

ACCELERATION OF ECONOMIC REFORM IN JAPAN AND THE ROLE OF THE COUNCIL ON ECONOMIC AND FISCAL POLICY

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Acceleration of Economic Reform in Japan and the Role of the Council on Economic and Fiscal Policy¹

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ABSTRACT

Creation of the Council on Economic and Fiscal Policy (CEFP) made Japan's economic and fiscal policy making more transparent, consistent and coherent. This new institutional arrangement accelerated structural reform and improved economic and fiscal policy making in general, thus contributing to the recent economic recovery. Success of this new institutional arrangement is, at least in part, attributable to a couple of virtues of CEFP's decision making process: transparency, an economy-wide view and an integrated approach. However, the CEFP is a new institutional setting and not deeply rooted in Japanese political system. In post-Koizumi era, further efforts should be made to make more use of the CEFP as a tool to improve policy making and an engine of economic reform.

(Acceleration of structural reform in the recent past)

Under the Koizumi administration, which started in April 2001, a non-Keynesian economic policy stance has been taken and structural reform such as financial sector reform and regulatory reform has been accelerated, and thus contributing to a recent improvement in economic conditions in Japan.

Particularly important achievement in the last five years includes the following:

- (a) The non-performing loan problem has been resolved and the financial system has been stabilized.
- (b) Deregulation in financial, energy, telecommunication and other sectors has been accelerated.
- (c) Privatization of Japan Post, the biggest financial institution in the world, has been decided.

The economy bottomed out in January 2002 and has been recovering since then. The substantial improvement in Japanese economic conditions is thought, by a majority of economists, to be attributable to progress in structural reform as well as to restructuring efforts by the private sector.

(Economic impact of regulatory reform)

Although it is not easy to quantify impact of structural reform on economic growth or welfare, in the case of regulatory reform, for instance, its cumulative consumer benefits since the beginning of the 1990s was estimated by the Cabinet Office at 14.3 trillion yen (approximately 3% of GDP) in total and 112 thousand yen per capita in FY 2002. Particularly large benefits were brought about by regulatory reform in the areas of trucking, electric power, petroleum products and mobile telecommunication.

Incidentally, regulatory reform issues have been primarily discussed and promoted by the Council for Promotion of Regulatory Reform, an advisory body to the Prime Minister. However, important regulatory reform issues have also been discussed and promoted by the Council on Economic and Fiscal Policy.

(Factors behind acceleration of structural reform)

Acceleration of structural reform and improvement in economic policy making in general are partly due to strong personal commitment of Prime Minister Koizumi to structural reform and enthusiasm of the Ministers of State for Economic and Fiscal Policy under Koizumi administration, but a more fundamental institutional change was creation of the Council on Economic and Fiscal Policy (CEFP) in January 2001. Since the foundation of the CEFP, the decision making process of the government regarding economic and fiscal policies has been improved and those policies have been made more consistent and coherent.

(What is the CEFP)

In January 2001, a major reorganization of the central government was carried out. The main purpose of the reorganization was to strengthen the Prime Minister's initiative and leadership in policy making, and the centerpiece of the reorganization was introduction of the Council on Economic and Fiscal Policy. As a chairperson of the CEFP, the Prime Minister can now set an agenda and play an influential role in economic and fiscal policy making.

The CEFP makes deliberation on all important matters that relate to economic and fiscal policy. A wide variety of microeconomic, macroeconomic and fiscal issues have been discussed in the CEFP, including resolution of non-performing loans, acceleration of regulatory reform in various areas, expenditure and tax system reform. Decisions made by the CEFP become basic government policies through authorization by Cabinet Decisions, which should be reflected in policies and initiatives of relevant ministries.

The CEFP meetings are held at least once a month, and approximately 200 meetings were held in the last five years.

(Membership of the CEFP)

The CEFP is chaired by the Prime Minister and it has ten other members. The current members are the following:

Prime Minister
Chief Cabinet Secretary
Minister of State for Economic and Fiscal Policy
Minister of Internal Affairs and Communication
Minister of Finance
Minister of Economy, Trade and Industry
Governor of the Bank of Japan
Fujio Mitarai, Chairman and CEO, Canon Inc.
Uichiro Niwa, Chairman of ITOCHU Corporation
Takatoshi Ito, Professor, University of Tokyo
Naohiro Yashiro, Professor, International Christian University

The Prime Minister, the Chief Cabinet Secretary and the Minister of State for Economic and Fiscal Policy are permanent members of the CEFP. The last four members² from the private sector were

² They were appointed in October 2006. The previous members from the private sector were Jiro

appointed by the Prime Minister, and their term is two-year but renewable without limit. Private sector members should account for at least 40 percent of all CEFP members excluding the Prime Minister.

It is also noted that other ministers than CEFP member ministers may be invited to attend a CEFP meeting as extraordinary (special) members, depending on an agenda of a particular meeting. For example, when pension reform is discussed, the Minister of Welfare and Labour may be asked to participate in that particular meeting.

(Role of the Cabinet Office)

The CEFP is an organization set up in the Cabinet Office and three Directors General of the Cabinet Office serve as the secretariat of the CEFP. So it seems useful to briefly explain the role of the Cabinet Office at this stage.

The Cabinet Office was established in January 2001 as a part of the major reorganization of central government. This new agency assists the Cabinet in its overall strategic functions. While the individual line ministries are in charge of specific areas of public administration, the Cabinet Office carries out such tasks as planning and overall coordination from its position an echelon (one rank) above other ministries. The Cabinet Office directly supports the Prime Minister in the exercise of his leadership and assists in the policymaking process by conducting planning and overall coordination of key policies. Those policies range over several areas: economic and fiscal management, science and technology, gender equality, natural disaster management and so on.

The head of the Cabinet Office is the Prime Minister, and its top management also includes the Chief Cabinet Secretary and the Ministers of State for Special Missions, including the Minister of State for Economic and Fiscal Policy. The Office consists of a Ministers' Secretariat, seven Directors General for specific fields and four Bureaus.

(Virtues of the CEFP)

The success of the CEFP in promoting structural reform and improving economic and fiscal policy making in general is, at least in part, attributable to a couple of virtues of decision making process of the CEFP: transparency, an economy-wide view and an integrated approach.

(Transparency)

Ushio (Chairman and CEO of Ushio Inc.), Hiroshi Okuda (Chairman of Toyota Motor Corp.), Masahiko Homma (Professor, Osaka University), Hiroshi Yoshikawa (Professor, University of Tokyo).

Before the CEFP was established, important economic and fiscal policies were often decided behind closed doors by bureaucrats of the ministry in charge and interested members of ruling party. But now the Minister in charge has to discuss an issue with CEFP members including the Prime Minister and convince them before he or she goes ahead with his or her proposal, once it is taken up by the CEFP. Furthermore, all discussion at the CEFP is made public, with a very few exception. The CEFP makes a summary of minutes, including speakers' names, public within three days after the meeting and complete minutes within four years. It is also noted that a summary of minutes is fairly detailed. This procedure makes decision making process by the CEFP open and transparent.

This openness and transparency tend to make a final conclusion of policy discussion at the CEFP less prone to be affected by vested interests. First, it is difficult for vested interest groups to push their self-interest too much. Secondly, public opinion sometimes plays an important role in the decision making process at the CEFP. Since discussion at the CEFP is often carried by the press, the general public responds to the news in one way or the other, which may have an impact on a final conclusion. Most often, the public opinion is against vested interests.

This open and transparent decision making process at the CEFP is in sharp contrast with old days. Traditionally any important policy proposals needed to be approved by the ruling party (the Liberal Democratic Party) before they were formally approved by the government. So it was bureaucrats in charge of an individual policy matter and interested LDP members in that matter who made final decisions. It was not clear at all for the general public how policy conclusions were reached. The decision making process was closed and not transparent. It is still true that an approval by the LDP is needed for any important policy proposals, but this process is not as binding as before due to a strengthened leadership of the Prime Minister, who is the President of the LDP as well.

The Prime Minister's leadership in economic policy making was strengthened by the introduction of the CEFP itself. Since the Prime Minister chairs the CEFP, he or she can set an agenda and play an influential role in economic policy making. Also it is often argued that the Prime Minister's leadership was strengthened and power of LDP factions weakened by the introduction of the single-member constituency system in the Lower House in 1994.

(Economy-wide view)

Another strength of the CEFP as an economic policy institution is that most of its members have an economy-wide view and a broad perspective, and therefore it tends to attach more importance to net gains to the economy as a whole from any policy initiative than narrow sectional interests. Again, this is in sharp contrast with old days. It was bureaucrats in charge and interested ruling party

members who decide upon major economic policies, and they were more interested in net gains to a particular sector rather than to a national economy as a whole.

Two CEFP members are from the business sector and the other two from academics. The latter two members are free from any particular interest groups and can make unbiased decisions with an economy-wide perspective. Two members from the business sector may have vested interests in particular industries or companies they represent, but in reality such interests do not seem to have played an important role in policy-making process at the CEFP. This is probably due to the following two reasons. First, minutes of the CEFP will be made public. So, if they favored particular industries or companies they represent too much, their dignity would be impaired. Secondly, the current members from the business sector are both well-respected businessmen who represent Japanese industry as a whole, although they are both involved in top management of particular corporations.

Most of the CEFP member ministers have a horizontal responsibility rather than a sector-specific responsibility. Minister of State for Economic and Fiscal Policy is primarily concerned with macroeconomic development in the short-run as well as in the medium- and long-run. Minister of Finance is responsible for public finance, particularly for that of national government. Minister of Internal Affairs and Communication is, among others, responsible for public finance of local governments. Minister of Economy, Trade and Industry is interested, among others, in improving international competitiveness of Japanese industries. Needless to say, Governor of the Bank of Japan, who is responsible for the conduct of monetary policy, has a very broad perspective. Minister of Internal Affairs and Communication and Minister of Economy, Trade and Industry are in part line ministers. But, all in all, the members of the CEFP from the government side are from horizontal ministries and have an economy-wide view.

Deliberation at the CEFP is supported by three Directors General of the Cabinet Office acting as the secretariat of the CEFP. The secretariat represented by three Directors General does not have any link to vested interest groups and is of horizontal character. This also contributes to neutrality and an economy-wide perspective of the CEFP. However, more than half of the staff members of the secretariat are seconded from other ministries, and this sometimes creates difficulties in supporting deliberation and maintaining neutrality at the CEFP.

(Integrated approach: Economic growth and fiscal consolidation)

In the past, the Economic Planning Agency (EPA; currently the most important part of the Cabinet Office) was primarily interested in economic growth and macroeconomic development, whereas the

Ministry of Finance was basically concerned with fiscal consolidation. However, there was no effective coordination mechanism between these two interests. The EPA was supposed to coordinate economic and fiscal policies, but in reality it was not powerful enough to have the say in those policy matters. Now that the CEFPP is created, both economic and fiscal implications of any policy measures are examined in an integrated, coherent and consistent manner at the CEFPP, with both the Minister of State for Economic and Fiscal Policies (a Cabinet Office Minister) and the Minister of Finance present, and final decisions are made by the Prime Minister if a unanimous agreement is not reached.

In particular, fiscal policy, both expenditure and revenue sides, was exclusively handled and decided upon by the Ministry of Finance in the past. But under the current institutional arrangement, the CEFPP decides upon a basic design of an annual budget, and the Ministry of Finance is responsible for formulating annual budget based on that basic design. This new arrangement guarantees that economic implication of fiscal measures are taken account of, since most of the CEFPP members have an economy-wide view and a strong interest in economic implications of those measures.

(Special role played by the members from the private sector)

Four members from the private sector have played a very important role in economic policy making at the CEFPP. As was mentioned earlier, important policy decisions were mostly made by bureaucrats in charge and interested members of ruling parties. The private sector members are neither bureaucrats nor members of ruling party, and they can make policy recommendations free from any vested interests. In particular, a variety of policy recommendations have been made by two members from the business sector based on their cost-conscious management expertise. Two members from academics have made various proposals based on objective economic analyses.

(Case of pension reform – An illustration)

Take a recent pension reform case as an example of how the CEFPP contributed to reach a more balanced policy conclusion from an economy-wide perspective. This reform agenda was discussed at the CEFPP in 2003. Because of rapidly ageing population and declining birth rates, sustainability of public pension system was questioned and reform plans were discussed at the CEFPP. The Ministry of Welfare and Labour, which is in charge of public pension system, tended to favor a combination of relatively high pension benefits and relatively high premium, while four private-sector members of the CEFPP were in favor of relatively low benefits and premium, taking into account an adverse impact of high premium on economic activities. The Ministry of Welfare and Labour did not pay much attention to the impact of pension reform on economic activities, while the other camp had a wider perspective or an economy-wide view. One of the major issues at that time

was how much we tolerate a rise in the contribution rate in the future. The Ministry of Welfare and Labour proposed that the rate be raised to 20.0 percent in the future from the current rate of 13.85%, a half of which is paid by employers. The private-sector members as well as Minister of Finance, Minister of Economy, Industry and Trade, and Minister of State for Economic and Fiscal Policy argued that such a high contribution rate would have adverse effects on economic vitality. After intense discussion on this issue, it was decided that the contribution rate would be raised to 18.3%, although the final decision was made by the ruling parties, based on prior discussion at the CEF. While the Ministry of Welfare and Labour did not pay much attention to the impact of public pension system on economic vitality, most of the members of the CEF had an economy-wide view and understood that too high a contribution rate would jeopardize economic vitality.

(Case of mixed medical care – Another illustration)

Another example is the so-called “mixed medical care,” which make use of both medical care not covered by public insurance and covered one. Traditionally, if a patient receives both types of medical care, public pension does not pay an uncovered portion or a covered portion, and he or she has to pay all medical expenses, with a very few exceptional cases. The patient side wanted public insurance to pay the covered portion in the case of “mixed medical care.” However, practicing doctors and the Ministry of Welfare and Labour were strongly against that idea. This important but contentious regulatory reform issue was discussed at the CEF as well as at the Council for Promotion of Regulatory Reform in 2003 and 2004. In the end, the “mixed medical care” was partially deregulated, and the covered portion became payable by public insurance in more cases, because the Prime Minister took a position of deregulating it. In this case, leadership of the Prime Minister, which was facilitated by the new institutional setting, i.e., the CEF, was the main engine of regulatory reform.

(Next big policy reform priorities)

In the last five years or so, the focus of economic policy was on reactive reform to overcome aftereffects of the bubble burst such as mounting non-performing loans. Now that the post-bubble era is over, the emphasis of economic policy will be more on proactive reform to cope with medium- and long-term challenges ahead such as ageing of the population rather than reactive or passive reform.

In the “Basic Policies 2006,” which was adopted by the Government this July, the following three priority issues in the coming decade were identified in order to pass on an affluent and secure Japan to future generation.

(i) Enhancing growth potential and international competitiveness

Enhancing growth potential is the basis of all economic policies. With respect to the issue of population decline and the advent of an ageing society facing the Japanese economy, we must overcome it by developing a strategy to promote productivity improvement, technology innovation, and utilization of Asia's dynamism.

(ii) Advancing fiscal consolidation

With the aim of achieving fiscal consolidation, it is essential to draw up the "Integrated Reform of Expenditures and Revenues" and to make utmost efforts toward its realization. In this process, the reform should take a basic stance to rectify the current structure at the earliest possible stage, and to make citizens feel reassured by establishing sustainable social security systems.

(iii) Achieving a safe, secure, flexible and accommodating society

There is growing public concern about the future and strong public interest in safety and security, not only in internal affairs but also in external relations. There are also increasing needs for access to diverse options and second-chance opportunities at every life-stage. In light of these circumstances, the Government will achieve a safe, secure, flexible and accommodating society by effectively using the fruits of economic growth.

The second issue is probably easy to understand even for non-Japanese readers, since it is well-known that Japan's current fiscal conditions are the worst among G-7 countries. However, the first and the third ones may need some explanation. The first issue concerns economic efficiency, whereas the third one has to do with equity as well as other social objectives.

With China, India and other emerging economies rapidly catching up, there is a concern that Japan will lose its international competitiveness in many manufacturing sectors in not-so-distant future. In addition, Japan's ageing and declining population is expected to have an adverse impact on its growth potential. Against this background, enhancing growth potential and international competitiveness by increasing labour participation, improving labour productivity and other means is perceived one of the most important economic policy objectives in the coming decade.

There is a growing concern about widening income inequality in recent years. Sustainability of the social security system is also an anxiety to many Japanese. Crime rates have risen in recent years, and there is also a growing concern about natural disasters such as big earthquakes in Tokyo metropolitan and some other areas, because of a prolonged period of no big earthquake in those areas. In this sense, it is increasingly important to achieve a safe and secure society in the coming decade by

addressing these problems.

(Remaining regulatory reform issues)

Within the area of regulatory reform, (i) increased competition in the agricultural sector by, for example, entry of business corporations and (ii) reduced restriction on entry of foreign workers are two important remaining issues. They are remaining since they are both very difficult issues to start with. If they had been easier, they could have been resolved earlier. There are strong vested interest groups in the area of agriculture to protect the status quo and their political influence is very powerful. There are pros and cons regarding acceptance of more foreign workers in the Japanese labour market, and there is no political consensus yet among the Japanese people about this issue, although need for more foreign workers is becoming more and more apparent in view of declining and ageing population. Anyway, the government needs to tackle more and more difficult regulatory reform issues now compared with, say, five years ago, against the background of economic recovery and stronger temptation to complacency.

(Market testing)

Within the area of regulatory reform, a full-fledged introduction of market testing is also a priority at the moment. Market testing is a system whereby public services provided by the national and local governments are thrown open to competitive tendering between the public and private sector bidders under transparent, impartial and fair conditions of competition. The contract is awarded to the bidder offering the best combination of price and quality.

Market testing is designed to expose public services traditionally performed by civil servants to the discipline of competition. Regardless of whether a contract is won by a public or private entity, substantial efficiency gains can be expected and public services will improve in quality, yet cost less. Market testing has already been implemented in such countries as Australia, the United Kingdom and the United States.

The government is currently promoting a full-fledged introduction of this system as one means of improving public services. Again, this is a very challenging task, since the public sector has traditionally dominated the markets concerned and enhanced competition among public and private organizations is required in the case of market testing, whereas more competition is required but restricted to the private sector in most of previous regulatory reform agendas.

Line ministries tend to argue against market testing, since they will lose their jobs if contracts are won by private organizations. Again, the CERP is an appropriate mechanism to put forward market

testing, because its members are mostly ministers with horizontal responsibilities and representatives from the private sector, and none of its members has any strong incentive to argue against market testing.

(The post-bubble era to normality)

Now that the Japanese economy has overcome the post-bubble malaise and come back to normality, there is a risk that enthusiasm for economic reform will be weakened. In the last ten years or so, the government and the private sector were, in a sense, forced to carry out economic reform and restructuring to get out of economic malaise triggered by the bubble burst at the beginning of the 1990s. Prime Minister Koizumi was personally very eager and committed to carry out economic reform. It is really hoped that the same eagerness and enthusiasm will be sustained in the coming years to promote proactive reform to cope with medium- and long-term economic challenges. Any complacency should be avoided.

(Challenges ahead)

Under these circumstances just mentioned above, it is imperative to maintain or even strengthen the function of the CEFPP in economic and fiscal policy making process. A fundamental question for us is how to make the CEFPP function well even after the Prime Minister Koizumi retired in September 2006. As was mentioned earlier, an important reason for the success of the CEFPP as an engine of structural reform was Prime Minister Koizumi's strong personal commitment to making use of the CEFPP as the most important institutional mechanism to foster structural reform. We do not know yet whether successors will attach the same importance as Mr. Koizumi to the CEFPP.

Theoretically the CEFPP can take up any important economic and fiscal issues and discuss them, but in reality what issues to be taken up depends on views of the Prime Minister, the Minister of State for Economic and Fiscal Policy and other leaders of the Cabinet. LDP leaders may also play an important role in the selection process. There is no automatic guarantee that the CEFPP will deal with most of important economic and fiscal issues.

One way to bind future administrations was to make decisions during the Koizumi administration on medium- and long-term economic and fiscal issues. Actually, the Koizumi administration adopted the "Integrated Reform of Expenditures and Revenues" in July 2006, based on discussion at the CEFPP. This medium- and long-term fiscal consolidation plan up till mid-2010s is expected to bind future administrations' fiscal policy to a considerable degree.

However, this is a second best approach. A first best approach may be to make an institutional

arrangement in such a way that all important economic and fiscal policy issues are taken up by the CEFP automatically irrespective of the Prime Minister's and other influential ministers' views and so on.