Fiscal Management Strategy

(Cabinet Decision, 2010.6.22)

I. Basic Concept

1. Current economic and fiscal situation

Generally, Japan’s economy has not shown much growth since the collapse of the bubble economy at the beginning of 1990’s. Policies for economic growth did not work sufficiently well and the economy was not able to escape deflation. For the past ten years, the nominal economic growth rates, which correspond closely to what the people actually feel about the economy, were minus values. Japan's growth is at lowest among OECD countries.

Speaking about public finance, on the other hand, annual expenditures constantly exceed tax revenues by a large margin. Japan’s outstanding balance of government debt has increased by about 470 trillion yen in the past 20 years.

To consider the causes of this situation, let us review what has been happening in Japanese public finances so far as follows:

- Around 1990, the fiscal balance was largely improved by a temporary major increase in tax revenues thanks to the bubble economy. Since the collapse of the bubble economy, however, repeated tax reductions and the business recession, which has continued for a long time, resulted in a decline of tax revenues by about 210 trillion yen in the past 20 years. This led to an increase in the outstanding balance of government debt.
- Many public works were carried out in the past 20 years as a measure against recession, but they were not an efficient investment and did not always contribute to economic growth. They rather resulted in an increase in the outstanding balance of government debt of about 60 trillion yen (Note). The debt balance thus accumulated has reduced the alternatives available to fiscal policy planners.
- Further, the progress of the aging society since 90’s has caused an increase in the costs of social security, which has resulted in an increase in the outstanding balance of government debt of about 150 trillion yen in the past 20 years. This is one of the largest factors in the worsening fical situation.

(Note) In the past 20 years, the outstanding balance of government debt has increased by about 60 trillion yen because of increased investment in public works. The total amount spent on public works during these years amounted to about 200 trillion yen.

A large factor that allowed delay in improvement even under the worsening fiscal situation is the long-term interest rate that has been kept at a low level. The low interest rate resulted from underlying circumstances that are unique to Japan: abundant savings, decline of capital demand in the corporate sector reflecting long-lasting deflation and a sluggish economy, stable holding of government debt by domestic sectors such as the household, banks and the public sector.

However, it is not possible to remain content with the present state forever. The decline in the level of savings in the aging society, which is a negative factor, will be a larger problem in the future. In addition, if economic recovery continues, then more and more investment will be made in plant and equipment and this will result in a recovery of capital demand in the corporate sector. Such a phenomenon is necessary for the health of the economy, but, on the other hand, it will lead to a higher interest rate for government bonds.

2. Determined Actions against Financial Crisis Risk

As the financial crisis in Greece and some other countries is becoming quite a serious concern, the risk of public debt is seen as an increasingly serious problem in domestic and overseas markets.

In Japan, currently not even a half of the annual expenditures is covered by tax revenues. The long-term debt balance of national and local governments will amount to 181% of GDP at the end of this fiscal year. According to OECD statistics, the net debt ratio to GDP will exceed 100% at the end of this year and is anticipated to continue to go higher.

These circumstances need to be addressed or there will be a loss of confidence in Japan’s government bond market as in the case of Greece, which would result in sharp increase in interest rates and a financial crisis. Should such a situation occur, the country will lose fiscal autonomy as a nation and the levels of social security and other public services will become much lower. It will have a large adverse affect on the Japanese economy and the lives of the Japanese people.

However, it is not necessary to be pessimistic. We can take actions now without being forced into taking action later by a collapse in the government bond market. We should correctly understand what has caused the prolonged sluggish economy and the continued worsening of public finances and reform the system. If we start with strong political leadership before it is too late, we have sufficient time to recover. We are still able to achieve a recovery in time and must do so.

Based on the recognition described above, the new administration presents the Fiscal Management Strategy and the New Growth Strategy as one package to the people and will make every effort to put them into practice.

3. Lessons from Past Experience

(1) Inefficient investment in public works

The first lesson is about the use of the budgets. In spite of a large amount of investment in public works accompanied by an enormous and growing deficit, the Japanese government could not achieve sustainable economic growth based on the results of investment. This is because the same political party was in power for a long time without a break until the change of government in autumn last year and as a result the rigid structure of expenditures was not reformed and investment continued to be made into areas without new employment and growth.

Until the first half of the 80's, when Japan was in the development phase, we did not need to consider the issue of insufficient demand. Improvement of infrastructures (railways and expressways) to support corporations and increase production capacity had a major investment effect and directly resulted in economic growth. In and after the 90's, when basic infrastructures and sufficient supply capacity were available, however, conventional investment in infrastructures was less effective, and demand became insufficient when compared with the supply capacity. Administrations in the past did not understand such changes in the social and economic structures and, without a clear intention to foster growing industries for the future, continued wasteful investments in various existing areas. Enlarged inefficient investment in public works as a fiscal measure against recession did not lead to economic growth or the improvement of people's lives. This resulted in a vicious cycle where enormous deficits were built up and local regions became more and more exhausted.

Under the current circumstances where sufficient demand cannot be generated by private sector activities only, the fundamental economic policies to be formulated by the government should be shifted to measures that stimulate demand by providing goods and services directly resulting in an improvement in the quality of people's lives. In particular, social security services will be needed more than at present in a progressively aging society. By making investment in the social security area, new demand and employment will be created, making effective use of public money. It is necessary to escape from conventional ties and boldly review the uses of budgets by focusing on important areas.

(2) Lack of measures to assure revenues

The second lesson is that revenue reform was omitted even though it was necessary.

The major tax reform recently made in Japan was to change the conventional taxation system that focused on direct taxes to a system with a good balance among taxes on income, consumption and assets. This reform was made under the concept that, in an aging society with fewer children, the costs common to the entire society should be shared among a wide range of people, each of whom need to contribute a little.

However, though sources of public finance needed to be enhanced in order to provide the social security required in a rapidly aging society, in reality, tax reform to assure stable sources of finance was delayed. In addition, tax reductions were repeatedly carried out and tax revenue decreased under a stagnant economy. As a result, the base of tax revenues has become exceedingly weak.

A major role of fiscal policies is to have the costs required for policy implementation shared by the people and to re-distribute the wealth through the policies put into practice. When the revenue source raised by taxes is utilized appropriately, it will benefit the people in total and may result in economic growth. In Japan, however, since the people were distrustful of the government's use of the budget and the decisive political leadership was absent, reforms needed to ensure revenue sources were not implemented with the burdens carried forward into the future. As a result, a large amount of debt accumulated every fiscal year and the people became more and more concerned about the future. Their concern now serves as a weight that is suppressing the economic recovery.

4. Implementation of the New Growth Strategy

Since the Japanese economy has suffered deflation for a long time, even when a phase of economy recovery occurs, the people do not actually feel it. In addition, the tax revenues have not increased by much in nominal values, and the fiscal balance has become worse.

Further, due to the binding effects of unnecessary regulations and systems left by past administrations and lack of concentration in core competencies, demand was not generated in medical, care-giving, child nursing and many other areas in spite of their necessity being strongly felt by the people. In addition, there should be demand from overseas, which has not been insufficiently sought for so far.

In 1) Environment and energy areas, 2) Medical, care-giving and health areas, 3) Asia-related areas, 4) Tourism and local revitalization areas, 5) Science and technology and IT areas, 6) Employment and human resources areas and 7)Financial services areas, regulations and systems should be reformed to generate new demand by creating new markets and employment. The power of growth that Japan potentially possess needs to be activated through such reform in order to get the Japanese economy back on track toward recovery. In addition, a package of policies should be developed, with a view to enhance the economy, the public finances and the social security system at the same time, in such a way that the social security and welfare services that the people need are improved and at the same time their costs are shared by the people (through tax and insurance contributions) This will have the effect of enlarging demand and employment. Further, the government needs to summon all its strength to bring deflation to an end in cooperation with the Bank of Japan.

In addition, there is a large gap between supply and demand at present in the Japanese economy. The supply capacity does not restrict growth in the overall economy. However, when the gap between supply and demand disappears in the future, the possibility of growth being restricted by supply will become higher. Therefore, preparation of an environment where aged people, women and young people can be easily employed or start businesses, development of human resources, innovation promotion and other similar policies as well as financing through tax need to be promoted.

From the viewpoint described above, we aim at a nominal growth rate of over 3% and a real growth rate of over 2% (average of the rates until FY 2020) by implementing the New Growth Strategy integrated with the Fiscal Management Strategy.

5. Reconstruction of the Social Security System

A stable social security system is the foundation that ensures that security and hope can be brought to the people. The social security system tended to be discussed with the focus on burdens and was deemed to be a liability to economic growth. However, the new administration does not share this view. With a stronger social security system, the people feel a sense of security and are able to spend their money. In addition, the social security services encompass many areas that will lead to growth through creation of employment.

As the society is aging with fewer children, it is necessary to reconstruct a social security system that is sustainable and trusted by the people through securing a stable source of public funds for increasing expenditures. For this purpose, the government, local governments, proprietors and users need to play their roles appropriately so as to support the social security system.

Under such circumstances, approaches to lead the increasing expenditures related to the social security to the economic growth effectively are required.

For this purpose, concentration on most important policies should be promoted in the social security area. For example, by shifting from benefit in cash to supply of actual services with effect of employment creation, resource distribution should focus on important measures that will have significant effects on economic growth such as increased consumption or employment.

When implementing social security measures as above, it is necessary to ensure stable sources of finance rather than to rely on government bond issuance in order to increase and maintain the security and reliability of the system. Further, regulations need to be reviewed in order to provide satisfactory services to the people. At the same time, it is necessary to construct an efficient system that thoroughly eliminates the wasting of money to prevent the costs shared by the people from becoming excessive.

6. Fiscal Management Strategy by the New Government - For the Security and Hope of the People -

It is necessary to invest funds in the medical, care-giving and child nursing areas so that they lead to the creation of employment and economic growth. However, easy financing by issuance of government bonds will not result in increasing and maintaining security of the people or restore confidence in the market. In the first place, it is impossible to maintain fiscal management by continuously relying on government bonds when the government has accumulated so much debt.

For greater efficiency in the use of Japan’s public finances, it will be naturally required to thoroughly reduce the wastage of money and to review the use of budgets. First, it is necessary to implement a drastic reform of expenditure, to thoroughly review expenditures, and to assure that the necessary financial sources are available. In addition, provision of services for the people by citizens, enterprises and NPOs under the concept of “New Public" will enhance the fulfillment and happiness of the people, and may possibly result in a reduction in public expenditures.

However, some people may feel that there will be limits on expenditure reduction, which would result in a reduction in public services. If so, based on the concept of sharing the necessary costs among the people, and considering the change in the population structure with a decrease in the working generations and a sharp increase in the proportion of the aged, it is necessary to quickly restore the base of tax revenues, which have become remarkably weak. In other words, taking the opportunity of a change in government, drastic reform of the tax system, which has not been achieved to date, should be implemented. At the same time, expenditures for security and growth should be shared by the people, and the issuance of government bonds, which has expanded too much, will be reduced.

By implementing reforms to revenues and expenditures from a broad perspective as described above, the government will show the people a bright hope for the future, thus eliminating the expectation of continuous deflation and promoting growth and assure sound fiscal status. What is required now is a fiscal management based on these new concepts. We should consider such directions as alternatives in the future.

Considering the enormous gap between annual revenue and expenditure at present and further increases in expenditure resulting from the progressive aging of society in the future, it is obvious that haphazard measures are not sufficient to solve the problems. With a strong political will, without delay or evasion, we should present to the people alternatives on the degree to which annual expenditure will be reduced in the future and how drastic tax reform should be made to assure fiscal resources and implement reforms.

Assurance of the base of financial resources through such reform, construction of sustainable fiscal and social security systems and the thorough preparation of a safety net for the people's lives will create employment and eliminate the people's concern about the future. This will be the base of economic growth. Vitalization of the economy, achievement of a sound economy status and establishment of a social security system are all integrally related. Tax revenues obtained through economic growth are indispensable for achieving a sound fiscal status and, on the other hand, establishment of fiscal sustainability is essential for economic growth. In addition, social security is the largest expenditure item, and at the same time an important growing area. With social security established, the people will be able to consume more. Aim at the integrated realization of a "Strong economy", "Strong public finances" and "Strong social security". This is the "Fiscal Management Strategy" of the new government.

II. Specific Measures

On the basis of the basic concept described above, the following measures will be taken to realize sound fiscal status. Attention needs to be paid to the following points:

1) The government will make every effort to achieve economic growth as the target of the New Growth Strategy. On the other hand, prudent economic forecasts should be assumed when presenting the roadmap for fiscal consolidation. Thus, the reliability of the roadmap will be higher and, if the target economic growth is achieved, the people will receive a far greater reward as a result of further improvements in fiscal balance.

2) Fiscal management always needs to be carried out in an integrated and consistent manner from current and mid- to long-term economic management perspectives, taking the objective economic forecast and the economic and fiscal aspects into consideration. Highly inflexible fiscal consolidation plans have failed in the past. To avoid the same mistake, approaches to achieving fiscal consolidation should be able to respond flexibly to changes in economic circumstances.

3) As the financial crisis in Greece and some other countries has become a major concern, the risk of public debt is seen as an increasingly serious problem in domestic and overseas markets. In order to assure the market's confidence in Japan's fiscal management, approaches toward fiscal consolidation must first of all be honest. The government should strictly refrain from taking the easy approach to fiscal management that involves the transfer of funds between governmental accounts, the shifting of deficits to other accounts or other similar measures. In addition, it is necessary to improve government bond management by focusing on dialogue with the market and to make clear to the domestic and overseas markets the government's strong determination to enforce fiscal discipline.

1. Fiscal Consolidation Targets

(1) Flow Targets

To achieve the Stock Target, fiscal balance should be improved as follows:

1) For the national and local governments primary balance, the deficit ratio to GDP shall be halved from the ratio in FY 2010 by FY 2015 at the latest, and the surplus shall be achieved by FY 2020 at the latest.

2) For the national government primary balance, the deficit ratio to GDP shall be halved from the ratio in FY 2010 by FY 2015 at the latest, and the surplus shall be achieved by FY 2020 at the latest.

3) In and after FY 2021, efforts for fiscal consolidation shall be continued taking the progress against the Stock Target described in (2) below into consideration.

(2) Stock Target

From FY 2021, a stable reduction in the ratio of public debt to GDP for both national and local governments shall be maintained.

(3) Publication and examination of the progress

Considering the current economic forecast and Medium-term and long-term prospects for the economy and public finances, the latest data for various fiscal indices and the progress toward the achievement of fiscal consolidation targets should be examined and published without delay after the outline of the budget is decided for each fiscal year.

If it is judged considerably difficult to achieve the fiscal consolidation targets or to comply with the basic rules of fiscal management because of any material crisis in the international or domestic economy or other circumstances, a change in the timing for the achievement of fiscal consolidation targets, temporary suspension of basic rules for fiscal management or other appropriate measures should be taken. These measures need to be authorized by a Cabinet decision after a clear presentation of the reasons for the measures as well as their contents and scale. At the same time, a roadmap for returning to the path to achieve fiscal consolidation should be presented without delay.

2. Basic Rules of Fiscal Management

Budget formulation for each fiscal year and tax reform shall be made based on the basic rules as described below.

(1) Resource assurance rule (Pay-as-you-go principle)

When a measure involving increase in expenditure or decrease in revenue is to be introduced or enhanced, stable resources to compensate for such increase or decrease shall be assured by permanent reductions in expenditures or permanent revenue-raising measures.

(2) Fiscal deficit reduction rule

To achieve the Flow Targets as described above, the government budget shall be compiled taking the business cycles and other circumstances into consideration so that the fiscal status will be steadily improved year by year in principle in terms of reduction in the amount of government bonds issued, reduction in the dependency on government bonds or improvement in the primary balance.

(3) Securing revenue sources for structural expenditures

For items that are structural factors of expansion of expenditure, such as social security costs required for pension and medical and care-giving benefits, stable resources shall be assured through the reform of both revenue and expenditure.

(4) Basic principles for reviewing expenditure

Wasteful expenditure shall be thoroughly eliminated by constantly reviewing administrative work and projects in all expenditure areas including special accounts and carrying out major budget revisions accordingly. The expenditure items shall be checked considering their contents and nature to see whether they are really necessary and whether they are being executed efficiently.

Transparency shall be assured through appropriate check and disclosure of the circumstances related to administrative work and projects, which will contribute to the elimination of needless expenditure.

(5) Stable management of local government finances

To achieve fiscal consolidation, in addition to the national government's reforms based on this strategy, mutual cooperation is required between the national and local governments that together manage the public sector economy. Local governments are requested to make efforts to ensure sound fiscal management in line with the basic rules of governmental fiscal management as described above. At the same time, the government should consider the question of maintaining independent and stable fiscal management by local governments. It should not take any measures that would undermine their autonomy or shift burdens onto them.

3. Medium-term Fiscal Framework

To achieve the fiscal consolidation targets, it is necessary to compile budgets each year with an outlook over several fiscal years considering the economic and fiscal forecasts and prospects. As a mechanism for such budget compilation, a Medium-term Fiscal Framework for FY 2011 to FY 2013 shall be introduced as follows:

(1) Toward integrated realization of a "Strong economy", "Strong public finances" and "Strong social security system"

The three-year period from FY 2011 is the first stage in which the government will initiate approaches toward integrated realization of a "Strong economy", "Strong public finance" and

“Strong social security system”. The basic concept of the Medium-term Fiscal Framework is to support the achievement of this goal from a fiscal perspective.

Under such circumstances, the following measures will be adopted on both revenue and expenditure: 1) Control of the amount of government bonds issued, 2) Comprehensive tax reform and 3) Achieving the target of primary balance improvement.

(2) Measures on both revenue and expenditure

1) Control of the amount of government bonds issuance

In order to make sure that the fiscal consolidation targets are achieved and to make clear to the market the government’s positive attitude toward fiscal consolidation in order to ensure confidence in the market, the government will make every effort to ensure that the amount of government bonds newly issued in FY 2011 does not exceed the level in the FY 2010 budget (about 44 trillion yen). The government will also make every effort to steadily reduce the amount of newly issued government bonds after that toward the achievement of the fiscal consolidation targets. Therefore, a great deal of effort will be made in the areas of both revenue and expenditure.

2) Measures on revenue

In order to carry out comprehensive reforms of taxes including personal income tax, corporation tax, and taxes on consumption and assets, specific details shall be decided soon. With these reforms of taxes, the revenue required to achieve the fiscal consolidation targets shall be assured. Special taxation measures shall be subject to zero-based review according to the policy presented in the FY 2010 Tax Reform Outline. New taxation-related measures involving reduction in revenue have to be introduced while making sure that there are new resources to cover the reduction in principle.

3) Measures on expenditure

To achieve the fiscal consolidation targets, expenditure shall be permanently reduced for the “primary balance expenses” (expenditure of the government’s general account minus national debt service and the refund to the Settlement Adjustment Fund) during the period from FY 2011 to FY 2013. These expenses shall not, in substance, exceed the level in the initial budget for the previous fiscal year (this amount is regarded as the “Overall Expenditure Limit”), and shall be reduced as far as possible.

Among the above expenses, the treatment of "Contingency Reserve for Economic Crisis

Response and Regional Revitalization" for FY 2011 and subsequent years (1 trillion yen) will be considered in the process of budget compilation, because it is difficult to foresee the economic situation at present.

For the expenditure of local governments, considering the basic rules described in 2. (5), in line with the national government's approaches to reduce expenditure, the total amount of general resources available to local governments, which are required for stable fiscal management of local governments including those receiving grants, shall be kept, in substance, at least at the FY 2010 level.

When any measure that results in an increase of expenditure is to be implemented or enhanced, the required resources shall be obtained by further and permanent reduction in expenditure so that the amount of "primary balance expenses" in the initial budget of this fiscal year shall be contained within the "Overall Expenditure Limit" described above.

To avoid overly inflexible management of expenditure reduction, it is important to enable actions related to revenue measures such as tax reform. For integrated realization of "a Strong economy", "Strong public finances" and "Strong social security system", if permanent increase of revenue is assured through new reform of the system in relation to the introduction of new measures such as a policy package for integrated improvement of various areas including those where demand and employment creation are expected, an amount up to the amount of the permanently assured revenue may be added to the "Overall Expenditure Limit" provided the rules on control of the amount of government bonds issuance described above are complied with. If the assured increase of revenue is temporary, it shall be used for reduction in the amount of government bonds issued.

(Note) The breakdown of the "primary balance expenses" for FY 2011 and subsequent fiscal years will be decided through budget requests and other processes of budget compilation. Local Allocation Tax will be also decided through consideration of fiscal measures for local government finances, taking system reform related to administration and fiscal management of local governments into consideration.

(3) Budget formulation for each fiscal year based on the Medium-term Fiscal Framework

To facilitate budget modification during the budget request phase, a budget request ceiling consistent with the Medium-term Fiscal Framework shall be set for each minister every fiscal year, taking the basic principles governing budget compilation and nature of expenses into consideration. The minister shall, as “Minister of Budget Examination”, make a budget request under the budget request ceiling while making priorities, changing budget distributions and reducing expenditure.

The ministers should make budget requests taking the results of budget screening by the Government Revitalization Unit into consideration. In addition, the ministers shall consider priority criteria for policies in the New Growth Strategy so that existing measures can undergo major revision. They shall modify the budget focusing on those measures that contribute to growth in making a budget request.

Also, in the budget compilation process after the request phase is completed, the ministers shall positively review requests to reduce expenditure.

(4) Revision of the Medium-term Fiscal Framework

The Medium-term Fiscal Framework will be revised around the middle of 2011 considering the current economic forecast and mid-term and long-term economic and fiscal circumstances and prospects so as to establish a new Medium-term Fiscal Framework for the period from 2012 to 2014. Thereafter, the Medium-term Fiscal Framework will be revised around the middle of every year to create a new Medium-term Fiscal Framework for the subsequent three years starting from the following fiscal year. The budget requests and budget compilation for the following fiscal year shall be made according to the Medium-term Fiscal Framework stipulated in each fiscal year.

When revising the framework, measures on both revenue and expenditure for two fiscal years as specified in the existing Medium-term Fiscal Framework shall not be modified in principle. Measures on both revenue and expenditure for the newly added fiscal year shall be also specified so that they conform to the basic rules of fiscal management.

[Exhibit]

Primary Balance Expenses from FY 2011 to FY 2013

(Unit: trillion yen)

	Overall Expenditure Limit		
	FY 2011	FY 2012	FY 2013
Primary balance expenses (Note 1) (70.9 for FY 2010)	71 (See Notes 2 and 3)	71 (See Notes 2 and 3)	71 (See Notes 2 and 3)
Of which: Contingency Reserve for Economic Crisis Response and Regional Revitalization (1.0 for FY 2010)	1.0 (Note 4)	1.0 (Note 4)	1.0 (Note 4)

(Note 1) The term "Primary balance expenses" refers to the amount obtained by subtracting national debt service and the refund to the Settlement Adjustment Fund from the expenditure of general account.

(Note 2) If permanent increase of revenue is assured through new reform of the system in relation to the introduction of new measures such as a policy package for integrated enhancement, for example, an amount up to the amount of the permanently assured revenue amount may be added to the "Overall Expenditure Limit" provided the rules on control of the amount of government bond issuance are complied with.

(Note 3) The breakdown of the "primary balance expenses" for FY 2011 and subsequent fiscal years will be decided through budget requests and other processes of budget compilation. Local Allocation Tax will be also decided through consideration of fiscal measures for local government finances, taking system reform related to administration and fiscal management of local governments into consideration.

(Note 4) The treatment of "Contingency Reserve for Economic Crisis Response and Regional Revitalization" for FY 2011 and subsequent years will be considered in the process of budget compilation.