "standard" local tax base is far from obvious since it would require correcting for the impact of all local policy actions (*e.g.* the quality of the infrastructure and administrative services or the elasticity of local tax bases to changes in tax rates).

The LAT may also weaken local government incentives to provide services in a cost-efficient manner for several reasons. Indeed, there was a diverging trend in spending between local governments which received LAT and those which did not: spending by non-LAT recipients declined in the second half of the 1990s while LAT recipients continued to increase spending (Cabinet Office, 2001).[34] Among the features of the LAT system which create adverse incentive effects, several are worth mentioning, including:

- The LAT formula is not completely based on "standard fiscal needs" but includes some elements of actual spending (*e.g.* the length of roads or bridges and the number of schools). Thus, if a local government spends money on an unnecessary port or bridge construction project, it will receive more LAT (Doi, 2004). This contrasts with the practice in several other OECD countries where only those criteria that cannot be directly manipulated by local governments enter the formula.[35]
- A high unit cost of local public services can be compensated through higher grants (through modification coefficients), thus reducing the benefit of managerial efforts to contain costs. Additional LAT payments made to small jurisdictions to compensate for the higher costs associated with diseconomies of scale have been reduced but remain quite generous.[36]

- As grant entitlements are adjusted upward to finance most of the redemption costs of local bonds issued to finance public works, the LAT creates incentives to rely on debt financing instead of adjusting local taxes or spending levels. This also reflects the use of the LAT system to support national fiscal policy in recent years. In FY 2001, interest and redemption costs of local bonds accounted for 13.4 per cent of local governments' standard fiscal needs (Cabinet Office, 2001).
- The risk-sharing arrangement created within the LAT – the so-called special LAT which accounts for 6 per cent of total LAT payments and which is allocated to jurisdictions suffering from special factors such as natural disasters – has been used partly for redistributive purposes or to bail out jurisdictions facing financial difficulties (Akai *et al.,* 2004).

The "Trinity Reform"

The government launched in FY 2002 an ambitious reform of the three main components of local government financial resources – earmarked grants, local taxes and the local allocation tax – the so-called "Trinity Reform". Although details are still under discussion, the general framework announced in November 2004 includes the following elements:

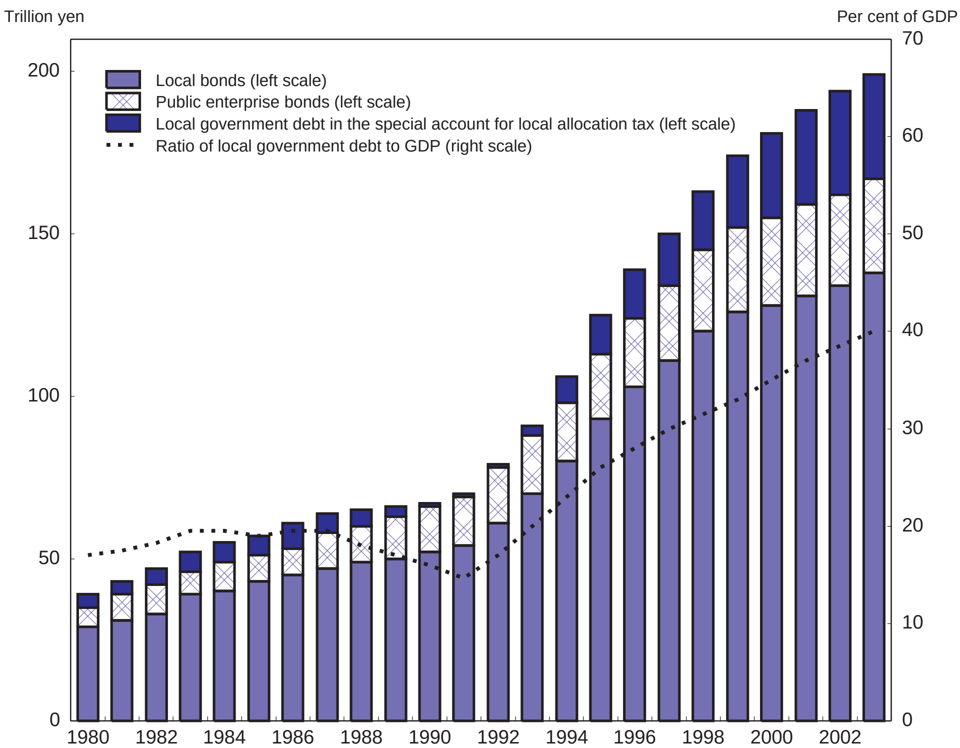
- *A cut in earmarked grants to local governments* by around 4 trillion yen over the period FY 2004-06 (*i.e.* about 0.8 per cent of GDP). The budget for FY 2004 embodies a 1 trillion yen cut, of which 0.45 trillion yen are grants earmarked to public works. The remainder falls mainly on compulsory education and childcare which are still subject to rather strict regulations and standards set by the central government.[37] For the years 2005 and 2006, based on a Cabinet decision, the central government has asked local governments to submit proposals on which earmarked grants could be cut (for an overall amount of 3 trillion yen). After intensive discussions, groups of local government leaders proposed to the prime minister a 9 trillion yen cut in earmarked grants (among which 3.2 trillion yen should be implemented over the years 2005 and 2006 and the rest during the period 2007 to 2009), thus surpassing the central government's target.[38] However, this plan raised strong opposition from many of the central government ministries as well as ruling party members in the national Diet, and the debate between relevant parties was continuing as of the end of October.
- *A streamlining of the Local Allocation Tax*. Although the details of the changes in the LAT formula have not yet been announced, the FY 2004 budget incorporated a 1.2 trillion yen cut, which fell mainly on infrastructure spending.
- *A transfer in tax resources from the central to local governments* of about 3 trillion yen. The FY 2004 budget incorporated a 0.4 trillion yen transfer of national personal income tax revenues from the central to local governments. The allocation across local governments was based on population data. It should be noted that this tax-sharing arrangement is not accompanied by a transfer of taxing powers since local governments are not entitled to set either the rates or the base of the national personal income tax. In June 2004, the government announced that it will cut the national personal income tax and increase local governments' reliance on the individual inhabitant tax by FY 2006. In the event, standard rates for the individual inhabitant tax on income will be flattened so as to strengthen the benefit principle (local taxes should reflect more the use of local public services than residents' ability to pay) and avoid a distribution of tax resources across local governments that would be too uneven.

Securing fiscal discipline in a decentralised setting

Local debt has soared rapidly since the early 1990s, reaching about 40 per cent of GDP in FY 2003, up from 15 per cent in 1991 (Figure 4.7). While local government borrowing has largely been used to finance infrastructure projects, there is doubt as to whether this has helped to boost the potential growth of the economy since the rate of return of local public investment has been low (see above). Local governments' ability to repay their debts is thus questionable, creating the risk of adding to the bad loan problem that Japan has faced over the past decade.[39]

Figure 4.7. **Trends in local government debt**

Stocks at end of fiscal year



Source: Ministry of Internal Affairs and Communications.

Contingent liabilities at the local government level also seem to be high. Although reliable estimates are difficult to produce, the upward revision to general government debt by about 10 per cent of GDP in 2002 – when the liabilities held by the local government special account for sewage were recognised – suggests that contingent liabilities may turn out to be sizeable. One important risk originates from the financial difficulties currently faced by many local public corporations jointly owned with the private sector (the so-called "third-sector"). According to the MIC, there were over 10 thousand local public corporations in March 2003 and about 56 per cent of these were jointly established with the private sector. Many of these third-sector corporations appear to be subject to insufficient public monitoring. Unless the government's share of equity is more than 25 per cent, the companies are subject to neither monitoring by the local assemblies nor to review by the audit committee. Residents, though, may request disclosure. The lack of strict rules for risk sharing in the contracts leads the private sector to expect an implicit guarantee, thereby weakening incentives to minimise costs. One study suggests a positive correlation between the amount of debt held by companies and the share of public funds in their capital (Akai, 2003). In addition to the third sector, the government introduced the so-called "Private Finance Initiative" in the late 1990s for specific projects and with clearer rules for the sharing of risk across public and private participants. It is, however, still too early to judge whether potential adverse incentives have been redressed (Akai, 2003) and estimates of implicit liabilities are still lacking.

Pressures on future public spending stemming from the rapid ageing of the Japanese population further reinforce fiscal sustainability concerns at the local level. The projected increase in public spending on health and nursing care for the elderly will largely fall on local governments. In the shorter run, the number of local public employees retiring is expected to reach a peak between 2007 and 2009. The Cabinet Office (2001) estimated that local government implicit liabilities associated with pensions and retirement allowances amount to 70 trillion yen (14 per cent of GDP). Although some local governments have accumulated reserves to finance these obligations, they are likely to be insufficient.

Administrative controls and fiscal rules have failed to restrain local government debt

While requirements for local public services imposed by the central government and the design of the grant and tax system have created the conditions for an increase in local government debt, administrative controls on local bonds and fiscal rules have so far failed to provide counteracting pressures. Local government access to the bond market is, in principle, subject to a rather strict system of administrative controls by the central government. National laws prescribe which expenditures can be financed by local government bonds and dictate a number of fiscal rules to be respected if a local government envisages issuing local bonds (Box 4.5). In addition to these rules, any individual prefecture and large city must obtain permission from the MIC before issuing bonds, whereas small municipalities have to get approval from the prefectures.

Despite a rapid increase in local debt, the existing fiscal rule on debt servicing costs has not yet become binding since it deducts bond repayment costs, which are financed through the LAT, from the total amount of local government servicing costs. According to the type of bond and/or the fiscal capacity of local government, from 30 to 100 per cent of the repayment costs are to be financed through higher grant entitlements (Table 4.7).[40] Reflecting this very generous system, the amount of local debt service which is not accounted for in the fiscal rule is significant. At the aggregate level, local government debt servicing costs (including interest payments and principal costs covered by the LAT) stood at about 27 per cent of local government general-purpose revenues in the budget for FY 2004. This means that if the broader definition of the rule were to be implemented, a large number of local governments would probably overshoot the 20 per cent ceiling.

The rule on local governments' financial balance has also remained extremely lenient. Local governments in many OECD countries (including Denmark, France, Korea, and Spain) are now subject to a balanced budget rule, either for the total budget or on an operating basis (Joumard and Kongsrud, 2003). In contrast, the "net revenue" rule in Japan obliges municipalities to keep their reliance on *ad hoc* financing sources below 20 per cent of their general-purpose revenues (5 per cent for prefectures). The grant system has contributed to further soften this rule. *First*, the longstanding increase in block/equalisation grants has been reflected in higher general-purpose resources for local governments, thus raising

Box 4.5. **Fiscal rules imposed on local governments and regulations for issuing bonds**

The Local Finance Law states that bonds can only be used to finance: *i)* expenditures on local public corporations engaged in transportation, gas, water and others; *ii)* investment in, and lending to, organisations (including third-sector companies) involved in areas of public interest (*e.g.* local roads, airports, sports, etc.); *iii)* loan refinancing; *iv)* expenditure on disaster recovery; and *v)* expenditure on construction of public facilities (such as schools and roads) and purchase of land for building public facilities. In addition, the central government has "exceptionally" allowed the issuance of bonds in a number of specific situations. Over the period FY 1990-2001, local governments issued "temporary bonds for public works" (15 trillion yen), "tax cut supplement bonds" (7 trillion yen), "revenue decrease supplement bonds" (6 trillion yen), "retirement benefit bonds" and "amalgamation bonds".

The Local Autonomy Law and the Local Finance Law – both national laws – also define a number of conditions a local government should comply with in order to be allowed to issue bonds. The main ones are:

- "*Ad hoc* financing" (the so-called "net revenue") should not exceed 5 and 20 per cent, respectively, for prefectures and municipalities of general-purpose resources (*i.e.* mainly ordinary taxes, LAT and the Local Transfer Tax). The net revenue is defined by subtracting expenditure from the sum of local taxes, LAT, earmarked grants, fees and charges, and local bond issues.*
- The average ratio of debt repayment costs (only principal and excluding those financed through the Local Allocation Tax) to general-purpose resources over the past three fiscal years should be below 20 per cent.
- Its ratio of tax collection to estimated tax revenues in the year falls to less than 90 per cent.

In addition, a local government setting tax rates below standard rates set by the central government is not allowed to issue bonds to finance public works.

If local governments do not comply with these rules, they can, under certain conditions, continue to issue bonds. For instance, a municipality running a so-called net revenue exceeding 20 per cent of its general-purpose resources can still issue bonds if it has introduced a "financial rehabilitation plan" approved by the MIC. This entails measures to increase revenues by setting tax rates above standard tax rates and measures to cut spending by reducing the number of government employees and their compensation and by cutting investment. When introducing a financial rehabilitation plan, the local government receives extra financial support from the central government, including subsidised bonds and special LAT. The most recent financial rehabilitation plan was approved for the town of Akaike in 1991 and was completed in 2000. Currently, no local government is under a financial rehabilitation plan.

* If bond issues were used only to finance investment, this "net revenue" rule would be broadly similar to a rule on the operating balance. However, bonds have been used extensively to finance local government deficits. Examples of *ad hoc* financing used by local governments include: withdrawals from various funds (Osaka prefecture) and advance spending from the next year's budget (Chiba prefecture).

their borrowing limit. *Second*, the rule is so designed that increases in local government debt make it possible for local governments to run into more debt in the future since bond repayment costs are taken into account when calculating their grant entitlements, and, hence their general-purpose resources.

Table 4.7. **Sharing the repayment costs of selected local government bonds**

FY 2001, billion yen

	Outstanding local bonds	Share of repayment costs accounted for in the LAT formula (per cent)	Estimated central government repayment costs
Name of local bonds			
General public works	25 452	–	11 068
Temporary public works	13 835	80	11 068
General independent public works	52 487	–	10 249
General regional development	10 871	30-55	3 261
Temporary local road building	16 071	30-55	4 821
Temporary river related projects	2 147	30-55	644
Temporary economic package	2 051	45	923
Public housing construction	5 150	–	0
Compulsory education facilities building	5 031	30-70, 100	1 509
Advance purchase of land for public facilities	2 226	Interest only	0
Natural disaster recovery	1 304	–	1 072
Tokyo metropolitan area development	1 178	–	0
General waste disposal	4 702	50/100	2 351
Depopulated area aid	2 418	70	1 693
National budget-related and government-affiliated organisation loans	1 203	–	0
Financial support to fill local government financing gap	3 109	80	2 488
Revenue decrease supplement (1982, 1993, 1997)	5 302	75-80	4 242
Temporary special fiscal	2 689	100	2 689
Tax cut supplement	6 227	100	6 227
Temporary tax cut supplement	1 265	100	1 265
Temporary fiscal aid	1 227	80	982
Memorandum item:			
Total outstanding local bonds (excluding borrowing from LAT Special Account)	130 954		47 403

Note: Repayment costs borne by the central government were calculated by multiplying the outstanding amounts of local bonds and the LAT compensation rate. When the LAT compensation rate varies with local government "fiscal strength", the lower rate was used, leading to an underestimation of future repayment costs for the central government.

Source: Mochida (2004).

Central government control not only applies to the amount of bond issuance but also, to a large extent, specifies bond subscribers. When permission to issue bonds is granted, the MIC decides how many of the bonds will be bought by public bodies (Doi, 2002) – mainly under the umbrella of the Fiscal Investment and Loan Programme (FILP). In FY 2002, almost 60 per cent of local bond issues were purchased by public institutions (Table 4.8). The system is largely designed to ensure that adequate funds flow into smaller or poorer local governments so as to balance fiscal resources across prefectures (Hayashi, 2004).[41] Empirical evidence on the composition of lenders by prefecture suggests that in distributing FILP funds, central government gives priority to local governments facing financial difficulties. Since conditions attached to public funds are more favourable (with both lower interest rates and longer maturity), local governments may be shielded from pressure to redress their financial situation. Evidence from Doi (2002) indeed suggests that a prefecture which relied heavily on FILP funds in the past tends to remain heavily dependent on such funds.[42]

Table 4.8. **Purchases of local government bonds by type of institution**

Billion yen

	FY 1990	Per cent	FY 2002	Per cent
Public funds total	4 069.2	64.9	7 412.8	55.7
Government funds	2 894.7	46.2	6 160.6	46.3
NTT special fund	877.8	14.0	746.9	5.6
Japan Finance Corporation for Municipal Enterprises Funds	296.8	4.7	505.2	3.8
Private funds	2 184.8	34.9	5 835.5	43.8
Public offerings[1]	483.8	7.7	1 919.1	14.4
Mutual relief of local government employees	156.0	2.5	170.5	1.3
Banks and others	1 545.0	24.7	3 745.9	28.1
Total	**6 258.8**	**100.0**	**13 319.3**	**100.0**

1. A significant part of public offerings is purchased by public institutions, including postal savings (285.8 billion yen in FY 2002) and postal life insurance (85 billion yen in FY 2002).

Source: Ministry of Internal Affairs and Communications.

Financial markets have not enhanced the fiscal discipline of local governments

Although the private sector has underwritten an increasing share of local government bonds, market mechanisms have not been playing a major role in enhancing local government fiscal discipline. In several OECD countries, particularly Canada and the United States, credit ratings in bond markets seem to act as a disciplining factor (Poterba and Reuben, 1997). Financial markets also play a part in disciplining sub-national authorities in countries like the Czech Republic, Hungary, Finland and New Zealand, as sub-national debt is not guaranteed by the central government. In Japan, several factors have limited the disciplining role of financial markets:

- Local government debt is implicitly guaranteed by the central government. The permission from the MIC to issue bonds is often interpreted as a *de facto* central government guarantee on those bonds (Ishii and Wada, 1998 and Hayashi, 2004). In addition, under the existing approval system for local bonds, the central government guarantees financial resources for the repayment costs of approved bonds through the LAT system.
- Private-sector funds cover only about 40 per cent of total local bond issues – private banks buy 30 per cent and the remaining 10 per cent are offered directly on the market. In this context, public institutions play a dominant role in setting the conditions for publicly-advertised bonds as well as for bank lending. For bonds underwritten by private banks and other financial institutions, the issuing conditions are, in principle, established through bilateral negotiations between individual local governments and lenders. In practice, however, lending terms have followed those agreed upon for other publicly-advertised bonds (partly subscribed by public bodies).
- In deciding whether to buy local government bonds, private banks often take into account a number of factors aside from local government creditworthiness, including the ability to secure a significant amount of public funds as deposits and the possibility to legally acquire valuable information such as the value of public works orders that local governments place with certain companies (Doi, 2004). Banks have also been keen to finance local governments in a period when the demand for loans from private companies remained sluggish. Recent signs of a recovery in private domestic demand may, however, reduce their ability and eagerness to buy local government bonds.[43]

Recent reform initiatives could contribute to enhancing the role of financial markets in disciplining local governments. Reflecting the widening gap in the secondary market prices, the central government has allowed the Tokyo metropolitan government to issue bonds under different conditions (in particular lower interest rates) than those applying to publicly-advertised bonds issued by other local governments since April 2002. By acknowledging differences in the financial situations of local governments and in the liquidity of local bonds, this new approach – called the 2-Table-approach – could have served to enhance market principles. However, although interest rates on local bonds initially differed, the gap gradually narrowed and completely vanished between September 2002 and March 2004. Doi (2004) attributes this convergence to statements by officials from the MIC denying the differences in creditworthiness of local bonds, attributing the differences in market prices in the secondary market only to liquidity factors, and restating the implicit central government guarantee on all local bonds.[44] Despite this price convergence, there is a possibility that the gap in secondary market prices may widen again and that uniform issuance conditions would become difficult to maintain in the future. To avoid a sudden increase in financing costs for local governments facing financial difficulties, the central government allowed local governments other than Tokyo to jointly issue publicly-advertised bonds in April 2003. This approach improves liquidity of local bonds. It may, however, weaken individual local governments' incentives to improve their creditworthiness once they have joined the group.[45]

Another major reform announced by the central government is the abolition of the approval system for local bonds in FY 2006. Under the new system, local governments should consult with the MIC before issuing bonds. If the MIC disagrees, they can still issue bonds but repayment costs will not be accounted for in the LAT formula. This system could contribute to enhancing the role of financial markets in disciplining local government fiscal behaviour since the previous approval system has often been perceived as an implicit guarantee by many investors and local government officials. Local bonds with an agreement will, however, continue to be guaranteed by the central government.

Agenda for further reform

Heightened concerns about fiscal sustainability and the demand for better tailored local public services are making it necessary to revamp fiscal relations across levels of government. The Japanese authorities have recently implemented some reforms and are planning additional measures that are steps in the right direction. To deliver their full benefits, though, they should be accompanied by other initiatives. Recommendations for further reform are discussed below and Box 4.6 provides a synopsis.

Improve local governments' ability and incentives to manage local public services efficiently

There is ample scope to increase the cost effectiveness of local public spending by giving local governments more leeway in carrying out responsibilities that have been assigned to them and by strengthening incentives to exploit scale economies. Reform of the grant system would be instrumental in these two respects.

Policy measures to support amalgamation of small municipalities have been commendable and should be continued. Despite recent adjustments, the grant (LAT) system is still overly generous for small municipalities and needs to be further amended to promote efficiency-enhancing mergers. The reform of the LAT system should also remove

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Box 4.6. **Recommendations for improving fiscal relations across levels of government**

Improve local governments' ability and incentives to manage local public services efficiently

- Pursue and diversify measures to enable local governments to exploit scale economies. Co-operative arrangements across local governments should be encouraged. This would require reforming further the grant (LAT) system and possibly providing legal and accounting assistance to local governments.
- Reassess the need for strict standards and regulations imposed on the delivery of local public services. For those sectors where national objectives are of concern, rely on norms defined in terms of outcomes/outputs rather than on regulations on inputs and operational management. Standards on local government employee salaries should also be reviewed, allowing regional variations in wage levels.
- Clarify the actual norms imposed by the central government and the responsibilities of both prefectures and municipalities so as to allow local governments to exercise their autonomy and become more accountable towards local citizens.
- Improve transparency in local public procurement contracts, with clear dispute and settlement facilities.

Contain the costs and adverse effects of the grant system

- Reliance on earmarked grants should be reduced, the objectives reviewed so as to avoid potential conflicts and old grant programmes reviewed in the light of new objectives and financial constraints.
- End the reliance of equalisation grants (LAT) on volatile national revenues for funding in order to reduce their asymmetrical behaviour over the business cycle.
- Reassess the coverage of local public services to be included in equalisation schemes. Adjust the grant formula so as to reflect objective needs (*e.g.* resulting from topographic or socio-economic circumstances rather than from actual spending or infrastructure endowments).
- Remove the incentives embodied in the grant system that favour debt financing by ending the practice of including debt repayment costs in the calculation of grant entitlements for new bond issues.
- Limit discretionary elements (including the special LAT), which could create moral hazard problems, and improve the transparency of the adjustment factors accounted for in the LAT formula.

Increase local government tax autonomy while keeping the tax system as simple and neutral as possible

- Barriers to the effective use of existing powers to set local tax rates should be removed. In particular, central government permission for local bond issuance should no longer be made conditional on local governments' setting local tax rates at, or above, the standard levels defined by the central government. Local business and property taxes should no longer be deductible from central government tax bases.
- In raising local government tax revenues, priority should be given to base-broadening measures for existing taxes (in particular the personal income tax) as opposed to the introduction of new taxes. Local governments' right to introduce specific tax rebates to attract companies should be limited since it does not promote healthy tax competition. Raising property values for tax purpose closer to the market value would also be desirable.

Box 4.6. **Recommendations for improving fiscal relations across levels of government** *(cont.)*

- If new tax resources are to be transferred to local governments, give priority to taxes which are less volatile, have no significant adverse effects on the potential growth rate and cannot be easily exported.

Harden fiscal rules and strengthen the role of financial markets to ensure fiscal discipline

- The "net revenue" rule should be transformed into a balanced operating budget rule while the coverage of the rule on debt servicing costs should be broadened to include all bonds and interest payments.
- To enhance local government incentives to comply with the rules, sanction mechanisms may be needed. At a minimum, the existing financial support for local governments facing financial difficulties (*e.g.* subsidies for bond issues, access to preferential borrowing conditions) should be eliminated so as to avoid moral hazard problems.
- Fiscal rules should be re-designed so as to prevent new debt from raising grant entitlements and thus enabling local governments to accumulate more debt.
- Financial markets should be given a role in disciplining local government fiscal behaviour. This will require reducing further the share of local bond issues underwritten by public bodies, by removing central government *de facto* guarantees (grant entitlements being adjusted to cover bond repayment costs) and by stating consistently that the central government will not act as a lender of last resort.
- Improve transparency of local government contingent liabilities (including the unfunded liabilities stemming from retirement allowances and pension commitments for local public employees, deficits and liabilities of local public enterprises and public-private partnerships).
- Clarify risk-sharing arrangements when local public enterprises or third-sector enterprises are providing public services on the behalf of one or several local governments.

the existing barriers to co-operative arrangements. In particular, the grant formula should no longer take into account the number of providers in receiving jurisdictions.

Streamlining regulations imposed on local governments and making them more transparent is desirable. While some regulations may be needed to ensure that local governments behave in conformity with national objectives, care should be taken that they do not impair local government ability to manage effectively the responsibilities assigned to them. Reliance on regulations formulated in terms of inputs and procedures (*e.g.* floor size of schools) should be minimised.

Reduce reliance on earmarked grants

The low cost-effectiveness of local spending programmes financed through earmarked grants calls for a profound reform in this area. Problems have mainly arisen from the number of objectives (which in some cases are not internally consistent) attached to earmarked grants, the rigidities in the allocation process combined with the lack of a proper assessment of their benefits, as well as from the limits and adverse incentives they create on local government efforts to improve cost-effectiveness. While the use of earmarked grants to account for clear spillover effects makes sense, the central government should aim at changing the conditionality from pure input/procedure elements to target outcomes and quality of services provided by local governments. This would enable local governments to develop more cost-effective managerial approaches. In the education sector for instance, grants should no longer be made conditional on local governments complying with extremely detailed standards for floor size, availability of rooms, equipment and so on, but rather on school performance.

The use of earmarked grants for economic stabilisation and redistributive objectives should be reconsidered, in particular for public works. This would entail reforming further the budget process so as to trigger the reallocation of public funds across ministries – which has proved to be overly rigid in the past – within the general government expenditure cap. In addition, the allocation of funds should be based more systematically on *ex ante* cost-benefit analysis, relying as much as possible on independent evaluations. This would likely entail a cut in local public works and a change in the allocation of funds across regions (away from poor and rural areas to urban ones) and sectors. Achieving redistribution objectives through direct income transfers to individuals or block grants are likely to be more cost-effective than through local public works. Efforts to reduce the costs of developing local infrastructure should be made by widening the coverage of competitive bidding in public works, reviewing policies aimed at supporting small and medium-sized enterprises (SMEs) through tendering arrangements and introducing a common nation-wide framework for public procurement with clear dispute and settlement facilities (see the 2003 *OECD Economic Survey of Japan*).

Reforming the fiscal equalisation scheme to mitigate its fiscal costs and efficiency/equity trade-offs

The longstanding upward drift in the coverage and costs of the main equalisation scheme (LAT) needs to be halted. Recognising that the quality of public services is now high in most parts of the country, there is a need to reassess the coverage and generosity of the LAT against other major national policy objectives, in particular the need to restore fiscal sustainability. The coverage of "standard fiscal needs", which enter in the calculation of grant entitlements, should be reviewed systematically and be open to public debate. In particular, the inclusion of some public infrastructure endowments, whose impacts on local resident welfare seem low, should be reconsidered. In parallel, the amount made available for equalisation should no longer be derived as a fixed share of national tax revenues. This would help to avoid increases in grant entitlements during boom periods that are difficult to cut during recessions.

The LAT formula should be redesigned so as to encourage local governments to deliver services in the most cost-effective manner. In the first place, it should be based more systematically on objective needs (*e.g.* size of school-age population or remoteness indices) rather than on actual endowments, such as the number of schools or length of roads. This would mitigate the incentives for local governments to embark on spending with low economic returns or welfare impacts. The reliance on discretionary elements, including the special LAT and various aspects of modification coefficients used in the LAT calculation, should be reduced and, in general, the formula made more transparent. Similarly, there is a need to remove existing incentives in the LAT system in favour of local bond issues (as the LAT formula takes into account bond repayment costs) because they may hinder otherwise desirable adjustments in local tax rates or cuts in spending. The reduction in the LAT coverage of repayment costs for some public infrastructure (*e.g.* river and coastal protection as well as agricultural roads) made in FY 2002 is a step in the right direction, as is the increase in the share of local taxes (reservation ratio) retained by prefectures. A bolder reform, however, is needed since a large share (commonly between 35 and 100 per cent) of local bond repayment costs is still paid back by the equalisation scheme while 75 per cent of a rise in local tax revenues stemming from an increase in taxable income is given away to the equalisation pool.

Increase local government tax autonomy while keeping the tax system as neutral and simple as possible

Increasing local government revenue-raising powers could allow them to better respond to local citizen preferences and, by making the cost of local public services more visible for local taxpayers, to secure fiscal discipline. Before introducing new local taxes, however, the central government should remove barriers to the effective use of local governments' existing powers to set tax rates. *First*, central government permission for local bond issuance should no longer be conditional on local governments applying local tax rates at, or above, standard tax rates set by the central government. *Second*, local taxes should no longer be deductible from central government tax bases since this hinders tax competition from playing a role in disciplining local governments. *Third*, local governments should not fear that changes in local tax rates or efforts to develop the local tax base will be offset by a reduction in grants. This would require limiting the use of discretionary support for those facing financial difficulties (*e.g.* through the special LAT or the coverage of bond repayment costs by the LAT). Some of the existing ceilings on local tax rates – *e.g.* for the automobile tax – should also be reconsidered.

In increasing local government tax autonomy, care should be taken to keep the tax system as simple and neutral as possible. Local governments already rely on a large number of taxes by international standards, the revenue of which is often limited by various exemptions and rebates. In this context, efforts to widen the base of the existing local taxes should take precedence over the introduction of new taxes. Recent steps in this direction have been carried out at the central government level (*e.g.* the abolition of the special allowance for spouses in the national personal income tax) and should be pursued. Since local governments often piggy-back on central government taxes, these reforms would have beneficial trickle-down effects at the local level. There is also some scope to increase local government revenues from taxes on immovable properties whose proceeds, as a share of GDP or total taxes, are still below the level in Canada, the United Kingdom and the United States. This would require bringing the property value for tax purposes into line with the actual value once the market cycle has normalised. On the other hand, reducing the complexity and increasing the transparency of the local tax system requires imposing limits on local governments' ability to introduce special and *ad hoc* tax exemptions, in particular for taxes on businesses.

Local government reliance on taxes which are highly volatile, can be easily shifted to non-residents or are unevenly distributed, should be avoided. Concerns have been expressed that several of the "supra-legal taxes" introduced after the 2000 amendment of the Local Taxation Act score low in at least some of these respects. These taxes also add to the complexity of the tax system. This would call for a reassessment of the benefits and limits of the system of supra-legal taxes. Efforts to rationalise existing local business taxes, which are numerous and often overlap, would also be desirable while recognising that local taxes on business assets and value-added may have serious drawbacks for the economy as a whole.

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Harden fiscal rules and strengthen the role of financial markets to ensure fiscal discipline

As at the central government level, there is an urgent need to restore fiscal sustainability at the local level, and to contain debt in particular. The central government has announced that from FY 2006 it will remove the approval system for local bond issues. While this may have a positive impact on local government fiscal discipline by weakening the implicit guarantee on their bond issues, it will deprive the central government of a direct control instrument over local debt. This calls for a strengthening of other instruments – fiscal rules and/or market instruments – to discipline local government fiscal behaviour.

Existing fiscal rules should be gradually hardened, and their coverage broadened. While local government debt as a share of GDP in Japan is one of the highest among OECD countries, fiscal rules have remained rather lenient. The rule on local government financial balance ("net revenue") should be tightened in two main respects. *First*, it should no longer consider local bonds as a source of revenue for local governments. A rule on the operating balance would be highly preferable. *Second*, the existing ceilings for this rule should be brought down significantly. In parallel, the existing ceiling on debt servicing costs should be made more binding by no longer excluding interest payments and certain categories of bonds from the rule and, once the current level of total debt servicing costs is recognised, by setting a downward path.

To be credible, fiscal rules should embody some elements of flexibility and sanction mechanisms. The existing ceiling on debt servicing costs, by being based on a past three-year average, already contains a medium-term perspective. A similar degree of flexibility should be built into the deficit rule, the more so because the current set of local taxes display high volatility. This would serve to avoid having local governments behave in a pro-cyclical manner (*e.g.* increasing taxes or cutting spending when the economy slows). Enforcement mechanisms may also be required to strengthen local government incentives to comply with fiscal rules. A necessary action is to reconsider existing financial supports to local governments facing financial troubles, including discretionary grants (the so-called special LAT when local governments are under a financial rehabilitation plan) and the access to subsidised bonds, which could create moral hazard problems.

Financial markets should also play a more prominent role in enhancing fiscal discipline at the local level. This would require reducing further the amount of local bonds bought by public institutions, which currently play a dominant role in setting the conditions for bonds underwritten by private banks and those publicly advertised. The central government should also ensure that adequate information on local government financial positions is available and recognise differences in the creditworthiness of local bonds. It may be difficult to exclude some bail-outs of local governments facing serious financial problems in Japan, where local governments provide core public services with relatively high minimum standards imposed by the central government. Nevertheless, not all local bonds should be given an implicit guarantee from the central government.

For financial markets and fiscal rules to exert effective discipline on local government borrowing, adequate information on borrowers' outstanding and implicit liabilities, as well as on their repayment capacity, must be readily available. The central government should request local governments to disclose information on their implicit liabilities, including those associated with retirement allowances for local public employees, as well as net assets of local public enterprises and the so-called "third-sector companies" (valuing assets at their current prices). In addition, stricter rules for risk-sharing in the contracts for public-private partnerships (third-sector companies) should be implemented and, if appropriate, the companies should be closed or privatised.

Notes

1. Even if nominal GDP were to grow at a 2 per cent annual average rate, social security spending would rise to 18.4 per cent by 2010. However, its share would increase to 21 per cent if nominal GDP, which fell by 3 per cent between 1998 and 2003, were to remain constant through the end of the decade.
2. See Council of Local Authorities for International Relations (2002) and data from the National Governors' Association.
3. The Basic Research Report of the Study Group on amalgamation of municipalities around Tanabe city in Wakayama prefecture, produced in 2002, provides evidence of the still generous treatment for small municipalities.
4. Joint provision of a large number of public services is frequent in France where municipalities are extremely small (less than 2 thousand inhabitants on average) as well as in other OECD countries (including Finland for hospital care).
5. Democratic accountability has been another cause of concern in a number of countries since intergovernmental bodies are not elected by the population. The entanglements of special bodies with different legal backgrounds and territorial coverage could leave citizens with little influence over local and regional public services. See Le Saout (1998) for a discussion on this issue for France.
6. This form of co-operative arrangements across cantons has been implemented for several services, including tertiary education and hospital care. For information concerning such co-operative arrangements, see OECD (2002).
7. Recent cross-country analysis shows that Japan has succeeded in combining a high level of education with low disparities across the country by OECD standards. See OECD (2003), *Education at a Glance*.
8. The 1998 report by the Central Council for Education recommended that the Ministry of Education limit its practice of giving detailed advice to lower levels as well as minimise the participation by the national and prefectural governments in the activity of municipalities and schools. It introduced a new course of study, allowing schools some flexibility in designing curriculum and length of class time.
9. Muta (2000) notes that after the introduction of flexibility in designing curriculum at a local level, local boards of education and schools sent so many requests for assistance to the Ministry of Education that a publication was distributed in 2000 and became a best seller.
10. Several OECD countries (including Canada, Finland, Iceland, Ireland, Norway and Sweden) drastically reformed their grant system in the 1990s, replacing most earmarked grants by general-purpose grants (Joumard and Kongsrud, 2003). The United States is the main exception in this regard.
11. The Ministry of Education, Culture, Sports, Science and Technology (MEXT) has removed the conditions that the earmarked grant for teacher wages be used only for full-time teachers, beginning in FY 2004. However, because of a lack of information, a certain number of local governments still believe that the constraint is binding. The Ministry of Education still needs to better inform local governments of the benefits of the new grant system. Furthermore, the central government envisages giving local governments more freedom in setting the wage levels and the number of teachers within the total amount of the grant. A central government law requires that the wages of teachers in the compulsory education system be set above the level of other local public officials with the objective of maintaining a high education standard. In addition, the MEXT sent a letter in 2004 to all local education boards urging them to maintain teacher wages at a "necessary level".
12. A recent survey revealed that a majority of local government representatives would favour the removal of many earmarked grants with compensation in the form of higher block grants and/or local tax revenues. See the paper submitted to the Council on Economic and Fiscal Policy by its private-sector members on 21 November 2003.
13. Infrastructure projects are possibly more costly in Japan since the land is mountainous and prone to earthquakes, the ground is soft and rainfall is high. The development of social infrastructure started only in the late 19th century in Japan, much later than in most western nations. Kondo (2002) argues that the provision of public capital is sufficient at the aggregate level but that infrastructure for railways, telephone networks, telegraph and postal services is below the optimal level.

14. See Cabinet Office (2004), Ministry of Finance (2002), Ishii and Wada (1998), Nakazato (2003) for road construction projects, and Yoshino and Sakakibara (2002). The *OECD Growth Study* shows that the overall impact of public investment on economic growth is extremely low when one accounts for the extra taxes a government will have to impose to finance it (Bassanini *et al.*, 2001).

15. Korea has introduced a preliminary feasibility study system aimed at strengthening the *ex ante* evaluation process. Since 1999, the Public Investment Management Centre (PIMA) has conducted studies for all new large public investment projects. In most studies, public investment is evaluated from both social policy and economic perspectives. By 2003, PIMA had examined 153 projects, of which 78 were rejected.

16. See, for instance, the fifth Comprehensive National Development Plan, "Grand Design for the 21st Century", adopted in 1998.

17. See the European Business Community in Japan (2003).

18. Prefectural taxes prescribed by the Local Tax Law are: the inhabitant tax on individuals, the inhabitant tax on companies, the enterprise tax, the local consumption tax, the real property acquisition tax, the tobacco tax, the golf course utilisation tax, the automobile tax, the automobile acquisition tax, the mining tax, the hunter registration tax, the hunting tax and the light-oil delivery tax. Municipal taxes prescribed by the Local Tax Law are: the inhabitant tax on individuals, the inhabitant tax on companies, the property tax, the light vehicle tax, the tobacco tax, the mineral product tax, the special landholding tax, the hot springs tax, the urban planning tax and the business office tax. The Local Tax Law also defines standard tax rates which are used to derive Standard Fiscal Revenue, and thus grant entitlements, of each local government (see below). Although local governments do have the possibility to set some local tax rates below or above the standard ones, they have exercised this power only to a limited extent.

19. Companies are further subject to the national corporate income tax although the three local taxes on companies are deductible from taxable income at the national level.

20. These tax allowances are very similar to those for the national individual income tax – in particular a high tax-exempted income threshold, generous deductions for pension income and the "regular" spouse allowance – which were considered as excessive by the Tax Commission in 2003 (Tax Commission, 2003).

21. Nippon Keidanren – the leading business group in Japan which is mainly composed of large companies – recommended in September 2003 that the government reconsider the introduction of a value-added and an asset component in the prefectural enterprise tax. According to Keidanren, the new enterprise tax raises two concerns. *First*, it introduces a new distortion between large and small companies. *Second*, members fear that taxing assets could disrupt companies' efforts to strengthen their own capital.

22. Differences in local tax rates contribute only little to the dispersion in actual tax revenues since discretionary powers are rather limited and, when used, variations across jurisdictions are small. For example, seven prefectures out of 47 applied rates above the standard level for the enterprise tax in FY 2004. For six of them, the actual rates were set at, or below, 5 per cent above the standard tax rate.

23. The definition of the standard tax rate in the Local Tax Law was amended in 2004. It was changed from "the tax rate that local governments should use in standard cases but are not required to use if a special fiscal need is recognised" to "the tax rate… if fiscal and other needs are recognised" (the term "special" was dropped and "other" was added). In principle, local governments now have more flexibility in setting tax rates. No concrete examples of "other needs" have, however, been provided by the central government, raising questions about the local governments' effective use of this new flexibility.

24. According to Akai, Sato and Yamashita (2001), the allocation of the special LAT is also to some extent discretionary.

25. According to the Economic Planning Agency (1998), exemptions are usually made on the prefectural enterprise tax, real estate acquisition tax and property tax for a limited period of time, usually three years. Some participants to the Expert Committee of the Japan Investment Council claimed in 1997 that local governments use such tax rebates quite extensively and in a discretionary manner to attract companies. The MIC has notified prefectural governors on several occasions that "Tax exemption, unequal taxation and tax relief should be thoroughly examined and should not be overused".

26. The central government is legally required to approve proposals of local authorities to introduce new taxes, except when the new tax: *a)* results in extremely high tax rates; *b)* impedes the mobility of goods and capital across jurisdictions; *c)* conflicts with national economic policies. Since April 2004, cuts in rates for the so-called "supra-legal taxes" no longer need to be approved by the central government.

27. In contrast, differences in expenditure needs are not taken into account in some other OECD countries, including Canada.

28. As an illustration, 53 per cent of the national corporate income tax originated from Tokyo and Osaka prefectures in FY 2002 while these two urban centres accounted only for one-sixth of the country's entire population (National Tax Agency and Ministry of Internal Affairs and Communications).

29. See Mochida (1998) for a time perspective and Spiezia (2003) for cross-country comparisons.

30. See for instance Akai *et al.* (2001), DeWit (2002) and Doi (2004).

31. For Tokyo, the LAT formula is based on a daytime inflow population of 0.7 million inhabitants while 3.7 million people commute into Tokyo according to the Tokyo metropolitan government.

32. In its *Annual Report on Japan's Economy and Public Finance, 2000-01*, the Cabinet Office stated that "the present local administration and finance system is based on the national government's engagement in local government spending and its massive fund transfers to local governments, working to discourage local governments from taking their own measures for regional development and prompting them to beg the national government for funding".

33. In Germany, similar concerns have arisen. See the 2002 *OECD Economic Survey of Germany* and Söllner (2001) for a theoretical analysis.

34. Although virtually all local governments receive a LAT transfer, Tokyo prefecture and several large municipalities do not. Because of their size, their share in total local public spending is large.

35. Similarly to Japan, maintaining a balanced settlement pattern in the country by providing high-quality public services even in remote areas has long been a priority in Norway (see the 2002 *OECD Economic Survey of Norway*). The equalisation scheme does take into account special topographic factors (in particular indexes for remoteness or population density) but does not include actual infrastructure endowments.

36. Recent changes have reduced the generosity of the system for small municipalities. *First*, the special treatment of municipalities with a population below 4 thousand inhabitants was abolished. *Second*, the sample used to calculate modification coefficients for local government size has been narrowed from all local governments to the most efficient two-thirds. To further lessen the amalgamation penalty, the "grace period" before entitlements to the LAT are recalculated has been extended: entitlements are maintained during the first five years and are reduced only gradually between the sixth and tenth years following the amalgamation.

37. The budget for 2004 embodies a 0.2 trillion yen increase in special local grants, which are not earmarked, to compensate for the cut in earmarked subsidies on primary education.

38. The proposal to cut 3.2 trillion yen in 2005 and 2006 requires the abolition of 45 subsidies in the social security area, 33 in public works, 15 in education and 55 in other areas.

39. Doi (2002) estimates the risk of local government insolvency under several scenarios and, as a consequence, the default risk for public institutions holding local government bonds. Assuming that local governments' primary financial balance will remain at the average level of FY 1997-2000, 64 per cent of the outstanding loans from the Fiscal Investment and Loan Programme (FILP) to local governments and 62 per cent of those from the Japan Finance Corporation for Municipal Enterprises would be defaulted. It should, however, be kept in mind that the assumption on the local government financial balance is rather pessimistic in the light of recent economic developments.

40. Mochida (2004) estimated that the central government finances more than one-third of local government outstanding bonds. Higo and Nakagawa (2001) have produced similar estimations for FY 1999.

41. See, for instance, Risk and Investment (2002), which notes that "there are growing doubts that the (central) government will be able to fully support the future ability of local governments to fulfil their debt service obligations". It thus introduced new rating criteria for local government bonds. Doi (2001) found a negative correlation between the share of public finance lending and the effective interest rate of local bonds, which implies that a tacit regional income redistribution is carried out by the local bond approval system.

42. Even after the reform of the FILP in 2001, postal savings and the postal insurance fund have continued lending money directly to financially weak local governments. Lending conditions are not subject to bilateral negotiations between lenders and borrowers. Instead, uniform standards are set by the central government. On this issue, see also Doi and Hoshi (2002). The government plan to privatise postal services and related businesses in FY 2007 is, however, likely to significantly affect local government financing conditions (PHP, 2004).

43. According to Norinchukin Research Institute (2003), city banks and regional banks have been reducing their holding of local bonds in recent years while those of mutual benefit associations (especially those in the agricultural sector) have increased. The Japan Credit Rating Agency argues that after the partial introduction of the pay-off deposit insurance in April 2002, some local governments have withdrawn their deposits from financial institutions in difficulty, leading to a deterioration in the relationship between local governments and local financial institutions (including bond underwriting).

44. There are several analyses of the determinants of local bond prices on the secondary market. Using December 2001 data, Mochida (2004) found that the main factor behind the price gap was the difference in the degree of liquidity, but the influence of creditworthiness could not be totally denied. Norinchukin Research Institute (2002) notes that the interest rate spreads across local bonds widened markedly since the latter half of 2001 and that the influence of creditworthiness became clearer between 2000 and 2002.

45. Issuing local governments agreed to contribute to a fund that serves to ensure the repayment of the debt in the case of a natural disaster or a crisis in a local financial institution. This introduces a moral hazard problem, leading to weaker local authorities borrowing more than they would without the pooling system (Robaschik and Yoshino, 2004).

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Chapter 5

Removing the obstacles to faster growth

This chapter discusses policies to accelerate growth through regulatory reform and measures to strengthen competition. It looks at a number of major initiatives, including the privatisation of Japan Post, the Special Zones for Structural Reform and the use of market testing to allow a greater private-sector role in social welfare areas. The chapter concludes that improving regulatory tools, including the Administrative Procedure Law, the No-Action Letter system, the Public Comment Procedure and Regulatory Impact Analysis, would enhance transparency and encourage inflows of foreign direct investment. Strengthening competition requires upgrading the Japan Fair Trade Commission and increasing sanctions on violations of the Anti-Monopoly Act. In network industries, such as electricity and telecommunications, enhancing competition depends on improving the regulatory framework. Another priority is increasing openness to international trade through multilateral negotiations and free trade agreements with neighbouring countries. Progress in this regard will require reducing the high level of agricultural protection.

Japan ranks high in a number of areas identified by the OECD's *Growth Study* as key to promoting sustainable growth over the medium term. For example, despite the decline during the past decade, the share of business investment in GDP is among the highest in the OECD area, while Japan ranks third in the proportion of young adults with at least a secondary school education. Japanese students continue to perform well in international tests of scholastic achievement. Moreover, the level of R&D expenditure as a share of GDP in Japan is the third-highest in the OECD, with more than three quarters of this investment financed by the business sector. Despite the strong fundamentals in a number of areas, Japan's decade of economic stagnation has opened a large gap relative to the most advanced OECD countries in terms of per capita income levels (Figure 1.2). Indeed, by 2002, it had fallen to 25 per cent below the United States. Labour productivity (per hour of labour input) is more than 30 per cent below the US level, the largest gap among the major seven economies (Figure 1.4).

Coping with rapid population ageing and the serious fiscal situation make faster growth essential to ensure rising living standards in Japan. While the strength of the current expansion is encouraging, it will need to be sustained over the medium term to meet these challenges and to narrow the gap in per capita income. The low level of productivity, despite the favourable indicators cited above, suggests a fundamental weakness in reallocating resources – human, financial and intellectual – in an efficient manner. Consequently, reforms are required in a wide range of areas, some of which are discussed in this chapter. It begins by examining the centrepiece of the prime minister's reform programme – the privatisation of Japan Post. The second section addresses regulatory reform, including new initiatives such as market testing, the No-Action Letter system and Special Zones for Structural Reform. This is followed by a discussion of ways to strengthen competition, in particular by giving more power to the Japan Fair Trade Commission and increasing openness to foreign competition. The chapter ends with an overall assessment.

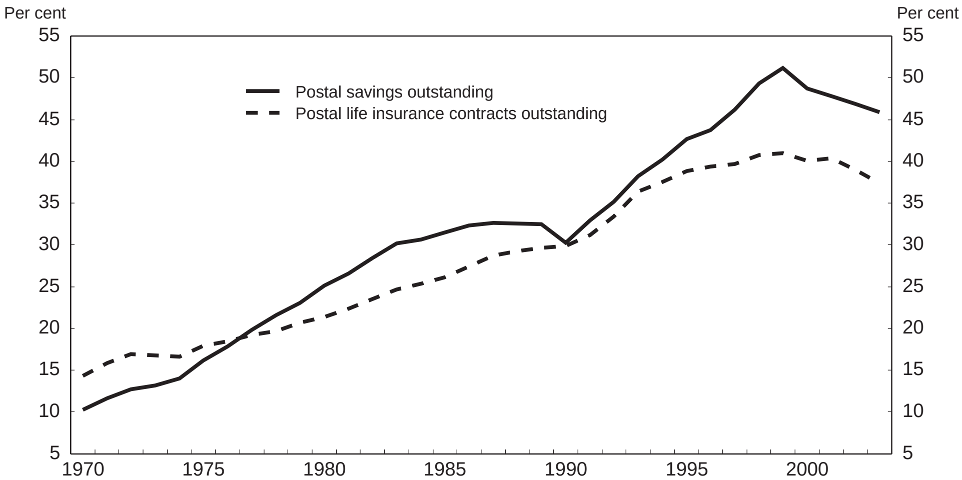
The analysis below leads to the conclusion that action is needed in each of the areas discussed to improve Japan's growth prospects over the medium term. The privatisation of Japan Post has the potential for large benefits so long as certain conditions are met. In particular, it is essential to establish a level playing field between the newly-privatised entities and private financial institutions and to sell the government's ownership share completely. Regulatory reform has brought significant gains and the process should be accelerated in social welfare areas, such as healthcare and education, in part through market testing to allow a larger role for the private sector. Improving regulatory tools is essential to upgrade the quality of regulation and encourage inflows of direct investment. Increasing foreign competition also depends on greater openness to imports, which will require addressing the high level of agricultural protection as part of liberalisation on a multilateral or regional basis. Strengthening competition requires a number of reforms, including higher penalties on violations of competition law and improving the regulatory framework in network industries. The recommendations are presented in more detail in the final section of the chapter and are summarised in Box 5.1.

Privatising Japan Post

Japan Post is the largest financial institution in the world. The assets of the postal savings system (Yucho), the world's largest saving institution, have risen from 10 per cent of GDP in FY 1970 to a peak of more than 50 per cent of GDP in FY 1999 (Figure 5.1). While some other countries also have postal savings systems, the scale is much smaller than in Japan (Figure 5.2). Postal life insurance (Kampo), the world's largest life insurer, has experienced a similar rise in its contracts over the past three decades. Despite some decline since 1999, their combined assets amounted to 80 per cent of GDP in FY 2003. These institutions dominate their respective sectors in Japan: the assets of postal savings account for 30 per cent of individual saving deposits, while the assets of postal life insurance account for 40 per cent of the industry total.

Figure 5.1. **Postal savings and life insurance in Japan**

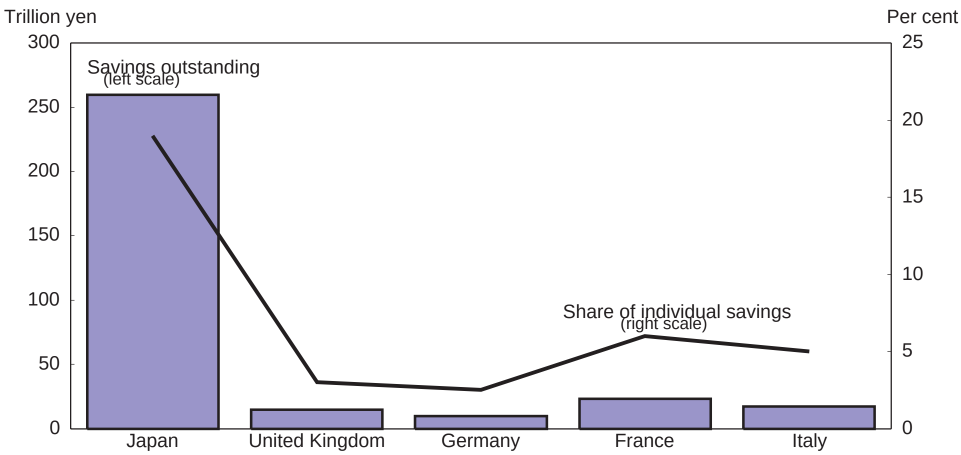
Per cent of GDP



Source: Japan Post and Cabinet Office.

Figure 5.2. **International comparison of postal savings systems**

In trillion yen and as a share of individual savings



Source: Japanese Bankers' Association (2000), *Our thinking concerning postal savings.*

Postal savings and life insurance have played key roles in transferring private savings to public corporations and to the government for public investment. In FY 2003, postal savings and life insurance held 135 trillion yen (27 per cent of GDP) of government bonds, in addition to 38 trillion yen of local government bonds and loans to local governments (Table 5.1). Postal savings and life insurance have also lent a considerable amount to public corporations. In sum, the government and public corporations account for 85 per cent of their assets. Moreover, this does not include 115 trillion yen (23 per cent of GDP) that is deposited with the Fiscal Loan Fund, which provides funds to Fiscal Investment and Loan Programme (FILP) agencies for the development of social infrastructure and lending to small and medium-sized enterprises.

Table 5.1. **Assets of postal saving and postal insurance**

Trillion yen in December 2003

	Postal savings	Postal insurance	Total	Share of total assets
Bonds	104.5	81.8	186.4	79.2
Government bonds[1]	84.5	50.7	135.2	57.5
Local government bonds	9.5	7.5	17.0	7.2
Corporate bonds	6.8	22.1	28.8	12.3
of which: Public corporation bonds	3.7	18.9	22.6	9.6
Foreign bonds	3.7	1.6	5.2	2.2
Money in trust	3.8	11.5	15.4	6.5
Money on loan	2.5	25.3	27.8	11.8
Loans to local governments	1.8	19.1	21.0	8.9
Loans to public corporations	0.0	3.7	3.7	1.6
Loans to depositors	0.6	0.0	0.6	0.2
Loans to policyholders	0.0	2.3	2.3	1.0
Loans to postal services	0.2	0.2	0.4	0.2
Deposits	3.7	2.0	5.7	2.4
Total[2]	**114.6**	**120.6**	**235.3**	**100.0**

1. Includes FILP bonds, which, to the holder, are indistinguishable from government bonds.
2. Excluding 115.2 trillion yen of loans that is deposited with the Fiscal Loan Fund.

Source: Japan Post.

The growth of Japan Post reflects a number of privileges that provide it with significant commercial advantages over competing private-sector institutions. *First*, the insurance payments and savings accounts of postal savings and life insurance are guaranteed by the government.[1] This has driven households to Japan Post for security during a period of financial fragility, reinforcing the weakness of private-sector institutions. *Second*, both postal savings and life insurance are exempt from taxes, saving them a combined 5.4 trillion yen during the past decade (ACCJ, 2004). *Third*, although subject to legal constraints such as ceilings on deposits, both are exempt from some regulations imposed on private-sector institutions, such as capital-adequacy ratios. While Japan Post is popular with households for the financial services it provides on attractive terms, a significant portion of the cost is borne by the public. In sum, preferential treatment of Japan Post has undermined the development of private-sector financial institutions.

The rationale for public-sector financial institutions is less clear than when they were established in the 19th century, given the development of private-sector institutions, suggesting the need to consider whether such public-sector institutions are still necessary.[2] The government has proposed the privatisation of Japan Post to achieve a number of objectives: *i)* provide better services at a lower cost for consumers; *ii)* remove government support and thus improve resource allocation; and *iii)* shift the flow of funds from the public to the private sector, thereby enhancing Japan's growth potential. The initial privatisation plan, which was decided by the Cabinet in September 2004, calls for Japan Post to be privatised beginning in April 2007 and split into four companies, plus a holding company, with all shares initially held by the government.[3] Such a separation is essential to end cross-subsidisation between the different operations within Japan Post and to insulate financial services from the business risks of the other services.

- The Postal Delivery Service will become the **Postal Services Company**, and the current regulation on the correspondence delivery service will be maintained for the time being.[4] By mid-2004, 51 private firms had entered the "special correspondence delivery business".
- The Post Office Network will become the **Over-the-Counter Services Company** and offer a wider range of services, including the financial services of private institutions, notably to benefit those living in rural areas. At present, 550 villages do not have a branch office of a private financial institution and 417 do not have a convenience store, which typically have ATMs provided by private banks and pick-up points for private service delivery companies.
- The Postal Savings System will become the **Postal Savings Company** and will be treated as a private financial institution.
- The Postal Life Insurance System will become the **Postal Life Insurance Company** and will be treated as a private life insurance company.

Being treated as private financial institutions means that the new companies will be subject to taxes, while new deposits and insurance contracts that begin after 2007 will not be guaranteed by the government. Instead, Postal Savings and Postal Life Insurance will have to pay premiums to the Deposit Insurance Corporation and the Life Insurance Policyholder Protection Corporation, respectively. During the transition period, which must end by 2017 at the latest, Postal Savings and Postal Life Insurance will be sold to private investors, but the holding company will keep all the shares of Postal Services and Over-the-Counter Services. Shares in the holding company will also be sold during the transition period, but the government will maintain more than a one-third share.

Achieving the full benefits of privatising Japan Post will require addressing a number of issues that are not clearly spelt out in the initial plan and overcoming opposition within the government and the ruling parties. One key concern is that the sheer size of Postal Savings and Postal Life Insurance will make it difficult to ensure fair competition in the financial sector. For example, the assets of the postal insurance system exceed those of the top four private life insurers combined. One remedy would be to break up Postal Savings and Postal Life Insurance along regional lines, as was done in the case of Japanese National Railways. Allowing the newly-privatised companies a free hand to expand the range of their products and services – prior to the establishment of a clearly-defined level playing field – would further exacerbate the problems of private institutions. At a minimum, equal treatment would require that – in addition to paying taxes and premiums for deposit and insurance contracts – Postal Savings and Postal Life Insurance would be subject to the same regulatory framework as private institutions. For example, allowing Postal Savings to begin lending to individuals and firms in the current regulatory environment would constitute unfair competition for banks, in addition to putting the soundness of Postal Savings at risk by generating new non-performing loans on a large scale.

Privatisation, which is planned during a transition period ending in 2017 at the latest, is a key to ensuring equal treatment and should be clearly defined as a complete divestiture of the government's holdings.[5] Past experience shows that privatisation is not always easy to accomplish. For example, although the re-organisation and privatisation of Japanese National Railways began in 1987, the government's share remains at 100 per cent in four of the seven new companies. The case of Postal Savings and Postal Life Insurance is complicated by the fact that they will exist as virtual companies, while many of the staff and buildings where their services are sold will be shared with the Over-the-Counter Services Company. Such ambiguity may discourage private investors. Moreover, privatisation is also complicated by the fact that Japan Post holds a quarter of the outstanding stock of government bonds. Consequently, government bonds accounted for 58 per cent of the assets of postal savings and life insurance in 2003.[6] With long-term bond yields and prices expected to normalise in coming years, these large bond holdings are likely to have a major impact on the privatisation price and the initial performance of the new companies. At the same time, the government may want to have some influence on the management of such a significant proportion of public debt on the grounds of maintaining financial stability.

While the government clearly has an interest in maintaining stability in the bond market, achieving the benefits of privatising Japan Post also requires allowing the new management the freedom to invest as it sees fit. Although the reform of the FILP in 2001 severed its automatic link to postal savings,[7] the ministers in charge agreed that both Japan Post and the public pension fund continue purchasing a certain share of FILP bonds until FY 2007 to moderate the effect on the market.[8] The continued government ownership after 2007 may lead to a bias in the allocation of their assets toward the public sector.

The privatisation process would be accelerated by making clear that the new management of Postal Savings and Postal Life Insurance will have the same independence as other private institutions in formulating their business plans once a level playing field is achieved. The size of Japan Post – with 25 000 branches nation-wide – has made it a key tool for public policy, particularly in providing services in rural areas. Moreover, it has a large labour force of 400 000. The privatisation plan for Postal Savings and Postal Life Insurance should make clear that the government is not allowed to appoint or dismiss their executives and that the new management is free to adjust employment as it sees fit.

As for the Postal Services Company, it is desirable that it should be subject to more competition by reducing the barriers to private firms in delivering correspondence. Any universal service obligations should be compensated with fiscal transfers, as in a few OECD countries, or by maintaining Postal Service's monopoly, a solution chosen in many other OECD countries. In addition, Postal Services should be able to close branches that are not profitable. In sum, the privatisation of Japan Post should be carefully managed to achieve the potential efficiency gains and avoid the pitfalls, such as those made in privatising the Highway Corporation (see below), which would limit the positive effects.

Regulatory reform

Regulatory reform, which began in the early 1990s in earnest in Japan, has had some successes (Table 5.2). In particular, the removal of entry barriers in the trucking industry, the introduction of choice for large consumers of electricity and the abolition of price controls on petroleum products have had significant benefits. According to the government, regulatory reform boosted consumer surplus by 14.3 trillion yen (4.6 per cent of national income)

Table 5.2. **Impact of regulatory reforms**
Increase in consumer surplus in 2002 in billion yen

Sector	Industry	Consumer surplus	Major aspects of deregulation	
Telecommunications	Cellular phones	1 721	Free entry, relaxation of price controls	1993
Transportation	Domestic airlines	274	Introduction of fare discounting	1992
	Railways	239	Introduction of a price-cap scheme	1996
	Taxis	5	Relaxation of fare controls	1996
	Trucks	3 876	Relaxation of entry regulations	1989
	Auto inspections	830	Simplification of safety checks	1995
Energy	Electricity	2 481	Free entry in large-scale sales	1994
	Gas	167	Free entry in large-scale sales	1994
	Petroleum products	2 271	Abolition of price controls	1993
Financial services	Commissions on stock	385	Liberalisation of commissions	1993
	Non-life insurance	274	Liberalisation of premiums	1996
Foods and drinks	Rice sales	1 171	Abolition of government controls	1994
	Alcoholic beverage sales	547	Relaxation of licensing	1994
Retail prices	Cosmetics	93	Abolition of retail price controls (4.6 per cent of national income)	1996
Total consumer surplus		**14 334**		

Source: Cabinet Office (2003).

by 2002. Another important reform was the reduction of the capital requirements for new start-ups in 2003 from 3 million yen (10 million yen for companies that issue stock) to only 1 yen. This contributed to a 10 per cent rise in the number of newly created companies in 2003. In addition, Japan's e-government policy has eased the burden of administrative procedures. By the end of FY 2003, 96 per cent of all procedures required by the national government (around 13 000 in all) were available on the Internet. International recognition of positive changes is reflected by Japan's jump from 21st to 9th place over three years in the World Economic Forum's global competitiveness rankings. This section looks at the new priorities for regulatory reform and ways to improve regulatory tools, including the Administrative Procedure Law, the No-Action Letter system, the Public Comment Procedure and Regulatory Impact Analysis. It concludes with a discussion of the Special Zones for Structural Reform.

Accelerating the pace of regulatory reform

Progress in regulatory reform has been hindered by the traditionally strong independence of individual ministries and weak central control. Instead, reform has been driven by a series of councils composed of private-sector experts. The annual report of the *Council for Regulatory Reform*,[9] created in 2001 for a three-year term, formed the basis of the government's Three-Year Plan for Promoting Regulatory Reform, which is updated each year. However, the three-year plans have been markedly less ambitious than the Council's initial proposals. A Minister of State for Regulatory Reform, located in the Cabinet Office, is responsible for supervising the progress made by ministries in implementing the three-year plans. Members of the private-sector Council are able to negotiate directly with ministries about reform proposals, although it has been difficult to overcome the power of vested interests in ministries opposing reform. The organisational structure was changed in 2004 by the creation of the *Headquarters for the Promotion of Regulatory Reform*, which is composed of all cabinet members. In addition to strengthening horizontal co-ordination, there is hope that it may shift the balance toward reform since proposals will be discussed by all ministries, including those favouring reform, rather than just the ministry responsible for the regulation. At the same time, the mandate of the Council for Regulatory Reform (re-named the *Council for the Promotion of Regulatory Reform*) was extended for another three years.

The Three-Year Programme for Promoting Regulatory Reform approved by the Cabinet in March 2004 includes a 762-item action plan covering 17 priority areas that focuses on opening "government-driven markets" to the private sector. These sectors are concentrated in social welfare areas, such as medical services, long-term nursing care and education. Services in these sectors are provided directly by the government or by entities meeting certain entry criteria. The objective of reform is to provide better services to citizens, promote administrative reform and fiscal consolidation, and stimulate new activity in the business sector. A number of regulatory reforms have been proposed to achieve these goals. In the healthcare sector, for example, proposed reforms include allowing joint-stock companies to manage medical institutions, liberalising the pricing mechanism, easing regulations on the number of hospital beds and allowing combined provision of insured and non-insured medical services.[10]

A new initiative, proposed by the re-organised Council in August 2004, is to open government-driven markets through "market testing" to determine what is best done in the private sector and what should be kept in the public sector. Under this approach, which has been used in the United States, the United Kingdom and Australia, competitive tendering is opened to both public and private entities. The list of sectors for testing will be based on applications from the private sector. Ministries must provide valid reasons for rejecting any such proposals. If the private sector is judged to perform better, the service will be privatised, transferred to a private entity or contracted out. Performance will be evaluated based on the quality as well as the price of the services. An independent organisation of private-sector experts will monitor the process in order to ensure transparency, neutrality and fairness between the competing entities. The sectors where market tests are used will be subject to continuous monitoring and the competitive tendering process will be repeated periodically. The government will decide the rules for market testing on a pilot basis in FY 2005, before introducing it during the following year. While initially aimed at the central government, it may be extended to local authorities.

Improving regulatory tools[11]

Another element of the three-year plan is to review the 1993 *Administrative Procedure Law*, which was intended to increase the transparency and predictability of regulations. It requires government agencies to specify and make public the standards used to evaluate applications, and to specify the time period for issuing licenses, permissions and approvals. Government authorities must put administrative guidance in written form, if requested, and explain its legal basis. The act also specifies that compliance with administrative guidance is voluntary. One decade later, the success of the law in reducing the use of such guidance is uncertain. Indeed, both international and domestic business groups continue to criticise the prevalence of both oral and written administrative guidance.[12] Such guidance is not included in the Official Gazette of Japan, or in the Internet site listing new regulations.[13] In sum, administrative guidance appears to be a weak link in progress towards transparency in the regulatory system. The three-year plan will look at ways to strengthen the requirement for written answers and disclosure of criteria for reaching administrative decisions. Such revisions are needed to enhance the ability of the Administrative Procedure Law to increase transparency and predictability.

Another priority should be to improve the *No-Action Letter* system, which enables firms to seek prior clarification from administrative bodies concerning how regulations will be applied in situations where existing laws and regulations do not provide guidance or leave significant scope for interpretation. Given the lack of transparency and predictability in Japan's regulatory framework, this system can save time and money for companies by preventing discretionary action by a ministry. However, No-Action Letters have been used sparingly thus far, with only nine in FY 2001 and 14 in FY 2002, due to a number of factors. *First*, the authorities tend to rely on informal oral guidance instead. *Second*, the letters are not legally binding. *Third*, the No-Action Letter system is not applicable to local government regulations. *Fourth*, each administrative agency establishes its own rules based on common guidelines in this area. *Fifth*, this system was limited to so-called "new business" areas.

The 2004 Regulatory Reform Programme commits the government to improve the No-Action Letter system by making the requests and answers publicly accessible and expanding the scope to cover existing business activities. However, additional steps are needed to make the system more effective:

- *First*, the government should expand the current efforts to encourage the use of No-Action Letters. This could include making clear that requests for No-Action Letters are welcome, that all requests should be accepted for formal review by the regulator, and that responses – to the extent feasible – be made in writing.
- *Second*, the letters should be more strictly binding on the issuing organisation.
- *Third*, the system should be extended to local government regulations.
- *Fourth*, there should be more uniform implementation that covers all ministries and administrative agencies.

Making better use of this system should significantly enhance transparency and predictability, thus encouraging in particular the participation of foreign firms in the Japanese economy.

The number of *ex ante* permits and licenses has not been significantly reduced despite the shift to *ex post* notifications (Table 5.3), although quantity changes may not reflect qualitative improvements. Moreover, new authorisations may be needed to meet emerging health, safety and environmental concerns. Nevertheless, the steady flow of new *ex ante* permits indicates that there is still progress to be made in reducing administrative burdens and promoting alternatives to regulation.

Table 5.3. **Number of permissions/authorisation required at the national level**

	1985	1990	1995	1998	1999	2000	2001	2002	2003
Ex ante permits and licenses	n.a.	n.a.	n.a.	5 782	5 989	n.a.	n.a.	5 394	5 591
Notification and reports	n.a.	n.a.	n.a.	4 880	5 126	n.a.	n.a.	4 749	4 930
Other	n.a.	n.a.	n.a.	455	466	n.a.	n.a.	478	486
Total	**10 054**	**10 581**	**10 760**	**11 117**	**11 581**	**n.a.**	**n.a.**	**10 621**	**11 007**

Source: OECD (2004), *Japan: Progress in implementing regulatory reform.*

Increased review of proposed regulations is needed to address the apparent increase in the administrative burden. While the *Council for the Promotion of Regulatory Reform* and the associated Headquarters concentrate on improving the stock of existing regulations, there is no central government unit assigned responsibility for vetting the quality of new regulations.

One way to improve the examination of new regulations is to upgrade the *Public Comment Procedure*, introduced in 1999. It requires advanced public notice of proposed regulations, providing an opportunity for the public to comment. The authorities must take the comments into account when preparing the final version of regulations. The number of public consultations for proposed regulations increased steadily from 256 in FY 1999 to 399 in FY 2002,[14] leading to revisions in 15 per cent of the cases. However, an August 2003 survey by the Ministry of Internal Affairs and Communications showed that only about half of the public comment periods were at least 30 days, which limits the scope for participation by the public, particularly foreign firms. One-third of all drafts received no comments. The measures subject to the Public Comment Procedure include Cabinet orders, Ministerial ordinances and notifications, as well as guidelines applied uniformly in administrative guidance issued to more than one person. A number of activities, including advisory council reports and the development of bills that are to be considered by the Diet, are excluded from the Procedure. To improve the Public Comment Procedure, the period for public comment should be extended beyond 30 days and applied to all forms of regulation.

One tool that is widely used in a number of OECD countries to improve the quality of both new and existing regulations is *Regulatory Impact Analysis* (RIA), which identifies and weighs both costs and benefits. In Japan, RIAs were introduced on a trial basis in FY 2004, with formal, binding obligations to be introduced later. Experience in other OECD countries shows that the effectiveness of RIAs can be enhanced by:

- Ensuring ministerial accountability by requiring ministers to "sign off" on all RIAs in their portfolio.
- Establishing training programmes to help ministries learn how to produce RIAs.
- Designating a central agency to monitor progress.
- Targeting RIA efforts on regulations with significant economic and social impacts.
- Assessing all relevant regulatory effects, including on competition and market openness.

Special zones: an effective mechanism for nation-wide reform?

The launching of *Special Zones for Structural Reform* in 2002 marked the start of a fundamentally new approach of using local government initiatives to advance nation-wide regulatory reform. The success of this programme depends on the creativity and knowledge of local authorities and private-sector entities in identifying and removing obstacles to growth and circumventing vested interests capable of blocking reforms at the national level. The special zone approach allows geographically limited areas to act as a testing ground for the implementation of reforms at the national level. This approach is a significant departure from the tradition of highly centralised power in Japan and strict regulations set by the central government that allow municipalities little authority to make independent decisions.[15] Special zones are thus complementary to the "Trinity Reform" to allow local jurisdictions more authority over their fiscal affairs (see Chapter 4). A second crucial element for the success of this initiative is stimulating "regulatory competition" between municipalities to attract new business activities by both domestic and foreign firms in special zones. In contrast to special zones in China, which use financial incentives to attract foreign investment, no fiscal measures are allowed in Japan and the goal goes well beyond promoting the economic development of specific regions.

The creation of special zones is based on a mix of local initiative, informal consultations, and central government approval. The process begins with the Office for Special Zones for Structural Reform (located in the Cabinet Secretariat) soliciting reform proposals from interested parties, including local governments, individual citizens and enterprises, both domestic and foreign. Thus far, there have been five rounds, each lasting around a month, resulting in more than 2 300 reform proposals from nearly 1 500 entities (Table 5.4). The decision on whether to accept the proposal depends on negotiations between the Office and the line ministry responsible for the regulation that would be changed. To date, 285 of the proposals have been accepted for nation-wide implementation and 188 for special zones (Table 5.5). By area, the largest number concerns the Ministry of Health, Labour and Welfare, reflecting the focus on relaxing regulations on social welfare areas. The proportion of proposals accepted has fallen from nearly half in the first round in 2002 to around 15 per cent in the fourth round, as the easiest proposals were dealt with initially. While there are no clear criteria for which measures can be accepted under the special zone initiative, transparency is enhanced by requiring that the original proposals and the responses of the authorities be made public on the Internet. Proposals that are refused are considered to be pending for

Table 5.4. **Proposals for special zones**

	August 2002	January 2003	July 2003	November 2003	June 2004	Total
Proposals	426	651	280	338	652	2 347
Proposers	249	412	188	223	385	1 457
Local authorities	231	248	112	121	250	962
Firms and individuals	18	164	76	102	135	495
Results						
Implemented in special zones	93	47	19	17	12	188
Implemented at national level	111	77	29	33	35	285

Source: Headquarters for the Promotion of Special Zones for Structural Reform.

Table 5.5. **Reform proposals accepted under the special zone initiative nation-wide**

Ministry or agency	Accepted in special zones	Accepted nation-wide	Total
National Public Safety Commission	4	3	7
National Personnel Authority	3	0	3
Financial Services Agency	2	9	11
Ministry of Internal Affairs and Communications	11	36	47
Ministry of Justice	13	17	30
Ministry of Foreign Affairs	2	9	11
Ministry of Finance	7	16	23
Ministry of Education, Culture, Sports, Science and Technology	33	26	59
Ministry of Health, Labour and Welfare	31	71	102
Ministry of Agriculture, Forestry and Fisheries	9	8	17
Ministry of Economy, Trade and Industry	49	40	89
Ministry of Land, Infrastructure and Transport	17	42	59
Ministry of the Environment	6	7	13
Cabinet Office	1	1	2
Total	**188**	**285**	**473**

Source: Headquarters for the Promotion of Special Zones for Structural Reform.

future discussion. The special zone initiative has also helped to increase transparency; in many cases, local authorities have asked for the elimination of regulations that do not exist, suggesting a lack of adequate information on regulations.

The second step is a two-week period during which the Office for Promotion of Special Zones accepts petitions from local governments for designation as a special zone. In practice, local authorities have a menu of approved reform measures to choose from. The application from a local government requires approval by the "Headquarters for the Promotion of Special Zones", which is chaired by the prime minister and composed of cabinet ministers. The Headquarters considers the anticipated social and economic effects of the proposed zone and whether the project can be implemented smoothly. In practice, approval of special zones based on the approved regulatory changes (Table 5.5) is fairly automatic. By March 2004, 328 special zones had been created (Table 5.6). The most important sectors were agriculture and community life, which includes health and nursing care.

Table 5.6. **Number of special zones established by sector**

	2003 April/May	August 2003	October 2003	2004 March	Total
Infrastructure	15	0	2	1	18
Research and development	25	8	2	2	37
Industrial development	17	0	4	4	25
Agriculture	28	9	17	30	84
Education	17	16	8	32	73
Community life	19	12	33	17	81
Miscellaneous	0	2	6	2	10
Total	**121**	**47**	**72**	**88**	**328**

Source: Headquarters for the Promotion of Special Zones for Structural Reform.

The key step in the process is extending the reforms implemented in special zones to the rest of the country. The decision is based on recommendations by the "Evaluation Committee", which includes academic experts, business people and representatives of local government. This Committee, established in July 2003, has three choices in evaluating the reforms in the special zones; nation-wide implementation, continued use in the special zones only, or an end to the special zone. There is no fixed time period before the assessment by the Evaluation Committee. In the first half of FY 2004, 38 reform measures were evaluated. The Committee recommended that 26 of these be extended nation-wide, with the other 12 to be considered later when more data is available. In September 2004, these recommendations were accepted by the Headquarters for the Promotion of Special Zones.

Although it is still too early to make any judgements on the success of the special zone initiative, it is clear that its effectiveness will depend on the speed and extent to which reforms in local areas are applied on a nation-wide basis. There are a number of obstacles to a successful outcome. *First*, special interests opposing reform may stall the process by insisting on extended periods of testing and evaluation. Strong political and institutional support is thus necessary to ensure that successful measures in the zones are applied on a national basis as expeditiously as possible. In addition to setting time limits, it is important to ensure transparency in evaluating special zones. *Second*, there is a risk that the special zone initiative will be dominated by regional development considerations. Although each special zone begins with the goal of promoting development in a specific region, the key objective is nation-wide reform. Politicians concerned primarily with regional development issues created in 2003 the Regional Revitalisation Headquarters (chiikisaiseihonbu), which provides fiscal incentives for regional development. It is located with the Office for Special Zones for Structural Reform and uses the same staff. Consequently, the same chief secretary is responsible for both the special zone initiative and regional development policies. As this institutional framework may blur the different objectives of the special zone programme and regional development policies, responsibility for the latter should be delegated to another organisation. *Third*, given its reliance on a bottom-up approach, the special zone programme may be limited by a lack of initiative at the local government level. This suggests that adding a top-down element to the programme would be useful. For example, the Office for Special Zones could initiate discussions with local governments and try to identify ideal candidates for certain regulatory changes. Another possibility is to integrate the regulatory reform programme, which focuses on nation-wide reform, with the special zones. In particular, merging the Headquarters for the Promotion of Special Zones for Regulatory Reform and the Headquarters for Promoting Regulatory Reform would facilitate co-operation between two organisations that are both involved in promoting and implementing regulatory reform.

Strengthening competition

Enhancing competition would help lower prices in protected sectors and promote innovation, thus boosting consumer welfare and improving resource allocation. Competition could be strengthened by improving competition policy and upgrading the regulatory framework in network industries. The recommendations in this area, which was the subject of a special chapter in the 2003 *OECD Economic Survey of Japan*, are summarised in Box 5.1. Recent measures in these areas, as well as steps to increase openness to imports and foreign direct investment, are discussed in this section.

Making the Fair Trade Commission more effective

As recommended in the 2003 *Survey*, the FTC revised its guidelines on how it assesses proposed mergers and made them public in May 2004. In addition, it prepared legislation in April 2004 to amend the Anti-Monopoly Act to raise the level of sanctions on violations of the law. The surcharge rates, currently set at 6 per cent of revenue from affected sales for large manufacturers,[16] were to be doubled. In addition, a 50 per cent surcharge was to be added on firms guilty of frequent violations. As for coverage, the range of activities subject to the surcharge was to be expanded.[17] The legislation would have also introduced a leniency programme under which the FTC could forego or reduce the surcharge on those committing violations if they voluntarily provide the necessary information to the FTC.

However, the proposed amendment was not submitted to the Diet as a result of opposition from business groups, which expressed four major arguments (Nippon Keidanren, 2004). *First*, due process for suspected violators is not respected since the FTC acts as both prosecutor and judge in these cases. However, it should be noted that the FTC's system is similar to that used in most OECD countries. Moreover, a similar system is used for tax issues in Japan. In any case, decisions by the FTC can be appealed. *Second*, the FTC staff should be upgraded by increasing its professional expertise, which was a key recommendation in the 2003 *Survey*. *Third*, the level of surcharges should be set flexibly depending on the seriousness in each case. In some cases, the fixed 6 per cent surcharge exceeds the amount of illegal profit gained by cartels. *Fourth*, violators of the Anti-Monopoly Act should be subject to surcharges or criminal penalties but not both.

Despite the rejection of the initial amendment, similar legislation was introduced in the Diet in late 2004, though it proposes a more moderate increase in surcharges.[18] The key priority is to raise surcharges, which at present are low by international standards, to levels high enough to act as an effective deterrent against anti-competitive behaviour, without waiting for an upgrading of the expertise of the FTC. Experience in OECD countries shows that the gains to hard-core cartels are typically at least 10 to 15 per cent of turnover (OECD, 2002). Even if a 6 per cent surcharge in Japan were enough to recover the gain to violators, it is not enough to act as a deterrent given the difficulty of detection. Since many violations are not discovered, the surcharge must therefore be significantly higher than the expected gain. In Europe, administrative fines can be as high as 10 per cent of total firm turnover, rather than just the commerce affected, as in Japan. The fine in the United States may be up to two times the gain and up to three times in New Zealand. Deterrence in Japan is further weakened by the lower surcharges applied to violations by small business, retailers and wholesalers. Moreover, the decline in total surcharges by 85 per cent between 1999 and 2002 to only 2.7 billion yen underlines the weakness of the current system as a deterrent. However, this legislation did not pass the extraordinary session of the Diet in 2004.

The urgency of imposing higher surcharges is reinforced by the weakness of criminal penalties in deterring violations of the Anti-Monopoly Act. There have only been 13 criminal cases since 1950 and nobody has ever gone to jail for violating the competition law. Moreover, even in the rare instances that fines are imposed, they are much smaller than surcharges, even at the 6 per cent rate. The pending legislation proposes several legal changes to make the criminal enforcement process more flexible, such as authorising compulsory investigative measures for criminal investigations and allowing the cases to be tried in district courts, rather than being limited to the Tokyo High Court. The objection to imposing sanctions and criminal fines in the same case could be overcome by making an appropriate adjustment, such as applying one amount as a credit against the other. Indeed, the proposed legislation calls for deducting half of any criminal fines from the surcharge imposed in the same case.

Establishing a sanction that is substantial and credible is a necessary condition for a leniency programme, another element of the proposed legislation that is supported by the business sector. The law would allow the surcharge rate to be lowered, or even waived altogether, for a company that voluntarily informed the FTC of its conduct before the FTC started investigating and that voluntarily ceased such conduct. Total immunity from the surcharge would only be available to the first party to come in, while those who come in later could get some reduction for co-operation. Experience in other OECD countries shows that where there is a very clear advantage to being the first party to come forward to the authorities, as well as some advantage to coming forward even after an investigation has started, cartels can collapse in a race to confess. In addition, extending leniency to individuals by not recommending prosecution could be a tool for obtaining evidence about corporate violations. A measure to protect such "whistleblowers" against retribution from their employers was recently approved in the Diet.

Improving the regulatory framework for network industries

Legislation to privatise the four major *highway corporations* was approved in June 2004. The highway system is self-financed through the "toll-pool" system, which allows cross-subsidisation between profitable and unprofitable highways, and prices are very high. Indeed, tolls per kilometre are about three times as high as those in Italy and France. Under the plan, an organisation will hold the assets and liabilities of five regional operating companies, which will be responsible for managing the existing highways as well as for future construction.As noted in the 2003 *Survey*, privatisation will require the companies to observe the commercial law, which should improve cost transparency and incentives for cost control. Forcing highway construction to be financed by private companies would also improve resource allocation. However, under the plan passed in June, the prospective benefits of privatisation are not apparent, at least in economic terms. *First*, the national and local governments are to hold more than one-third of the voting shares and will continue to provide debt guarantees. *Second*, the choice of CEOs for the new companies and their operating plans must be approved by the Minister of Land, Infrastructure and Transport. Continued government ownership and guarantees will thus limit the hoped for improvement in resource allocation. *Third*, tolls will be subject to government approval and will not allow any profit for the highway companies, thus reducing incentives to cut costs. Moreover, the Ministry of Land, Infrastructure and Transport recently created a new framework for building highways using earmarked revenues for road construction. In sum, the economic benefits of the privatisation are uncertain.

Prices for network industries remain high in Japan. Despite considerable declines for *telecommunication services*, prices for both business and residential users in some network industries are among the highest in the OECD area, measured in current exchange rates (Figure 5.3). However, the price of Internet access is one of the lowest in the OECD area, suggesting that a more appropriate regulatory framework can lead to a better outcome. Progress during the past year in implementing the recommendations in the 2003 *Survey* concerning the network industries are limited to a few important steps. The most important reforms in the area of telecommunications and electricity include:

- Number portability in the mobile phone sector will be introduced from FY 2006, which should enhance competition.
- The setting of termination charges for calls from fixed to mobile phones – an inherently non-competitive situation – has been changed by allowing fixed-line operators to set the rates. Charges for calls originating in NTT East and NTT West and terminating in the mobile network were reduced by 55 per cent in the past year.
- Retail choice for electricity consumers will be extended from 26 per cent of the market to 63 per cent in 2005.
- A "Competition Enhancement Office", which handles competition-related disputes among market participants, was established within the Ministry of Economy, Trade and Industry in July 2004.

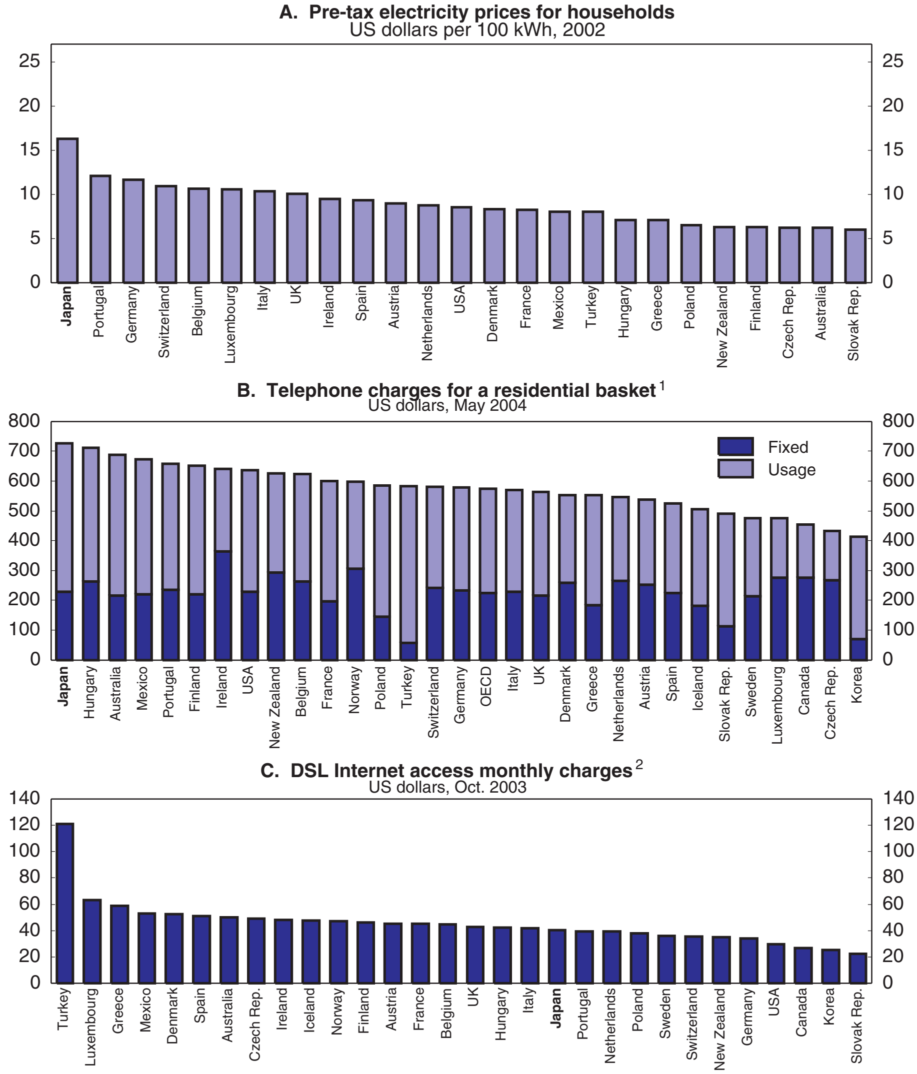
However, there needs to be stronger initiative to ensure pro-active *ex ante* regulation, a necessary condition for competition in markets dominated by strong incumbents. In order to achieve these objectives, most OECD countries have established sectoral regulators independent of the government. Japan tries to achieve this through government ministries.

Openness to international trade

Import penetration is surprisingly low in Japan, even after controlling for transportation costs and per capita income, and the increase in the overall import-to-GDP ratio in volume terms has been smaller than in other OECD countries. Moreover, the import share for the manufacturing industry is well below that of all other OECD countries. The low import share does not appear to be due to explicit trade barriers (Table 5.7). Indeed, the average tariff rate for manufactures is relatively low compared to the European Union and the United States, while

Figure 5.3. **International comparison of electricity and telecommunication prices**

US dollars



1. Composite basket that includes international calls and calls to mobile networks. Measuring prices at purchasing power exchange rates lowers the price for Japan.
2. Principal incumbent provider(s) only. Competitive operators are providing DSL services at lower prices in Japan, as in other countries. The combined market share of the two incumbents in Japan, NTT East and NTT West, is relatively low at 37 per cent.

Source: OECD Communications Outlook and Teligen.

the coverage of non-tariff barriers is roughly equivalent. While explicit trade barriers have been largely brought into line with those of other countries, imports in some sectors are still hampered by differences in regulatory and administrative procedures. The 1998 version of the three-year programme for regulatory reform identified conformity to international standards as one of six main pillars of reform. One indicator of progress has been an increase in the proportion of the Japan Industrial Standards – more than 9 000 in all – that are aligned with international standards from 21 per cent in 1999 to 91 per cent in 2003. The three-year plans have also urged government ministries to adopt mutual recognition agreements with trading partners in order to eliminate redundant inspections. Japan has reached such agreements

Table 5.7. **International comparison of tariff and non-tariff trade measures**

	Simple average			Weighted average[1]		
	Total	Agriculture	Manufacturing	Total	Agriculture	Manufacturing
A. Tariff rates in 2001 (per cent)						
Japan	**5.0**	**10.5**	**3.6**	**2.5**	**7.1**	**1.7**
United States	5.4	9.7	4.4	3.1	2.7	3.1
European Union	4.8	9.4	3.9	3.1	6.0	2.9

	Japan	United States	European Union
B. Coverage of non-tariff measures[2]			
Primary products	7.49	4.69	1.98
Agricultural products	7.69	4.56	2.30
Mining products	6.31	5.44	0.47
Manufactures	5.08	5.23	10.77
Iron and steel	0.48	42.44	51.94
Chemicals	1.15	3.35	4.18
Other semi-manufactures	0.64	4.59	0.86
Machinery and transport equipment	0.05	5.18	2.41
Textile and clothing	23.06	1.13	87.21
Other consumer goods	0.68	0.92	4.82
Other products	0.00	0.00	0.00
All products	5.61	5.08	5.79

1. Weighted by imports.
2. Coverage as a per cent of total imports in latest year available.

Source: World Trade Organisation for Panel A. UNCTAD for Panel B.

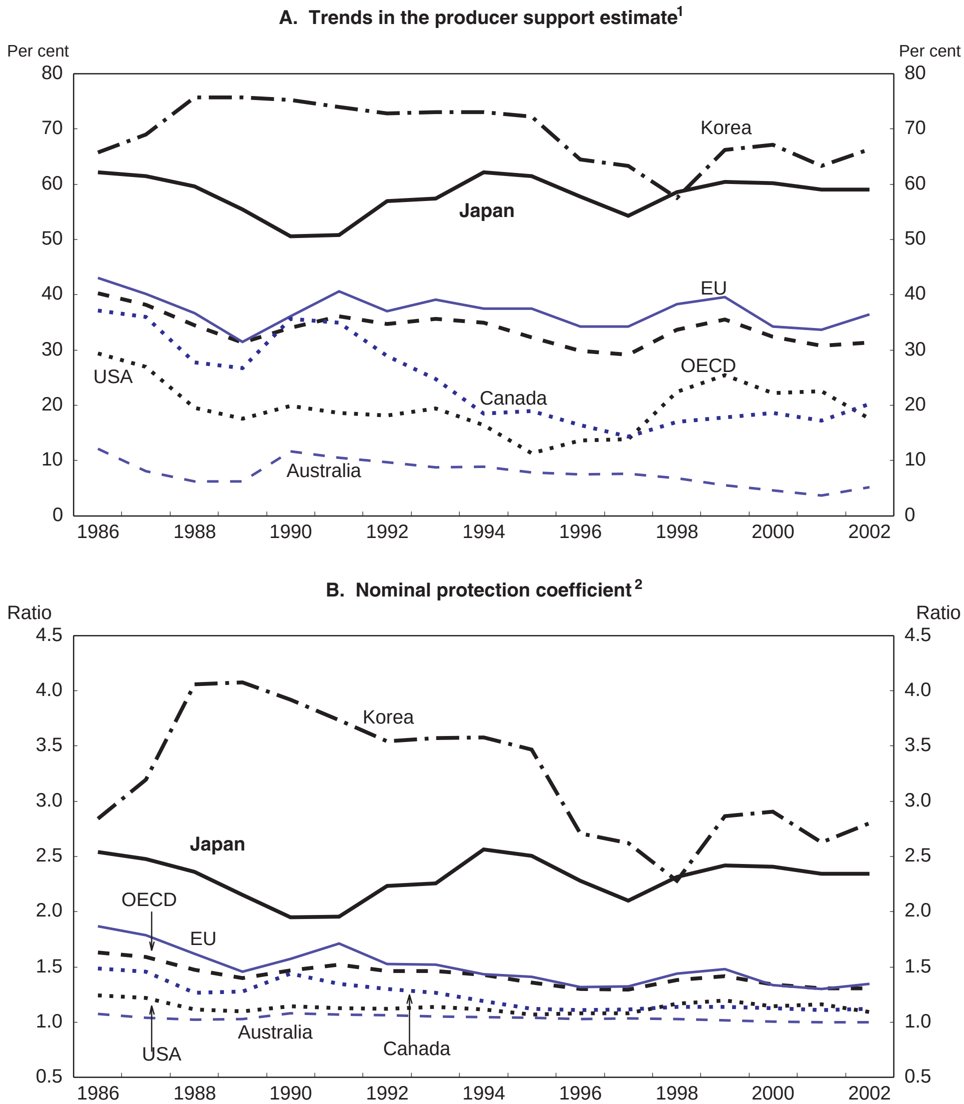
covering a number of products with the European Community and Singapore. In addition, the number of foreign factories entitled to affix the Japan Industrial Standard symbol increased from 50 in 1999 to 400 in 2002, covering 630 items produced in 22 countries.

Bilateral and regional trade agreements can usefully complement the multilateral trading system by allowing a smaller group of countries to go further in some sectors than would have been possible in a multilateral setting and to serve as laboratories for future consideration in multilateral negotiations. Nevertheless, bilateral and regional trade agreements can have a trade distorting as well as a trade creating component. Furthermore, there is a possibility that the coherence and predictability offered by multilateralism will be weakened if governments increasingly turn to regional agreements to manage their trade interests. A maze of conflicting regional regulations, standards and rules of origin risk creating new "walls" between blocks.

Given these risks, Japan recognises that the multilateral approach under the World Trade Organisation is the first priority for its trade policy, but that free trade agreements (FTAs) can play an important role complementing multilateral trade liberalisation. Japan's second FTA – with Mexico – was signed in 2004. Negotiations are also underway with Thailand, the Philippines, Malaysia and Korea. In addition, Japan will enter into negotiations for a Comprehensive Economic Partnership Agreement with the ASEAN countries, which would incorporate elements of a possible FTA that should be completed within ten years. Such agreements are intended to draw on the economic dynamism of Asian countries, which tend to have high tariff rates, to help revitalise the Japanese economy. However, there are some issues to be addressed, including agriculture, to allow Japanese participation in FTAs, creating the risk that Japan will be excluded from regional integration. For example, Thailand demanded the removal of tariffs on all agricultural products as part of an eventual FTA.

The level of protection for agriculture in Japan is much higher than for manufacturing (Table 5.7) Moreover, agricultural support, as measured by the Producer Support Estimate, is one of the highest in the OECD area and about double the OECD average (Figure 5.4). Such protection boosts farm incomes by about 2½ times (Panel B). The number of people who became independent farmers in 2003 rose for the 11th straight year. This is slowing the decline in the total agricultural workforce, which consists largely of older workers. The

Figure 5.4. **An international comparison of agricultural support**



1. An indicator of the value of monetary transfers to agriculture resulting from agricultural policies. It is presented as a share of the total value of production at domestic producer prices.
2. The nominal protection coefficient is a measure of market protection defined as the ratio between the average prices received by producers and border prices.

Source: OECD, *Agricultural Policies in OECD Countries.*

negative effect of support is compounded by the fact that 93 per cent is provided through market price supports, which distort trade and production decisions, compared to an average of 66 per cent in the OECD area.

Increasing inflows of foreign direct investment

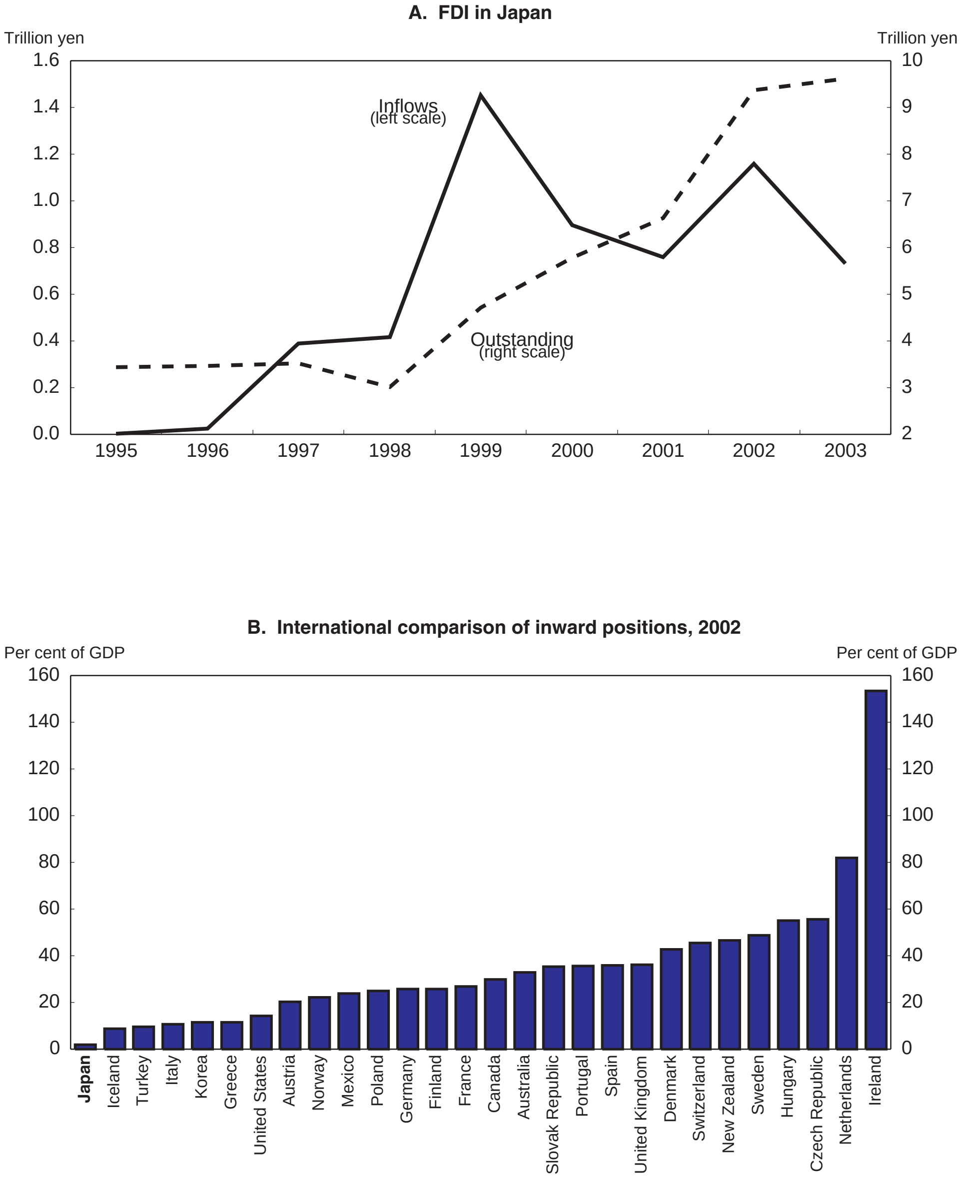
Between 1998 and 2003, the stock of foreign direct investment (FDI) in Japan more than tripled from 3 trillion to 9.6 trillion yen ($87 billion). The sharp increase reflects the sale of troubled firms and banks to foreign investors during a difficult economic period. Despite the increased foreign involvement in Japan, the stock of FDI remains exceptionally low at about 2 per cent of GDP, compared to more than 10 per cent in a majority of OECD countries (Figure 5.5). In 2003, the government set an objective of doubling the stock of FDI in Japan – from its 2001 level of 6.6 trillion yen ($56 billion) – over a five-year period. Achieving this goal would require annual net inflows of 1.3 trillion yen ($11 billion). To boost FDI inflows, the government has drawn up an action plan that covers 74 items in the following categories:

- Provide greater information about investment opportunities in Japan.
- Improve the business environment.
- Reform administrative processes, for example by making them available electronically.
- Create favourable employment and living environments in Japan.
- Enlarge the role of local governments in attracting FDI, in part through the special zone initiative.

Although Japan is a capital-rich country, boosting FDI is nonetheless a key to raising its growth potential by strengthening competition and bringing in new technology and methods of production. However, there are a number of obstacles to overcome in convincing companies that investment in Japan offers a high rate of return. In particular, costs of entry and operation are high and the country's growth potential is well below its neighbours. Even with an improved policy framework, Japan cannot hope to attract the roughly $50 billion a year in FDI received by China. Nevertheless, Japan does offer the advantage of a large and sophisticated market, in which successful foreign companies enjoy high rates of return on their investment.

Substantially increasing FDI inflows requires a number of policy measures. *First*, the priority should be to improve the general business environment, which tends to discourage potential foreign investors. Improving the regulatory tools noted above, particularly the Administrative Procedure Law, the No-Action Letter system and the Public Comment Procedure, would enhance transparency and encourage foreign participation in the Japanese economy. *Second*, it is necessary to activate the merger and acquisition market. However, discriminatory provisions governing the acquisition of Japanese firms by foreign investors continue to provide domestic firms with an artificial advantage over foreign firms. One provision prevents foreign firms from making 100 per cent acquisitions by way of share swaps, although such transactions are permitted in situations involving only domestic firms. In addition, share exchanges between two domestic firms may receive a tax deferral on capital appreciation while identical situations involving foreign partners do not (ACCJ, 2003). *Third*, the generally wary attitude toward FDI at the local level will need to change for Japan to compete with countries that are actively trying to attract foreign

Figure 5.5. **FDI inflows and stocks**



Source: OECD, *International Direct Investment Statistics Yearbook*.

investment. Although local governments have some programmes, such as tax exemptions and subsidies to attract foreign firms, they lack marketing and promotion strategies of the kind used by some local governments in other OECD countries.

Overall assessment

Moving to a sustainably higher growth path requires fundamental changes in the Japanese economy. During the past few decades, output growth has depended on high levels of investment, as well as on fiscal stimulus during the 1990s. Given the problems in the government's financial position and the still low rate of return on investment, growth will

Box 5.1. **Summary of recommendations to accelerate productivity growth**

Privatise Japan Post, the world's largest financial institution

- Establish a level playing field between the Postal Savings Company and the Postal Life Insurance Company and private institutions, including equal treatment under the regulatory framework and the tax system.
- Prohibit Postal Savings and Postal Life Insurance from offering new products prior to the establishment of equal treatment.
- Aim at a complete divestiture of government holdings in financial services of Japan Post.
- Allow the new management of Postal Savings and Postal Life Insurance to have independence in formulating their business plans.

Accelerate the pace of regulatory reform

- Utilise the newly-created Headquarters for the Promotion of Regulatory Reform to speed up reform, particularly in opening "government-driven markets".
- Effectively implement the "market-testing" initiative to benefit consumers, promote fiscal consolidation and provide new opportunities to the business sector.
- Improve regulatory tools in order to enhance transparency and predictability and encourage greater foreign participation in the Japanese economy:
  - Strengthen the *Administrative Procedure Law* in order to increase transparency and predictability.
  - Upgrade the *No-Action Letter* system by extending it to local governments, establishing more uniform implementation across ministries and agencies and making such letters more strictly binding on the issuing organisation.
  - Improve the review of proposed regulations, in part by extending the coverage and length of the *Public Comment Procedure*.
  - Make *Regulatory Impact Analysis* mandatory and ensure their quality through training and centralised control.
- Make the *Special* Zones *for Structural Reform* an effective tool to promote nation-wide reform:
  - Expedite the evaluation of special zones so that they can be promptly extended on a nation-wide basis.
  - Clarify the regulatory reform focus of the special zones by separating their management from the office responsible for regional development policies.
  - Add a top-down component by integrating the special zone initiative with the regulatory reform committee.

Strengthen the competition framework

- Enhance the independence and the professional expertise of the FTC by:
  - Selecting commissioners from a wider set of representatives from society and relying less on seconded personnel.
  - Establishing self-contained career paths within the organisation and considering elements of private-sector pay.

Box 5.1. **Summary of recommendations to accelerate productivity growth** *(cont.)*

- Develop a more pro-active stance of competition policy by:
  - Authorising the FTC to instigate criminal investigations or, alternatively, involving the prosecutor's office at an earlier stage of an investigation.
  - Making the FTC responsible for consumer protection.
  - Placing the FTC in charge of ensuring compliance with a nation-wide framework for public procurement.
  - Giving the FTC direct sanction possibilities against agencies or officials involved in bid-rigging.
- Raise the level of sanctions, including the possibilities for private recoveries, to strengthen deterrence, which would also allow the introduction of effective measures explicitly aimed at cartels, such as leniency and whistleblower programmes.
- Continue the reform of the merger control review process to clearly reveal standards in the law for blocking mergers and evaluate the impact of the current approach on competition.

Introduce comprehensive reforms to sectoral regulation

- Upgrade the current approach to regulating network industries by:
  - Consider the establishment of sectoral regulators independent of the government as part of active *ex ante* regulation to secure non-discriminatory third-party access, if the current approach through the government ministries does not work sufficiently well.
  - Introduce a common approach to universal service obligations, using cost-benefit analysis to determine the net cost of such obligations, and finance the obligations through a fiscal transfer.
- In the *energy sector*:
  - Enhance interconnection capacity both within a given region as well as between regions to allow physical access and consider unbundling through legal or ownership separation for further enhancement of competition.
  - Lower entry barriers that take the form of high administrative costs by streamlining all approvals into one level of government and bringing infrastructure standards into line with international standards.
  - Enhance infrastructure investment incentives, in part, by bringing together the networks in the *electricity* sector in a separate firm.
  - Consider replacing negotiated third-party access to terminals in the *gas sector* with a regulated third-party access approach.
- In the *telecommunication sector*:
  - Reconsider government ownership restrictions and preferably remove them to level the playing field.
  - Set interconnection charges independently in each telecommunication region to avoid cross-subsidies.
  - Regulate termination charges in the mobile networks where necessary unless competitive pressures substantially lower them.
- Abolish strict service obligations for new entrants in the *postal sector*, and introduce an explicit access regime for new entrants to the incumbent's essential facilities and services and eliminate cross-subsidisation.

Box 5.1. **Summary of recommendations to accelerate productivity growth** *(cont.)*

- Introduce competition between *harbours* so as to lower high costs, preferably through privatisation by local governments.
- Create a system of market-based slot allocation for *airports* to better exploit scarce capacity prior to the privatisation of airports. Prescriptive ticket regulation for air travel should be abolished.
- Privatisation of the *highway* corporations should be accompanied by new toll rules, stipulating cost-recovery for each individual highway, in order to abolish cross-subsidisation and to ensure an efficient expansion of the highway system.
- Relax large-store regulation by raising the threshold at which it applies and remove the possibility for competitors to block the establishment of large stores.

Increase openness to international competition

- Reduce barriers to trade in the context of multilateral trade negotiations, while pursuing regional integration through free-trade agreements.
- Address elements of multifunctionality in agriculture through well-targeted policy measures that minimise trade distortions.
- Encourage inflows of foreign direct investment by:
  - Increasing transparency, in part by upgrading regulatory tools, such as No-Action Letters and the Public Comment Procedure.
  - Activating the merger and acquisition market through regulatory reforms.

need to be driven increasingly by productivity gains. Such gains are even more important in the context of population ageing. The current government's slogan of "no growth without reform" correctly captures the policy challenge facing Japan over the medium term. To the credit of Japan's current leadership, a number of significant initiatives are underway to change institutions and regulatory tools in order to boost the growth potential.

The top priority for reform – the privatisation of Japan Post – has the potential to accelerate growth by shifting resources away from the public sector and towards the private sector and to re-vitalise the financial sector. The success, though, will depend on how Japan Post is re-organised and eventually privatised. Allowing public policy objectives, such as providing financial services in rural areas, assuring smooth financing of public deficits and avoiding employment losses, to take priority could make it difficult to achieve the desired goals. Moreover, the long time frame – the process is not scheduled to be completed until 2017 – means that the gains will not be realised until well in the future.

Regulatory reform depends on having appropriate institutions and tools to improve regulation. The absence of strong control at the centre to achieve reform forces reliance on private-sector advisory bodies and on second-best strategies, such as special zones. Nevertheless, these institutions should be used as effectively as possible to accelerate reform and overcome vested interests. They need to be accompanied by effective regulatory tools, notably the Administrative Procedure Law, the No-Action Letter system, the Public Comment Procedure and Regulatory Impact Analysis, to increase transparency. In addition to the benefits for domestic firms, greater transparency is necessary to encourage a greater foreign presence in the Japanese economy.

Finally, greater competition is essential to accelerate productivity growth and improve resource allocation. The productivity difference between closed, domestic-oriented sectors and exporting industries in Japan effectively demonstrates the importance of competition. While the FTC has been strengthened and made more independent, the sanctions for violations of the Anti-Monopoly Law must be high enough to deter anti-competitive behaviour. In the network industries, the development of a regulatory framework suitable for competition still needs to be improved. Achieving the government's goal of doubling the stock of inward FDI would be an important step to strengthening international competition. However, this goal requires improving the business environment through enhanced transparency. Finally, further progress in increasing openness to imports will likewise depend on strengthening competitive conditions in the domestic economy, while reducing remaining explicit barriers. Trade liberalisation through multilateral negotiations should be the policy priority in this regard, though further efforts at integration with dynamic Asian economies can have a positive effect as well. Both approaches, however, will require reducing the high level of protection for the agricultural sector.

Notes

1. The exemption from paying premiums to the Life Insurance Policyholder Protection Corporation saved postal life insurance 92 billion yen in the decade from 1993, while the obligation of private-sector companies amounted to 838 billion yen. For postal savings, the exemption from deposit insurance premiums saved it 1.6 trillion yen. In addition, not having to place interest-free reserves at the Bank of Japan allowed it to earn an additional 679 billion yen from 1993 to 2002 (American Chamber of Commerce, 2004).
2. Some experts, for example Lincoln (2001), have argued that postal savings should instead be closed once existing investments reach maturity.
3. However, the president of Japan Post recently stated that technical difficulties may delay splitting Japan Post into four companies by several years.
4. Since April 2004, there have been two types of correspondence delivery business for which an entry license is required: "general correspondence delivery business", which allows delivery of all types of correspondence, and "special correspondence delivery business" providing creative services with high added value in certain areas. Japan Post is obliged to provide universal service. General correspondence delivery firms are required to provide nation-wide service to prevent cream-skimming and ensure universal service by Japan Post.
5. In Japan, privatisation is sometimes used to describe the corporatisation of a government agency and partial sale to private investors, while the government maintains a controlling interest in the new company.
6. As noted above, the funds deposited with the Fiscal Loan Fund are not included in their assets.
7. Until 2001, all postal savings went directly to the Trust Fund Bureau Fund at the Ministry of Finance, except discretionary investment.
8. Purchases by postal savings and life insurance amounted to 49 per cent of FILP bonds in FY 2001, 53 per cent in FY 2002 and 45 per cent in FY 2003. In FY 2004, purchases are planned to amount to 54 per cent.
9. The Council for Regulatory Reform consisted of 15 experts from business and academia, organised into eight working groups, and was supported by a secretariat of 30 persons seconded from the private sector and the government.
10. When one treatment not covered by health insurance is combined with treatment that is, the entire expense must be paid by the patient.
11. This section draws on the 2004 OECD report, *Japan: Progress in implementing regulatory reform*.
12. For example, see the Government of the United States (2003), page 53; The European Commission (2003), page 11; and Nippon Keidanren (2003).

13. Publication requirements are in place for the *flow* of most new regulations. However, there is no single authoritative source for the *stock* of laws and regulations. A single registry of existing regulatory requirements would significantly enhance transparency and force a rationalisation of government rules.
14. Six of the 405 Cabinet and Ministerial Orders in FY 2002 were excluded based on the exemption allowed for "… circumstances [ ] in need of prompt implementation, in case of emergency or insignificant matters".
15. The lack of power at the local level is illustrated by the experience of Mie prefecture in trying to reduce the regulation of economic activity. The prefectural government discovered that it controlled only seven regulations, while thousands were under the control of the central government.
16. The rate is 3 per cent for small and medium-sized manufacturers, 2 per cent for large retailers and 1 per cent for small retailers and wholesalers.
17. At present, only cartels restraining the price and quantity of goods and services are subject to surcharges. The proposed legislation would include procurement market cartels and cartels whose control over other companies permits them to develop a private monopolisation, enabling them to control prices and the amount of goods and services supplied, market share and client base.
18. The rate is to be increased to 10 per cent for large manufacturers, 4 per cent for small and medium-sized manufacturers, 3 per cent and 2 per cent for large retailers and wholesalers, respectively, and 1.2 and 1 per cent for small retailers and wholesalers, respectively. The 50 per cent surcharge on frequent violators was also included in the revised bill.

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Chapter 6

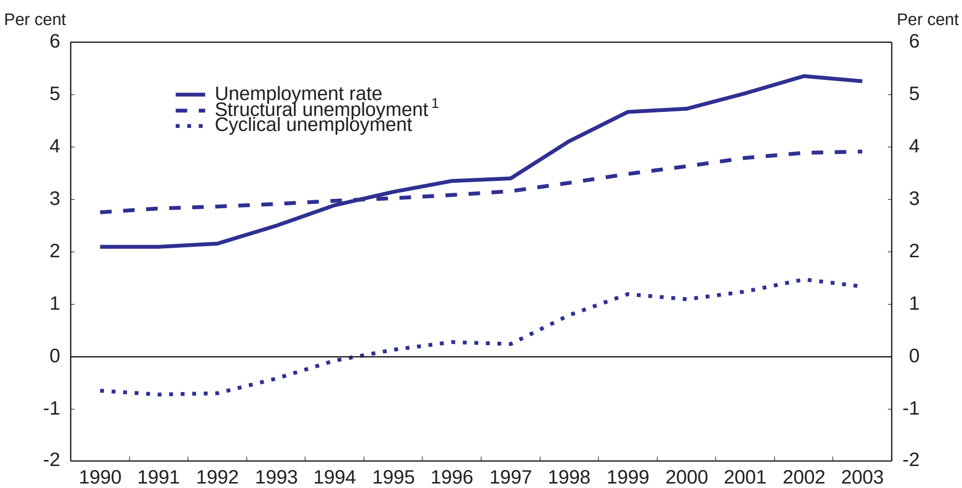
Improving the functioning of the labour market

This chapter discusses problems in the labour market, particularly the factors boosting the share of non-regular workers, such as part-time and temporary employees. While this enhances employment flexibility and reduces labour costs, increasing dualism creates both efficiency and equity concerns. A comprehensive approach, including relaxing the high degree of employment protection for regular workers, expanding the social security system's coverage of non-regular workers and other policies such as training would help limit the extent of segmentation in the labour market. The chapter also addresses policies to promote labour force participation to offset the on-going decline in the working-age population. It is important to eliminate features of the tax and social security system that discourage women from working full-time and to enhance the availability of childcare. Aspects of the pension system that encourage workers above age 60 to retire should be reformed in order to maintain the participation rate of older persons at its high level.

Japan's labour market has changed significantly during the decade of economic stagnation following the collapse of the bubble in the early 1990s. The unemployment rate, one of the lowest in the OECD area in 1990 at 2 per cent, peaked at nearly 5½ per cent in 2003, with a rate of 10 per cent for the 15 to 24 age group (Figure 6.1). While about two-thirds of the increase was due to weak macroeconomic conditions, structural factors have also boosted unemployment. The incidence of long-term unemployment has also risen sharply during the past decade to a level near the OECD average. In addition, there has been a marked increase in the share of non-regular workers – such as part-timers and employees with temporary contracts – since the mid-1990s. These structural changes are taking place in the context of rapid population ageing that is projected to reduce the number of working-age persons by 5 per cent in the decade from 2000 to 2010. This chapter begins by discussing the factors driving increasing dualism in the labour market and then examines policies to offset demographic trends by encouraging greater labour force participation. The chapter ends with an overall assessment.

The principal findings of this chapter are, first, that the increasing dualism in the labour market poses important efficiency and equity problems. The adverse consequences are concentrated among young people – an important resource in a rapidly ageing society – and among women, discouraging their participation in the labour force. It is thus important to rebalance incentives that favour the hiring of non-regular workers through a comprehensive approach. This includes relaxing employment protection provided to regular workers, while improving the social security coverage of non-regular workers to narrow the cost advantage of hiring such workers, without reducing their chances of finding a job, and training. These policies should also help reduce the unemployment rate for young people. Second, dealing

Figure 6.1. **Unemployment in Japan**



1. OECD estimate of the unemployment rate consistent with a non-accelerating rate of inflation (NAIRU).

Source: OECD Economic Outlook, No. 76.

with the sharp rise in long-term unemployment requires using active labour market policies effectively to improve the human capital of such workers. Finally, given the significant decline in the working-age population, it is important to raise female participation rates, while maintaining the high employment rate of older workers.

The changes in the labour market over the past decade

The Japanese labour market has been based on long-term employment of a core workforce, with adjustments in overtime hours[1] and the number of non-regular employees providing flexibility. Annual wage negotiations and bonus payments result in a relatively high level of wage flexibility. Such a system has the advantages of encouraging the training of workers, since long tenures make such investment worthwhile, and helps employees to accept changes in work practices and technology. Employment for prime-age males and new graduates was virtually guaranteed in this system. Indeed, the unemployment rate for men between the ages of 25 and 54 was only 1.4 per cent in 1990 (Figure 6.2).

Coping with increased labour market dualism

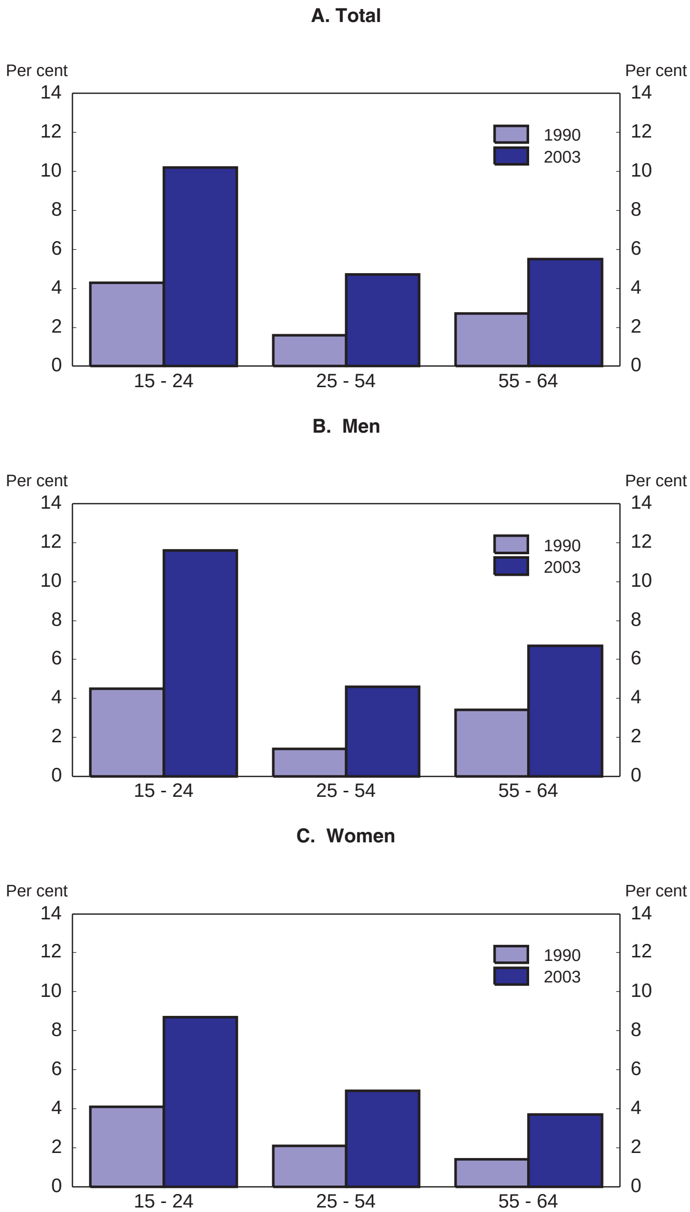
However, the traditional labour market model, which developed during the high-growth era, proved to be less well-suited to a decade of economic stagnation that required many enterprises to downsize. Firms prefer to limit the fixed costs associated with long-term employment, a disadvantage in increasingly competitive world markets in which some overseas competitors find it much easier to rapidly adjust their workforce. In addition, given the importance of seniority in wage-setting, population ageing tends to increase labour costs. Firms have responded to these pressures by:

- *Reducing wages:* total compensation started declining in real terms in 1997, and by 2003, had fallen by a cumulative 6 per cent (Figure 6.3). A large drop in bonus payments was responsible for most of the decline.
- *Cutting the hiring of new graduates:* given the difficulty of reducing the number of regular employees, firms hired fewer new graduates (Table 6.1). In 2003, the number of new graduates hired had fallen by more than half from its 1997 level, contributing to the rise in the unemployment rate for those in the 15 to 24 age group to 10 per cent (Figure 6.2). In addition, the proportion of idle youth who are not in the labour force or in school had doubled from 8 to 16 per cent since 1990. For firms, reduced hiring of new graduates has increased the average age and wage costs of their workforces.
- *Lowering working hours:* average annual working hours declined 10 per cent between 1990 and 2001 to around 1 800, although this remains about a quarter above some major European countries. The fall in working hours was also a result of government policies, notably the Law to Promote the Shortening of Working Hours in 1992.

Despite these steps, total compensation of employees increased from 60 per cent of business sector value-added in 1990 to a peak of 65 per cent in 2001, squeezing firms' profit margins.

Japanese firms also cut regular employment by 10 per cent in absolute terms between 1994 and 2003, lowering its share of total employees from 74 to 64 per cent (Table 6.2). A substantial share of the decline was achieved through retirement and reduced hiring of new graduates. In addition, early retirement and dismissal were also used, although official data do not provide specific information on their importance. According to one study, nearly half of large firms reduced employment through early retirement,

Figure 6.2. **Unemployment rates by age group**



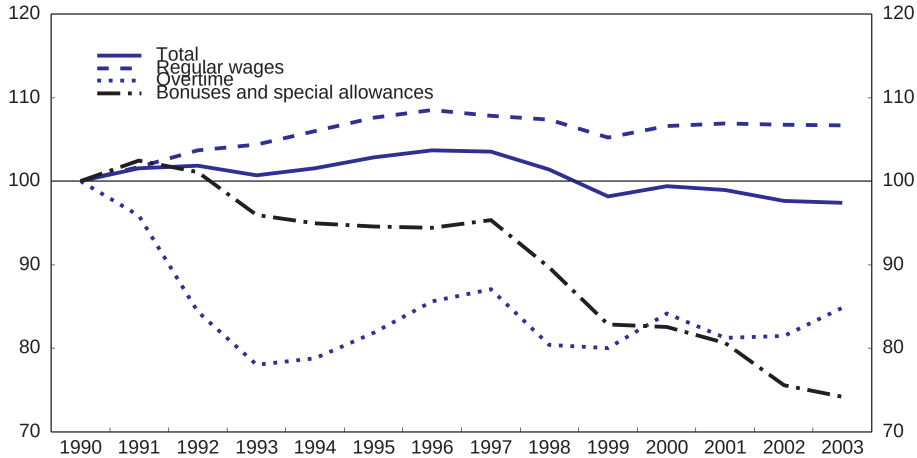
Source: *OECD Employment Outlook.*

usually by introducing or expanding incentives to leave before the official retirement age, which is normally 60.[2] One-third of firms seconded regular workers to related companies.[3] In contrast, less than 5 per cent reported dismissing workers. However, more recent data suggests that dismissals may have become more common. The proportion of regular workers leaving a job because of a "decision by management" increased from 7 per cent in 1996 to 12 per cent in 2001 and 2002. The sharp rise in the number of bankruptcies has been another factor reducing regular employment.[4]

The decline in regular workers was more than offset by the expanding number of non-regular workers, including part-timers. More than two-thirds of the rise in part-time work

Figure 6.3. **Employee compensation by component**

In real terms with 1990 = 100



Source: Ministry of Health, Labour and Welfare.

was accounted for by women and by young men in the 15 to 24 age group. Indeed, the proportion of women working part-time has increased from 32 to 42 per cent since 1990 (Table 6.3). As a result, women account for two-thirds of all part-time workers, and three-quarters in the prime working age between 25 to 54 (Panel C). For young men in the 15-24 age category, the share of part-timers has nearly doubled from 15 to 28 per cent since 1990. A significant portion of non-regular workers, including part-timers, are young people, who are called "freeters" in Japan. Initially, this group was thought to have voluntarily rejected the traditional approach of regular employment in favour of increased flexibility. However, a 2003 survey reported that 70 per cent of the freeters wanted to be hired as regular workers.

Most of the increase in non-regular workers since 1997 resulted from rising numbers of dispatched workers (who are employed by temporary worker agencies) and employees on fixed-term contracts (Table 6.2). This trend was facilitated by reforms implemented in recent years. Prior to 2003, only indefinite contracts or fixed-term contracts of less than one year were allowed.[5] The maximum length has now been extended to three years and five years in the case of workers over the age of 60. The number of sectors where dispatched workers are permitted has been gradually expanded from 26 specific job categories and now includes manufacturing, although such workers are still prohibited in some areas, notably construction and much of the healthcare sector.

Table 6.1. **Hiring of new graduates**

Percentage change from previous year[1]

	1998	1999	2000	2001	2002	2003	Cumulative decline
Manufacturing	–24.5	–25.7	4.5	–16.6	–17.8	3.8	60.4
Non-manufacturing	–22.2	–18.4	–3.8	–4.1	–12.7	–3.7	50.7
Total	**–23.5**	**–20.6**	**–1.4**	**–8.0**	**–14.1**	**–1.5**	**53.4**

1. In December of each year.

Source: Bank of Japan.

Table 6.2. **Employed persons by status**

	Total		Total excluding executives		Regular workers		Non-regular workers		Of which: Part-time workers[1]		Of which: Other[2]	
	Million	Per cent	Million	Per cent	Million	Per cent	Million	Per cent	Million	Per cent	Million	Per cent
1990	46.9	100.0	43.7	93.2	34.9	74.4	8.8	18.8	7.1	15.1	1.7	3.6
1991	48.8	100.0	45.4	93.0	36.4	74.6	9.0	18.4	7.3	15.1	1.6	3.3
1992	50.3	100.0	46.6	92.7	37.1	73.7	9.6	19.0	7.8	15.5	1.8	3.5
1993	51.2	100.0	47.4	92.7	37.6	73.4	9.9	19.3	8.0	15.7	1.9	3.6
1994	51.4	100.0	47.8	92.9	38.1	74.0	9.7	18.9	8.0	15.6	1.7	3.3
1995	51.7	100.0	47.8	92.5	37.8	73.1	10.0	19.4	8.3	16.0	1.8	3.4
1996	52.4	100.0	48.4	92.5	38.0	72.6	10.4	19.9	8.7	16.6	1.7	3.3
1997	53.5	100.0	49.6	92.8	38.1	71.3	11.5	21.5	9.5	17.7	2.1	3.9
1998	53.4	100.0	49.7	93.0	37.9	71.1	11.7	22.0	9.9	18.5	1.9	3.5
1999	52.8	100.0	49.1	93.1	36.9	69.9	12.3	23.2	10.2	19.4	2.0	3.8
2000	52.7	100.0	49.0	93.1	36.3	68.9	12.7	24.2	10.8	20.5	2.0	3.7
2001	53.4	100.0	50.0	93.6	36.4	68.1	13.6	25.5	11.5	21.6	2.1	3.9
2002	53.4	100.0	49.4	92.6	34.9	65.4	14.5	27.2	10.5	19.7	4.0	7.5
2003	53.4	100.0	49.5	92.6	34.4	64.5	15.0	28.1	10.9	20.4	4.2	7.8

1. The significant fall in the number of part-time workers in 2002 and rise in the other category is thought to be due to a change in the questionnaire.
2. Includes those working on short-term contracts, dispatched workers (employed by temporary worker agencies), workers on loan from other companies and other types of non-regular workers.

Source: Ministry of Internal Affairs and Communications.

Table 6.3. **Part-time workers in Japan**[1]

	Age group					
	All	15-24	25-39	40-54	55-64	65 and over
A. Male part-time workers as a share of total male workers by age group						
1980	6.1	8.9	4.2	4.9	9.6	24.2
1985	6.1	10.5	3.8	4.2	9.4	27.4
1990	8.3	14.9	4.9	5.7	11.2	30.3
1995	9.1	17.1	5.3	5.8	11.6	31.6
2000	10.5	23.3	5.7	6.1	13.1	35.8
2003	13.7	28.3	8.2	8.9	17.2	40.5
B. Female part-time workers as a share of total female workers by age group						
1980	26.0	11.6	30.3	26.7	29.0	41.4
1985	27.9	12.4	30.9	29.3	31.5	45.7
1990	31.8	18.4	33.0	34.7	35.0	46.7
1995	33.9	22.7	31.4	38.0	36.3	48.6
2000	37.7	30.4	32.1	42.1	40.5	52.5
2003	41.6	35.2	34.7	46.1	46.6	56.0
C. Female part-time workers as a percentage of total part-time workers						
1980	71.7	56.7	78.3	76.6	64.6	45.3
1985	74.2	53.8	81.5	82.2	65.7	50.0
1990	71.8	55.0	79.2	81.0	63.3	49.4
1995	71.3	55.6	77.6	82.1	64.6	46.8
2000	70.9	56.0	77.6	83.1	65.9	45.3
2003	67.7	54.5	73.1	78.8	63.0	44.6

1. The share of total employed persons in non-agricultural industries who work less than 35 hours a week.
Source: Higuchi and Hashimoto (2004).

The business sector's preference for greater flexibility in employment is one of the most important factors responsible for the rising number of non-regular workers (Table 6.4). Indeed, more than a quarter of firms hiring non-regular workers did so in order to cope with daily or weekly fluctuations in the workload and to be able to adjust the number of employees to changes in the business cycle. In addition, 18 per cent of firms hired non-regular workers to cope with temporary or seasonal fluctuations in the workload and long business hours. Such flexibility is needed to compensate for the high level of employment protection provided to regular workers. Indeed, Japan is ranked tenth out of 28 OECD countries in terms of the strictness of employment protection for regular workers, the same place as Austria, Greece and Korea (OECD, 2004b). As for restrictions on dismissal, perhaps more important than the legal code are the precedents established by the judicial system. Court cases have set four conditions that must be met in the case of collective dismissals. *First*, firms must show the economic necessity of reducing its workforce. *Second*, it must prove that there are no alternative measures that could achieve the necessary reduction. *Third*, it must demonstrate that the process of selecting employees for dismissal is reasonable and objective. *Fourth*, the firm must discuss the dismissals with the workers' union. As a result of these judicial precedents, enterprises do not know beforehand if their efforts to rationalise their workforce will be accepted by judges.[6]

Japan's experience is consistent with evidence from other OECD countries that the relative strictness in employment protection between regular and temporary workers

Table 6.4. **Reasons for hiring non-regular workers**

Per cent of firms citing the reasons shown below[1]

Type of employment	To adjust the number of employees due to business cycles	To cope with long business hours	To cope with daily or weekly fluctuations in the workload	To cope with temporary or seasonal fluctuations in the workload	To reduce wage costs	To reduce non-wage personnel costs
Contract employees	21.7	8.9	3.5	9.0	30.3	11.9
Re-employed workers after retirement	7.7	3.9	1.6	3.7	26.1	6.1
Transferred employees	9.6	2.2	1.6	1.3	13.1	7.7
Dispatched workers	26.4	2.8	8.0	14.4	26.2	26.6
Temporary employees	30.0	17.8	23.4	45.5	37.8	16.4
Part-timers	23.4	20.4	35.0	15.4	55.0	23.9
Others	25.4	10.0	18.3	23.6	43.8	22.3
Total	**26.5**	**18.1**	**28.0**	**17.6**	**51.7**	**22.5**

1. A survey of 16 232 firms that employ non-regular workers. As each firm was allowed to give three reasons, the sum of the columns exceeds 100 per cent. Other reasons (not shown in the table) include "To meet the need for expert workers", "Skilled and talented workers are necessary", "To re-employ aged workers", "Difficulty in hiring regular workers", "Regular workers are assigned only to important tasks", "To replace regular workers on maternity leave or caring for family members" and "Other".

Source: Ministry of Health, Labour and Welfare, "General Survey on Diversified Types of Employment, 2003".

tends to increase the incidence of temporary work.[7] The level of protection for temporary employees in Japan is in the lower half of OECD countries. The combination of relatively high protection for regular workers and relatively low protection for temporary workers results in increasing labour market dualism in Japan. The net effect of employment protection on the total number of people working is uncertain. However, evidence from the OECD area suggests that it influences the composition of employment by reducing the share of young people and women (OECD, 2004b).

Another important incentive to hire non-regular workers is to reduce labour costs. In the survey on why firms hire non-regular workers, around half of the firms cited reducing wage costs while nearly a quarter cited reducing non-labour wage costs (Table 6.4). On an hourly basis, part-time workers were paid only 40 per cent as much as full-time workers in 2003.[8] Firms benefit from an additional 13 per cent saving in non-wage costs since part-time employees are exempted from health insurance, pension contributions and unemployment insurance below certain thresholds, thus eliminating the need for co-payments from employers.[9] The existence of such thresholds also diminishes the supply of labour since some part-timers reduce the number of hours worked to avoid making payments to social insurance programmes.[10]

In sum, Japan's labour market is characterised by a growing dualism between regular and non-regular workers. Moreover, the degree of dualism appears to be relatively high by international standards, given that part-time workers account for 26 per cent of total employment in Japan compared to an OECD average of 15 per cent.[11] Such a segmented labour market creates both efficiency and equity concerns. Non-regular workers do not benefit from firm-based training, which plays an important role in Japan. Labour market dualism thus has adverse long-run implications for human capital, especially as the incidence of non-regular employment is particularly high among young people. In addition, the lack of movement between the regular and non-regular segments creates equity concerns as it results in a lifelong wage gap. A significant portion of the labour force risks being left with only short-term employment experience and a low level of human capital. There appears to be a significant degree of wage discrimination, as the 60 per cent gap between the hourly wages of full and part-time workers is unlikely to be matched by productivity differences. In addition to lower wages, non-regular workers are less protected by the social safety net. In sum, a quarter of employees receive substantially lower wages and reduced social protection, while bearing much of the burden of employment adjustment.

Stagnant employment and rising unemployment

The number of employees in Japan was at the same level in 2003 as in 1997. Empirical evidence suggests that while employment protection may slow the flow from employment to unemployment, it also slows the re-employment of those without jobs, reflecting the fact that companies take firing costs into account when deciding whether to hire workers (OECD, 2004b). Disappointing employment trends have also been blamed in some countries on the out-sourcing of jobs to countries with lower wage costs. In Japan, this phenomenon, which is referred to as "hollowing-out", is generally associated with China. However, it appears unlikely that outsourcing has had a significant effect on employment, given that the stock of foreign direct investment (FDI) abroad is relatively low, at 7 per cent of GDP, compared to that of other OECD countries (Figure 6.4). Moreover, outflows during the last three years have been small, at about 4 trillion yen (less than 1 per cent of GDP), compared to the 1990s (Panel B). The share invested in China is surprisingly small at less than 10 per cent of the total.

Rising unemployment has been accompanied by an increased incidence of long-term unemployment. Indeed, the number of persons out of a job for more than one year is now more than four times higher than in 1990. Even with the sharp rise in total unemployment, the proportion of long-term unemployed has risen to above the OECD average (Figure 6.5) Long-term unemployment poses a particular challenge as it leads to a deterioration in workers' skills, making it harder for them to find a job.

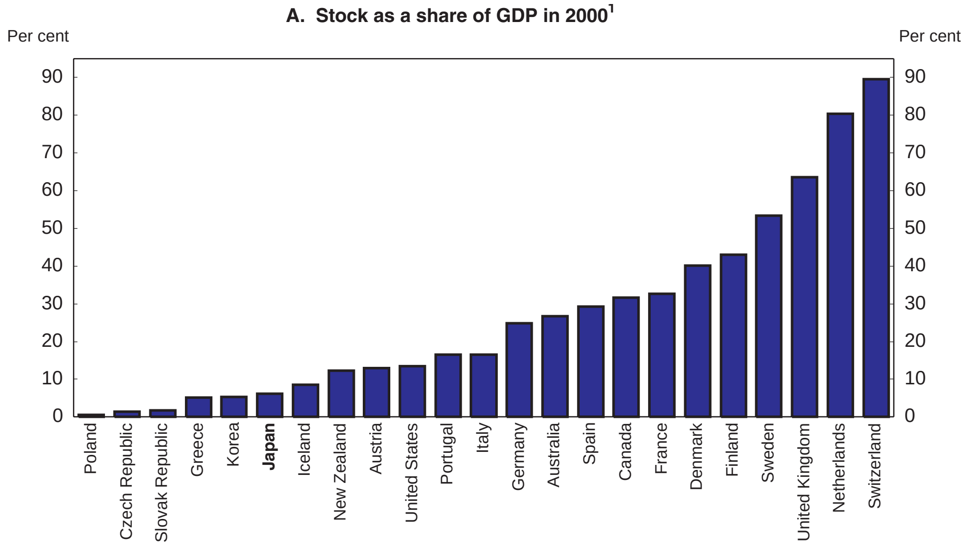
Coping with a declining working-age population

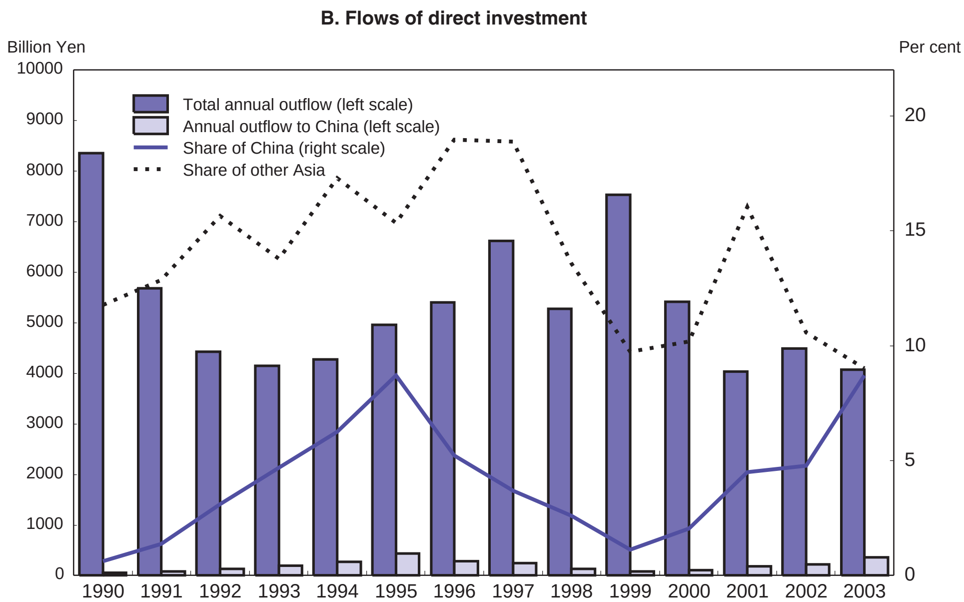
While a few other OECD countries also expect a decline in their working-age population between 2000 and 2010, the magnitude of the fall in Japan is projected to be the largest at 5 per cent. The impact could be tempered by policies to increase the labour force participation rate, which at 77.5 per cent, is already above the OECD average of 70 per cent.[12] This would require boosting the rate of prime-age women, while maintaining the relatively high rate of older workers in the 55 to 64 age group.

Encouraging greater labour force participation by women

Female labour force participation in Japan is close to the OECD average but well below the level in the other major countries apart from Italy. This reflects the fact that around 60 per cent of women withdraw from the labour force when their first child is born. This results in an M-shape pattern in employment rates, with peaks in the 25 to 29 age group and in the 45 to 49 age group (Figure 6.6). If female participation rates were boosted to the current level for men by the year 2030, the decline in the total labour force at that date would be limited to 4 per cent (Figure 6.7). However, if female participation rates remain at their current level, the labour force would fall by nearly one-fifth. The burden of population ageing under the latter scenario would be significantly heavier.

Figure 6.4. **Japan's outward foreign direct investment**





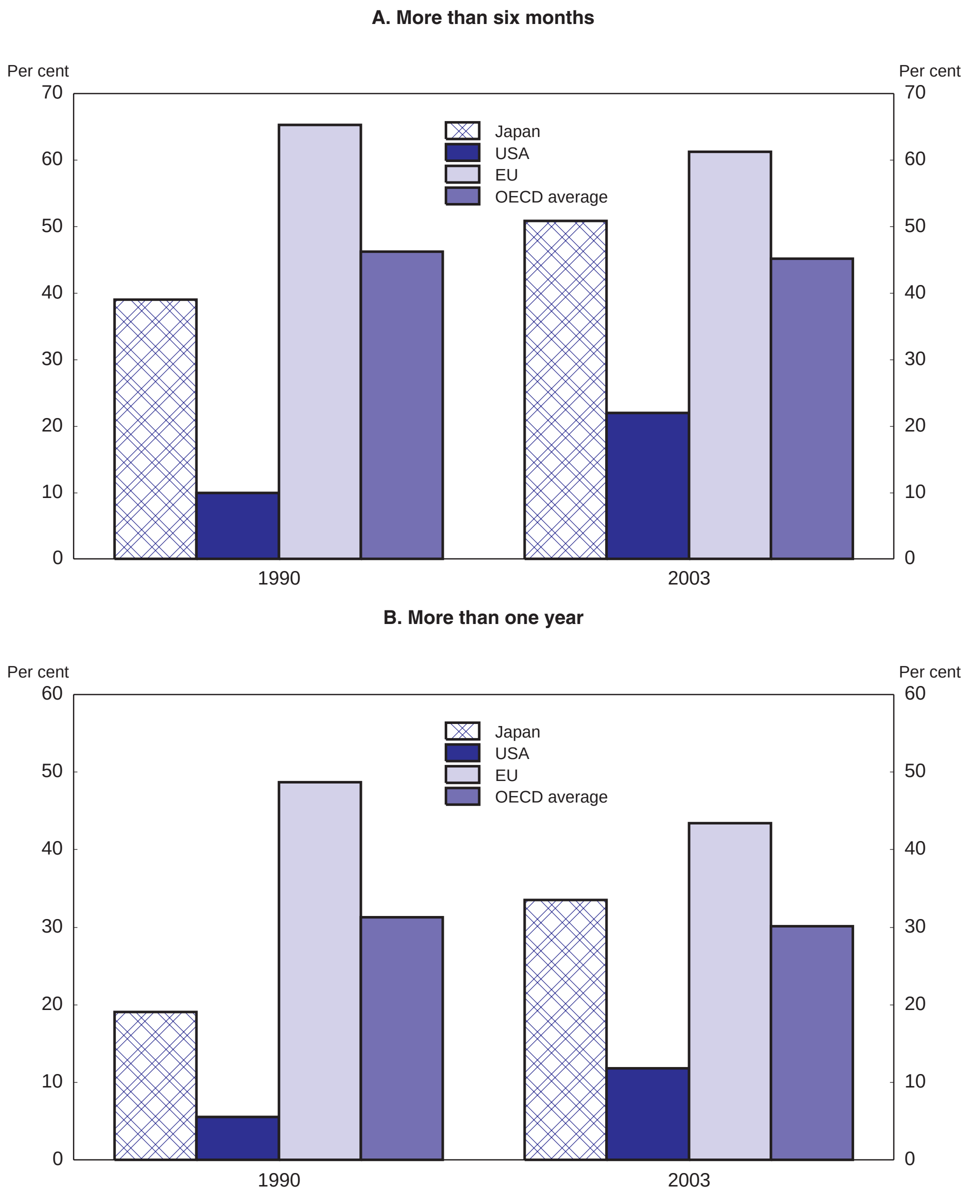
1. For countries where the FDI position data are not available, values of bilateral stocks reported by their OECD partners were summed to obtain an approximate measure of multilateral FDI stocks.

Source: Ministry of Finance and OECD.

The gender gap is larger in terms of job quality than in employment rates, despite the fact that the educational attainment level of women is relatively high in Japan (OECD, 2003a). Unique among OECD countries, Japanese women in all age groups are more likely than men to have at least a secondary education. Nevertheless, a full-time regular female employee earns 35 per cent less than her male counterpart on average. Part of the gap is due to differences in the length of service, which is an important determinant of pay in Japan. The average tenure for women is 9 years compared to 13½ years for men. The shorter length of service also slows promotion for women. In a 2003 government survey that asked firms about difficulties in utilising female employees, shorter tenure was cited by 43 per cent.

Figure 6.5. **An international comparison of long-term unemployment**

As a per cent of total unemployment

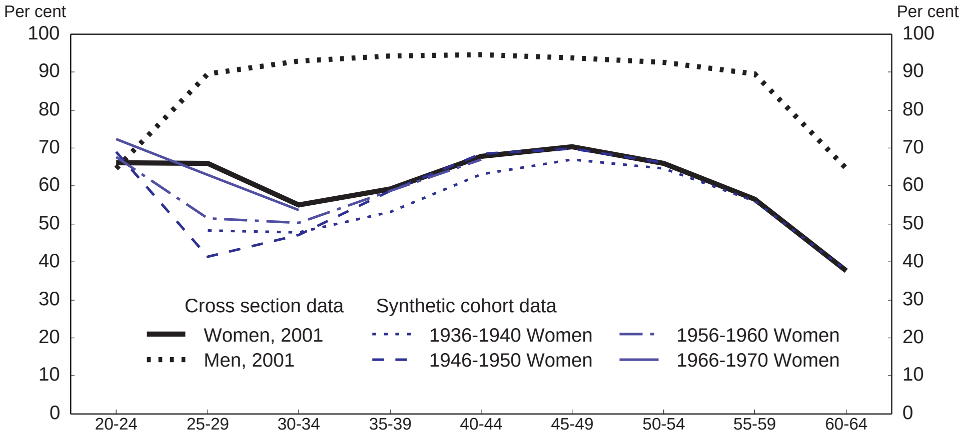


Source: *OECD Employment Outlook.*

The wage gap is even larger in reality since women account for 70 per cent of non-regular workers, who as noted above earn substantially less than regular workers. More than 85 per cent of male employees have regular contracts compared to about 55 per cent of females. An equal opportunity law encouraging firms not to discriminate against women was passed in 1985, and the law was amended in 1997 to prohibit such discrimination. The biggest obstacle to greater integration of women in the labour market is probably the prevailing workplace practices, which tend to be inhospitable to those with family responsibilities. Regular workers receive in-house training and employer benefits, such as allowances for spouses and dependents, while their compensation is essentially seniority-based and job

Figure 6.6. **Employment ratios by age and gender**

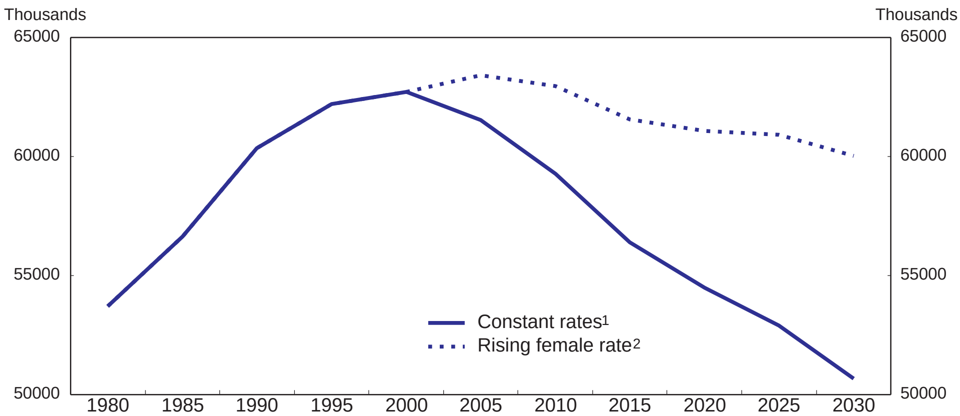
Cross-cohort comparisons of employment rates by age



Source: OECD, *Babies and Bosses*, Vol. 2.

Figure 6.7. **Long-term projections of the labour force**

Total labour force from 1980 to 2000 and projections to 2030, in thousands



1. Assumes that the labour force participation rates for men and women stay at current levels through 2030.
2. Assumes that female participation rates reach current male participation rates in 2030.

Source: OECD, *Babies and Bosses*, Vol. 2.

security is high. In return, such employees accept flexible adjustment of working conditions and long working hours, including unpaid overtime, and generally take less leave than the amount to which they are entitled. Such workplace practices make it difficult for women to return to their original employer and resume their careers after childbirth. In the survey mentioned above, firms cited family responsibilities (49 per cent) and reluctance to work overtime or during the night (36 per cent) as major problems in employing women, thus limiting many to non-regular positions. In addition, limits on the age of new recruits for career-track positions are still common, thus further limiting the availability of regular employment for women returning to the labour force after childbirth. This helps to explain why more than 40 per cent of women are part-time employees (Table 6.3).

In addition, some aspects of the tax and social security systems encourage dependent spouses to limit their working time.

- Wages are exempted from income tax and local inhabitant tax up to a level of 1 million yen per year (a quarter of the average annual wage).[13]
- The main income earner in a household qualifies for an income tax exemption of 380 thousand yen if the second earner makes less than 1 million yen per year.[14] Another 330 thousand yen is exempted from the local inhabitant tax.
- The second earner in a household is exempt from annual health and pension contributions on earnings of up to 1.3 million yen per year (a third of the annual wage). The fact that dependent spouses, including those working part-time, are covered by the old-age employees' pension without paying their own premiums is unfair to working wives who pay their own premiums. This undermines work incentives for women.

These incentives to work part-time are reinforced by allowances for spouses provided by firms. About three-quarters of firms provide allowances for spouses, which average about 4 per cent of regular wages. Nearly half of the employers who pay such allowances stop payments completely if the dependent spouse earns more than 1 million yen per year. Meanwhile, cash benefits previously limited to families with children under the age of six have been extended to the age of nine. About 85 per cent of families with children in that age group are eligible for the payment, although the amount is small at about $40 per month for the first two children.

The difficulty of reconciling work and family life is further heightened by the limited availability of childcare facilities. In major urban areas, public-sector nursery schools do not have sufficient capacity. Profit-making companies were allowed to enter this sector in 2000, subject to strict licensing conditions. For example, playgrounds were mandatory for private nursery schools, a difficult requirement in Tokyo. Unlicensed companies also offer childcare services, but doubts about quality cause parents to queue for places in public or licensed facilities. Regulatory reform has eased the licensing requirements at the national level,[15] though some local governments reportedly enforce additional regulations.

There are some aspects of social policy aimed at assisting the reconciliation of family and work responsibilities. Most importantly, the law requires six weeks of childbirth leave prior to birth and eight weeks after. Those covered by Employee Health Insurance can receive 60 per cent of their wage during childbirth leave. In addition, workers can also take one year of childcare leave, during which time they can receive 30 to 40 per cent of their wages if they are covered by employment insurance. Nevertheless, as noted above, almost two-thirds of women leave the labour force after childbirth.

The above discussion suggests a number of policy changes that would encourage female labour force participation.

- Dualism in the labour market should be reduced by addressing the factors that make employers prefer non-regular workers. Increasing the scope for regular employment – which pays a significantly higher salary on average than non-regular employment – may enhance the attractiveness of employment for women.
- The tax and social security systems should be reformed to reduce or eliminate disincentives to work by spouses. The thresholds at which income is exempted should be lowered or removed completely. Since the income limits set by firms in deciding eligibility for spouse allowances tend to match those in the tax system, lowering or removing the thresholds applied to taxes might encourage similar steps by firms.

- Increasing the importance of performance assessment in pay and promotion decisions for both regular and non-regular employees would reduce the importance of seniority and tenure, thus tending to reduce wage gaps between genders.
- The use of age limits in recruiting should be discouraged.
- The availability of childcare facilities should be increased by easing the licensing regulations and encouraging more private-sector firms to enter this sector.

Maintaining the high labour force participation rate of older persons

The labour force participation rate and employment rate for men in the 55 to 64 age group in Japan is the second highest in the OECD area and has remained relatively steady compared to other member countries (Table 6.5). Although the official retirement age was 60 until 2001, the labour force participation rate for men in the 60 to 64 age group has remained above 70 per cent. The eligibility age for the flat-rate portion of the pension is rising to 65 during the period 2001 to 2013 (2006 to 2018 for women), while the earnings-related portion will be similarly increased over the period 2013 to 2025 (2018 to 2030 for women).

The incentive to retire depends on the combined effect of the replacement rate – the level of pension income relative to wage earnings – and the change in pension wealth.[16] A high replacement rate encourages withdrawal from the labour force as would a loss in pension wealth if the person continues to work (Casey *et al.*, 2003). In the case of Japan, the replacement rate for a worker earning the average production wage remains around 50 per cent, although there is a loss in pension wealth, amounting to around 20 per cent of net earnings, until age 65. In sum, the incentives to retire are rather moderate compared to other OECD countries.[17] However, the existence of an earnings test to qualify for pension benefits for those in the 60 to 69 age group may encourage part-time work, since employees who work less than three-quarters of regular working hours or working days are not subject to the test. According to a 2000 survey, 23 per cent of persons in the 60 to 64 age group reduced their working hours in order to avoid a suspension of pension benefits (OECD, 2003a).

Reducing youth unemployment

Labour market conditions for young people have deteriorated markedly over the prolonged period of low economic growth. In addition to the rise in the unemployment rate to double-digit levels for the 15 to 24 age group (Figure 6.2), the proportion of this age group engaged in part-time work has nearly doubled since 1990 to around one-third (Table 6.3). These trends reflect intensified restructuring efforts by firms, which tend to reduce new recruitment rather than dismiss existing workers (Table 6.1). With job opportunities significantly reduced, a growing proportion of youth accept temporary jobs while searching for good jobs. However, remaining in temporary work or unemployment for extended periods reduces human capital, thus restricting access to regular jobs. The limited access to job training and the absence of a public loan scheme for such training also exacerbates the problem. The youth under-employment problem also raises equity concerns as they have limited access to the social security system, including unemployment benefits and private pension schemes. To address this issue, the government has adopted measures to improve the transition from school to work, in part through internships. In addition, it has expanded the capacity for job counselling at the public employment service. Such measures, combined with steps to reverse increasing dualism in the labour market, should improve employment conditions for young people.

Table 6.5. **Participation and employment rates of older men**[1]

Per cent

	1970		1980		1990		2000	
	Participation rate	Employment rate	Participation rate	Employment rate	Participation rate	Employment rate	Participation rate	Employment rate
Australia	85		69	67	63	59	62	59
Canada	84	79	75	71	64	60	61	58
Finland	74	73	57	55	47	46	48	44
France	75	74	69	65	46	43	42	38
Germany[2]	80	79	67	64	61	52	55	48
Hungary							35	33
Iceland					94[3]	93[3]	95	94
Italy[4]	48	48	40	39	36	35	31	30
Japan	**87**	**85**	**85**	**82**	**83**	**80**	**84**	**78**
Korea					77	76	71	68
Netherlands	81[5]	79[5]	63	61	46	46	51	50
Norway	84[6]	83[6]	79	79	73	71	74	73
Spain	84[6]	83[6]	76	71	62	57	60	55
Sweden	85	84	79	77	75	74	73	68
Switzerland					86[3]	85[3]	79	77
United Kingdom					68	62	63	60
United States	83	81	72	70	68	65	67	66
Average	**79**	**77**	**69**	**67**	**66**	**63**	**62**	**59**

1. Per cent of male population aged 55-64.
2. Until 1990, data refer to West Germany.
3. 1991.
4. Age group 60-64.
5. 1971.
6. 1972.

Source: Casey *et al.* (2003).

Overall assessment

The increasing dualism in the labour market creates both efficiency and equity issues. The rising share of non-regular workers has recently helped to boost profitability in the corporate sector, reducing total compensation of employees from 65 per cent of business sector value-added in 2001 to an estimated 62½ per cent in 2004. However, workers who are limited to short-term job tenures acquire less human capital, given the importance of enterprise-based training. In addition to the negative long-run effect on growth, there are equity implications, given the limited mobility between the regular and non-regular segments of the labour market. In particular, non-regular workers are disadvantaged by low wages – less than half on average of regular workers – and the limited coverage of the social safety net. Given that firms are increasing the share of non-regular workers in order to enhance employment flexibility and reduce labour costs, a comprehensive approach is needed to limit the trend towards labour market dualism. This should include the following measures. *First*, it is important to reduce the level of employment protection afforded to regular workers. *Second*, the coverage of social insurance programmes should be expanded to include more non-regular workers, thus reducing the disparity in costs, while limiting the negative effect on total employment. *Third*, as many non-regular workers are low-skilled, training programmes are needed to enhance their employment prospects.

Given that women account for more than two-thirds of non-regular employees, limiting labour market dualism may have positive implications for female participation in the labour force. Increasing the scope for regular employment, which on average pays higher salaries, may provide more attractive job opportunities for women. In addition, it is important to reduce or eliminate aspects of the tax and social security system that discourage women from working full-time. Relaxing licensing conditions for private-sector childcare facilities would also promote female labour force participation. Finally, aspects of company allowances for spouses, the importance of tenure in setting wages and age guidelines in recruiting new workers may each have negative implications for female participation. The authorities may want to consider how it could encourage changes in these private-sector practices.

Increasing employment rates for prime-age women will also help maintain the high participation rate of those in the 55 to 64 age category, which is important in order to mitigate the impact of population ageing. Reforming the pension system so as to reduce incentives to retire between the ages of 60 and 64 would encourage older workers to remain in the labour force. In particular, it may be useful to consider whether the earnings test is curtailing the working time of older persons. Many of the factors limiting employment of older persons, though, are found on the demand-side as a result of private-sector practices, such as mandatory retirement and seniority-based wages (OECD, 2003a).

Given the firm-specific nature of human capital in Japan, it tends to be difficult for those who lose their jobs to find new opportunities without some training. Although public expenditure on training programmes for the unemployed is very low (0.04 per cent of GDP), there is little scope for increasing outlays on active labour market policies, given the need to cut government spending to achieve fiscal consolidation. Shifting expenditures from employment subsidies, which typically have large deadweight costs in other OECD countries (Martin, 2000), to training might be beneficial, particularly in improving the employment prospects of young people. However, all policies should be subject to strict cost-benefit analysis to ensure their effectiveness.

Notes

1. The use of overtime work to meet fluctuations in demand is favoured by the low overtime wage premium, which is set at 25 per cent, compared to 50 per cent in some OECD countries. However, the premium is higher for work after midnight and on holidays.
2. In 2003, 90 per cent of firms had a mandatory retirement age. Of these firms, 89 per cent set retirement at age 60.
3. This study, by the Japan Institute for Labour Policy and Training (1998), covered more than 5 000 firms with at least 500 employees.
4. The number of bankruptcies increased from an annual average of around 12 000 in the first half of the 1990s to 19 000 in the period 2000 to 2002.
5. Dispatched workers employed in 26 specialised job categories were allowed contracts of up to three years. The maximum length of contract for those categories was abolished in 2003.
6. Prior to 2003, the legal code did not specify any criteria for dismissing workers in principal. A labour law reform proposed by the government in 2003 restated that corporations have the right, in principle, to dismiss workers. However, this statement was eliminated from the bill due to resistance from opposition parties and labour unions. The new law states that collective dismissals should be consistent with "social common sense".
7. The correlation between the strictness of protection for regular contracts and temporary employment as a share of total employment was 0.34 in 2002 (OECD, 2004b).
8. Part-time workers are defined as those working less regular hours on a daily or weekly basis than regular workers in the same workplace. Part-timers can be employed on fixed-term or indefinite contracts and often perform the same functions as regular employees.
9. Employees who work less three-quarters of the hours worked by regular employees in an enterprise (on a daily, weekly or monthly basis) are exempted from pension and health insurance contributions. Employees working less than one year or less than 20 hours a week are exempted from employment insurance.
10. Working-time decisions are also affected by the tax exemption on income up to 1 million yen (a quarter of the average wage).
11. The figures are not entirely comparable because the *OECD Employment Outlook* defines part-time as those working less than 30 hours a week except in Japan, where the threshold is 35 hours per week.
12. This is calculated as total employment divided by the working-age population (15 to 64 years of age). If labour force participation rate is measured as the number of employed in the 15 to 64 age group divided by the working-age population, Japan's rate would be 72 per cent, which is close to the OECD average of 71.5 per cent by this definition.
13. The deduction for employment income is set at 650 thousand yen plus a 380 thousand yen (330 thousand yen for the local inhabitant tax) basic deduction.
14. The exemption is phased out as the second earner's income rise from 1 million yen to 1.4 million yen. The special tax exemption on a second earner in a household, which exempts another 380 thousand yen, was removed in 2004.
15. For example, rather than having its own playground facilities, a nursery can qualify for a license if it is located near a park. Given the limited area of parkland in Tokyo, this regulation may still be a constraint.
16. Pension wealth corresponds to the present value of the future stream, net of tax, of pension payments to which the person is entitled over his or her life in retirement.
17. These calculations apply to the present situation and do not take into account the planned increase in the pension eligibility age, which should increase incentives to work.

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