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An Examination of the Koizumi Structural Reforms and Issues Facing the Administration in its Third Year

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Overview

A little over two years since the birth of the Koizumi Administration, with its slogan of "structural reform", the Koizumi reform program is being criticized on two counts: (i) that it has exacerbated the problems of deflation and economic deterioration and (ii) that its radical structural reforms have been ineffectual or been put off.

Over the past two years, Japan has suffered a sharp downturn in macroeconomic performance. Against a background of worsening deflation, share prices have plunged, there is growing anxiety over the future of the financial system, and unemployment and the number of corporate bankruptcies are rising. Substantial allowance should be made for the deterioration of external conditions, but it is also certain that the Koizumi Administration has lacked the flexibility and mobility it needed to cope with changes in macroeconomic conditions, such as deflation and economic deterioration.

By sticking rigidly to targets for the restoration of soundness to public finance (such as limiting annual issuance of government bonds to ¥30 trillion, and restoring a primary balance), policy management has given greater weight to restoring soundness to public finance than to revitalizing the economy. The Administration lacks a sense of crisis with regard to the problems of deflation and falling share prices, and has been slow to take remedial action. The Administration regards the problem of non-performing loans not as the result of deflation and macroeconomic deterioration, but as their cause, and its policies have focused on promoting the final disposal of non-performing loans. It has given insufficient attention to the

issues of industrial and corporate revitalization with a view to overcoming the problem of the excessive burden of debt on the business sector.

With regard to its radical structural reforms, the Koizumi Administration does deserve praise (i) for its use of the Council on Economic and Fiscal Policy, a new forum for policy-making, in an attempt to assert government leadership of the process of policy-making and (ii) for setting out a clear medium-to-long term vision and specific policy directions for structural reform. However, the individual reforms have yet to achieve significant results, and it is inevitable that they should be criticized as lacking in force.

The Koizumi Administration deserves praise for having proposed bold measures in the field of privatization, such as the privatization of postal savings and the reform of special corporations. However, the specific discussion of reforms has been limited to seven corporations, including the four highway corporations and the Government Housing Loan Corporation, and the overall progress of reform has been slow. Likewise, although some progress has been made with deregulation using "special zones for structural reform", amidst fierce resistance by government ministries and agencies, the results achieved to date are by no means satisfactory. The reform of the social security system (pensions, medical care, etc.), the *sanmi-ittai kaikaku* ["three-in-one reforms"] at central and local government level, and other "hard-core" areas of structural reform are also making slow progress.

The Koizumi Administration's reform philosophy, that there can be no economic recovery without structural reform, calls for a bold redistribution of economic resources from public to private sector and from central to local government. It is

basically justified. However, the two main reasons that the results achieved over the past two years have been unsatisfactory in terms of both economic and structural reform, can be summarized as follows.

First, even though the Administration's philosophy on structural reform may be right, there are problems with its targets and order of priority for reform. In spite of deteriorating conditions, specifically the growing severity of deflation, the Administration has continued to place first priority on the restoration of soundness to public finance and the disposal of non-performing loans. As a result, deflation has accelerated, the fiscal deficit has grown and the problem of non-performing loans has worsened. Meanwhile, the reform of the social security system, including pensions and medical care, intended to assuage public anxiety over the future, have made only slow progress. Basically, the first priority of the structural reform program should have been to revitalize the economy and to assuage public anxiety over the future rather than to restore soundness to public finance and dispose of non-performing loans.

Second, the Koizumi Administration's attempt to change the policy-making process was itself half-hearted. Although there were some signs of change in last year's tax reform debate, the reform of the social security system and the *sanmi-ittai kaikaku* reforms at central and local government level, that could be termed the core of the structural reform program have by no means been successful. The specific policies of setting targets for the latent national burden rate and cutting government subsidies under the recently announced third installment of the "strong bones policy" are likely to be ineffectual in practice. In contrast with the approach it has taken over the past two years, the Koizumi Administration sought the prior approval of the Liberal Democratic Party for these policies, and, as a

result, was forced to make over 40 changes and utterly abandon its initial aim of changing the policy-making process.

Given these problems, the issues facing the Koizumi Administration in its third year can be summarized as follows.

First, it should review its order of priorities for structural reform in a flexible manner, making allowance for the macroeconomic reality. In the short term, in particular, it should effect a bold turnaround in policy management, by giving first priority to resolving the problem of deflation as soon as possible. To this end, the goal of restoring a primary balance in government finance will have to be put back to reflect the economic reality, say to ten years after overcoming deflation.

In the meantime, fiscal policy management should focus on (i) not paying excessive heed to the level of the fiscal deficit in any single year but setting a "special framework for economic revitalization", involving a further narrowing down of priority areas of the economy and a bold allocation of budget resources to those areas, (ii) drawing up a concrete schedule for the reform of special status corporations including policy finance, (iii) setting specific numerical targets and a concrete schedule for the transfer of tax revenue sources relating to subsidies and grants paid by the central government to local governments, (iv) establishing a new budget-making process, including the drafting of multiple-year budgets, as soon as possible, and (v) establishing a framework for policy evaluation that will facilitate the efficient distribution of resources, without delay.

Moreover, while first priority remains on economic revitalization, it is urgent that the Koizumi Administration (i) should not treat the "special zones for structural

reform" simply as zones in which to experiment with deregulation, but should aim to use them to revitalize local economies as part of the three-in-one reform of regulation, budgets and tax systems, (ii) should draw up a concrete action program with a view to the realization of its target of creating 5.3 million jobs, and publish budget allocation figures for this medium-term program and (iii) implement tax reforms geared to economic revitalization (especially a lowering of the effective rate of corporate taxation, a long-neglected problem).

Second, the Koizumi Administration should set out a range of options with regard to the desirable relationship between the social security system and the national burden and make every effort to secure the understanding and support of the people of Japan.

In Japan, where population aging is advancing faster than in Europe and the United States, the national burden will inevitably rise. However, it is important that the government take responsibility for setting out clear proposals with regard to the desirable balance between the desirable level of benefits and the national burden, whether it be high welfare-high burden as in continental Europe, low welfare-low burden as in the United States and the United Kingdom, or medium welfare-medium burden, something between the two.

Proposals for the reform of the social security system have been put forward by the Ministry of Health, Labour and Welfare, which is pressing for radical reforms based on the assumption of a level of benefits comparable to those found in continental Europe, the Ministry of Finance, which insists on the need for substantial benefit cuts, placing excessive importance on the fiscal balance, and the

Council on Economic and Fiscal Policy, which is aiming for something between these two positions, and, at present, no clear direction has emerged.

Japan needs to escape from this stalemate as soon as possible, and to this end it is vital that the government and opposition parties work together to draw up a concrete plan and schedule for social security reform and publish a forecast of the final national burden. If the problems of a falling birthrate and population aging are to be overcome, the government will have to ask the people of Japan to endure "pain" in some form or other. The Koizumi Administration should make this clear to the people and do everything in its power to secure their support and understanding.

Third, to ensure that the changes in the policy-making process are not reversed, the Koizumi Administration should set out a concrete road map for structural reform.

To this end, it will be necessary to implement bold reforms of the policy-making process including (i) making the three senior officers of the elected parties ministers of state and establishing a sound democratic infrastructure in which both government and opposition parties publish their own manifestos and compete on the basis of their policies, with a view to correcting the distortions within the elected parties and the government, unparalleled in other developed nations, (ii) ensuring that policy proposals are not weakened or put off by making it clear that the Council on Economic and Fiscal Policy ranks above the councils, etc. of the various government ministries and agencies and (iii) appointing a considerable number of highly competent political secretaries to serve as policy advisors to the Prime Minister, allowing the Prime Minister himself to take responsibility and

show leadership in the management of policies, and pursuing the drafting and management of practical policies.

It is no exaggeration to say that whether future generations will refer to the structural reforms of the Koizumi Administration as the "Koizumi Revolution", on a par with the "Reagan Revolution" or the "Thatcher Revolution", depends on the ability of the Prime Minister to turn his ideals and vision into a comprehensive policy system and build a new policy-making system, on his own responsibility and judgment. It is to be hoped that the Prime Minister will make it clear that the success or failure of the third installment of the "strong bones policy" is the touchstone for the success of the structural reforms and that he will set about the budget-making process and tax reforms at the year end with a firm resolve.