

# Mizuho Economic Outlook & Analysis

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## Tax and fiscal reform in the “Basic Policies 2007”

Summary :

1. The spending cut scheme in the “Economic and Fiscal Reform 2007” (“Basic Policies 2007”) is the same as that in the “Basic Policies for Economic and Fiscal Management and Structural Reform 2006” (“Basic Policies 2006”). The Abe Administration deserves commendation for showing a firm attitude toward fiscal consolidation by spending cuts, as the former Koizumi Administration did. There are problems, however, from the standpoint of the budget process, such as the lack of revised budget estimates and the reflection of budget estimates in the spending cut program.
2. Regarding the long-term issue of fiscal policies, the Basic Policies 2007 proposes the deliberation on social security reform including debate on the value-added tax (VAT), referred to as the “consumption tax” in Japan. However, the government does not present any framework of social security reform. The government should start to build infrastructures for social security reform such as long-term budget estimates of about 50 years.
3. As to local taxes, the Basic Policies 2007 proposes the deliberation on the introduction of “hometown taxes” and reforms of corporate local taxes. The government regards local tax reforms as measures to correct disparities in tax revenues among local governments. However, the Abe Administration does not appear to understand why the disparities in tax revenues among local governments arise before local tax reforms. The substantial disparities stem mainly from the fact that current local tax systems violate local tax principles in which the local tax burden should be borne by residents. In effect, many non-residents pay taxes to a particular small number of local governments. Therefore, the government should eliminate the revenue disparity problem by reforming the local tax system to meet local tax principles.

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## **1. Introduction**

On June 19<sup>th</sup> of 2007, the Council on Economic and Fiscal Policy (CEFP) decided upon the Basic Policies 2007. The Basic Policies 2007 is the seventh of its kind starting in 2001 and is composed of three parts as follows: ① enhancing growth potential, ② establishing an administrative and fiscal system suitable for the 21<sup>st</sup> century, and ③ realizing a sustainable and safe society. Since the Basic Policies 2007 does not put emphasis upon particular policies, it lacks appeal and gives the impression of a mere collection of policy proposals. While the Basic Policies 2007 sets forth fiscal consolidation by spending cuts as the Basic Policies 2006 did, it does not address the specifics of many important challenges.

This paper focuses upon tax and fiscal reform in the Basic Policies 2007 and discusses the “integrated reforms of expenditures and revenues,” “tax reform,” “budget system reform,” and “decentralization reform.” The paper will first review the policies in the Basic Policies 2006 and the “Direction and Strategy for the Japanese Economy” (hereafter the “Direction and Strategy”), and point out what should be necessary for better policies and policy-making in the future.

## **2. “Integrated reforms of expenditures and revenues” in the Basic Policies 2007**

### **(1) “Integrated reforms of expenditures and revenues” so far**

The fiscal goals and strategies set forth in the “integrated reforms of expenditures and revenues” in the Basic Policies 2007 are the extensions of those in the Basic Policies 2006 and the Direction and Strategy. In the Basic Policies 2006, the Koizumi Administration defined the goals of fiscal consolidation as the achievement of a “primary surplus of the central and local governments in FY 2011,” and the “reduction in the debt of the central and local governments as a share of GDP around FY 2015.” To attain the goals, the government declared that drastic spending cuts would be prioritized and if spending cuts were not enough to attain the goal of a primary surplus in FY 2011, tax hikes would be added.

The spending cuts in the Basic Policies 2006 were 11.4 to 14.3 trillion yen (**Figure1**). Considering the economic situation at the time, the necessary amount of spending cuts and tax hikes was determined as 16.5 trillion yen, with 2.2 to 5.1 trillion yen to be covered by the increase of taxes.

**Figure 1 Spending cuts in the following 5 years**

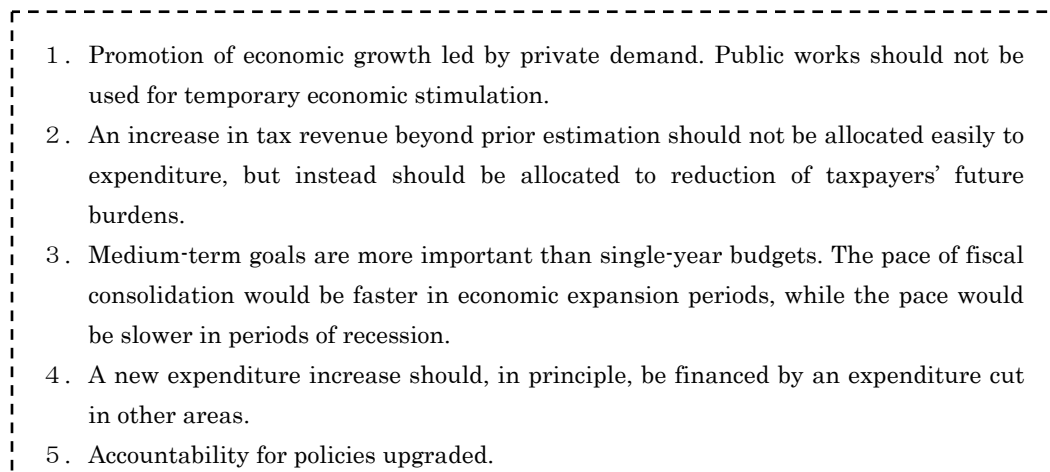
	FY2006	FY2011	FY2011	The amount of spending cut
		Natural growth	After reform	
Social security	31.1 trillion yen	39.9 trillion yen Growth rate : 5.1%	Around 38.3 trillion yen Growth rate : 4.3%	Around 1.6 trillion yen
Personnel expenses	30.1 trillion yen	35.0 trillion yen Growth rate : 3.1%	Around 32.4 trillion yen Growth rate : 1.5%	Around 2.6 trillion yen
Public works investment	18.8 trillion yen	21.7 trillion yen Growth rate : 2.9%	Around 16.1~17.8 trillion yen Growth rate : -3.1~-1.1%	Around 3.9~5.6 trillion yen Growth rate : [ Central government : -3%~-1% Local government : -3%~-1% ]
Other sectors	27.3 trillion yen	31.6 trillion yen Growth rate : 3.0%	Around 27.1~28.3 trillion yen Growth rate : -0.1~0.7%	3.3~4.5 trillion yen Growth rate : [ Science and technology : +1.1% ~Economic growth rate ODA : -4%~-2% ]
Total	107.3 trillion yen	128.2 trillion yen Growth rate : 3.6%	Around 113.9~116.8 trillion yen Growth rate : 1.2~1.7%	Around 11.4~14.3 trillion yen
	The amount of spending cuts and tax hikes which are necessary for a primary surplus in FY 2011 : 16.5 trillion yen Spending cuts : 11.4~14.3 trillion yen Tax hikes : 2.2~5.1 trillion yen			

Note: The sum of the central and local governments. Growth rates are calculated by the author.  
 Source: Made by the author, on the basis of the "Basic Policies 2006."

Since the release of the Basic policies 2006, economic activities have recovered, and the budget estimates have been altered in the Direction and Strategy released by the Abe Administration in January 2007. The new estimates suggest that if the spending cut program in the Basic Policies 2006 were implemented, the goals of fiscal consolidation would be attained without a tax hike. In the case of spending cuts of 14.3 trillion yen, a primary balance of the central and local governments would turn positive (+0.2% of GDP) in FY 2011 without a tax hike. In the case of smaller spending cuts (11.4 trillion yen), a primary balance of the central and local governments would remain negative (-0.1% of GDP), but the balance would still approach zero. Based upon the estimates, there is a consensus that a tax hike is unnecessary to attain a primary surplus in FY 2011, despite the increase in the public pension burden of the government in FY 2009. Therefore, it is important to keep in mind that the discussion on the VAT rate hike is not for a primary surplus in FY 2011, but is intended to address the long-term needs arising from medical care, nursing care, and countermeasures for the declining birthrate.

The Direction and Strategy also sets forth budget-making principles for the purpose of avoiding easy increase in spending and tax. Among the principles included are that “an increase in tax revenue beyond prior estimation should not be allocated easily to expenditure, but instead should be allocated to the reduction of taxpayers’ future burdens,” and that “a new expenditure increase should, in principle, be financed by an expenditure cut in other areas” (**Figure 2**).

**Figure 2 The budget-making principles set forth in the Direction and Strategy**

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1. Promotion of economic growth led by private demand. Public works should not be used for temporary economic stimulation.
  2. An increase in tax revenue beyond prior estimation should not be allocated easily to expenditure, but instead should be allocated to reduction of taxpayers’ future burdens.
  3. Medium-term goals are more important than single-year budgets. The pace of fiscal consolidation would be faster in economic expansion periods, while the pace would be slower in periods of recession.
  4. A new expenditure increase should, in principle, be financed by an expenditure cut in other areas.
  5. Accountability for policies upgraded.

Source: “Direction and Strategy” (January 25<sup>th</sup>, 2007). Translated by the author.

## **(2) “Integrated reforms of expenditures and revenues” in the Basic Policies 2007**

The “integrated reforms of expenditures and revenues” in the Basic Policies 2007 set forth the continuation of the government’s schemes on fiscal consolidation. The proposals (**Figure 3**) are as follows: ① the five-year expenditure reform specified by the Basic Policies 2006 will be steadily and systematically carried out, ② the current efforts for reform of expenditures as a whole will not be relaxed, and maximum reductions will be achieved at the central and local governments in line with the Basic Policies 2006, ③ disciplined fiscal management will be conducted in line with the principles of budget formulation set forth by the Direction and Strategy (**Figure 2**), ④ the shift of burdens to future generations will be avoided by securing a stable supply of revenue sources to cover the increase in burdens caused by social security services and the declining birthrate which cannot be covered by thorough expenditure reforms. Furthermore, as specific measures, ① public work reforms including the reexamination of public work programs formulated in the past, ② promoting the “Program for improving quality and promoting efficiency in the medical and nursing care services,” ③ specifying reform measures to pursue further reduction of personnel

costs of civil servants to exceed that shown in the Basic Policies 2006 (approximately 2.6 trillion yen).

**Figure 3 Integrated reforms of expenditures and revenues in the Basic Policies 2007**  
**(Excerpt)**

- The proposed reforms
  1. The five-year expenditure reform specified by the Basic Policies 2006 will be steadily and systematically carried out.
  2. The current efforts at expenditure reform as a whole will not be relaxed, and maximum reductions will be achieved at the central and local governments in line with the Basic Policies 2006.
  3. Disciplined fiscal management will be conducted in line with the principles of budget formulation set by the Direction and Strategy.
  4. The shift of burdens to future generations will be avoided by securing a stable supply of revenue sources to cover the increase in burdens caused by social security services and the declining birthrate that cannot be covered by expenditure reform.
- Specific measures
  1. Public work reforms: efficiency enhancement, abolition of collusive bidding, continuation of cost reduction, etc.
  2. Social security reforms: promoting the “Program for improving quality and promoting efficiency in the medical and nursing care services,” public hospital reforms, etc.
  3. Specifying reform measures to pursue further reduction of personnel costs of civil servants to exceed that shown in the Basic Policies 2006 (approximately 2.6 trillion yen).

Source: “Basic Policies 2007” (June 19<sup>th</sup>, 2007). Translated by the author.

The size of the spending cuts presented in the Basic Policies 2007 is the same as that of the Basic Policies 2006. The basic stance of the Abe Administration is understandable because it is rather strange to change the medium-term goals of fiscal policies substantially every year. Overall, it is commendable that the Abe Administration presented a firm attitude on the attainment of the goals of fiscal consolidation by spending cuts.

However, from the perspective of the budget process, there are some problems that the government did not present new budget estimates. According to the Basic Policies 2006, budget estimates are reviewed every year because of the difficulty to predict an exact outlook for economic activities and revenues. Meanwhile, the Basic Policies 2007 does not comment on how the changes in budget outlooks affect the spending cut programs. The Basic Policies 2007 could have compared the current budget outlooks

with past outlooks, and have reconsidered the spending cut programs based upon new budget estimates. More importantly, the Basic Policies 2007 could have conducted budget estimates in light of transparency of the budget process.

There are also problems on long-term fiscal issues. Other than the five-year-spending cut program in the Basic Policies 2006, there is no concrete plan on the long-term budget situation in the Basic Policies 2007. It only states that the “shift of burdens to future generations will be avoided by securing a stable supply of revenue sources to cover the increase in burdens caused by social security services.” While the Basic Policies 2007 implies that the VAT rate hike would cover the cost of social security services spending in the future, it does not set forth any long-term budget outlook.

In other words, the government is not prepared to discuss long-term fiscal issues including a VAT rate hike. Barring reliable long-term estimates of social security service expenditure, the discussions on VAT might be distracted by emotional arguments among stakeholders. In light of transparency of the budget process, the government should release a long-term budget outlook of about a 50-year budget window, as other major countries already do, and decide upon long-term spending and revenues on the basis of estimates before discussing specific reform plans.

### **3. Budget-making process reforms in the Basic Policies 2007**

It is not that the Basic Policies 2007 does not care about the transparency of the budget-making process. The Basic Policies 2007 refers to the budget-making process and proposes the following points (**Figure 4**): ① strengthening the strategy and comprehensiveness of budget formation by drafting a “Budget Overview <sup>1</sup>,” ② maintaining the consistency between each fiscal year budget and medium-term targets of fiscal consolidation, ③ drafting the budget under clear principles, ④ reflecting policy assessments to efficiency of budgets, among others.

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<sup>1</sup> The “Budget Overview” presents a basic guideline to reflect the goal and intention of the “Basic Policies” to each budget.



**Figure 4 : Budget-making process reforms in the “Basic Policies 2007” (Excerpt)**

1. Strengthening the strategy and comprehensiveness of budget formation through the compilation of a “Budget Overview.”
  - The elimination of sectionalism in ministries and agencies, budget formation consistent with economic situations, etc.
2. Securing the consistency between the budget of each fiscal year and medium-term targets of fiscal consolidation
  - Budgets must be consistent with medium-term goals of fiscal consolidation described in the Direction and Strategy. Public work spending in the budget must be consistent with Basic Policies and Direction and Strategy for the year.
3. Budget-making principles
  - Budget-making based upon the principles described in the Direction and Strategy.
4. Reflections of policy assessments to budgets
  - Policy assessments are reflected in budgets under the cooperation of the CEPR and other ministries.
5. Reexamination of budget and settlement of accounts
6. Improvement of annual reports

Source: “Basic Policies 2007” (June 19<sup>th</sup>, 2007). Translated by the author.

The so-called “single year budget mantra” must be abolished for the consistency of the budget with the goals of medium-term fiscal consolidation. It is commendable that the reform of the budget-making process in the Basic Policies 2007 presents a kind of policy framework to abolish the “single year budget mantra.” However, while the reform of the budget-making process argues the consistency of a budget with the medium-term goals of fiscal consolidation, the lack of numerical tools such as medium-term fiscal estimates weakens the argument for the maintenance of consistency.

In the current budget-making process, the medium-term budget estimates of the Direction and Strategy are regarded just as a reference. Ideally, the medium-term budget estimates should be officially built into the budget-making process, and be revised several times<sup>2</sup>. Then, the subsequent budget-making process should be based upon new estimates. Similar procedures may already be conducted within the government. However, since medium-term budget estimates are not released, it is unclear how budget outlooks affect the goals of fiscal consolidation in the “integrated reform of expenditures and revenues.” To enhance accountability, the government should build a system in which budget estimates are released and used in the policy-making process.

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<sup>2</sup> For example, in the U.S., medium-term budget estimates by the administration and the Congress, respectively, are revised twice a year.

#### 4. Tax reform and decentralization of the government in the Basic Policies 2007

Lastly, we shall turn to tax reform and decentralization of the government in the Basic Policies 2007. The Basic Policies 2007 addresses tax reforms which are rarely noted in the previous Basic Policies. The “principles of tax reform” presented are : ① the acceleration of economic growth by innovation and open economic system, ② the attainment of a variety of lifestyles and economic activities, ③ the realization of equality within and between generations, ④ the composition of safe and sustainable schemes of tax and social security, ⑤ the decentralization of the government, ⑥ the maintenance of the government’s credibility among taxpayers, and the construction of an equal and efficient tax collection system (Figure 5).

**Figure 5 : The principles of tax reform in the Basic Policies 2007 (Excerpt)**

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1. The acceleration of economic growth by innovation and open economic systems
    - Comprehensive reform to enhance economic and productivity growth.
    - Reform of capital income taxes to urge people to take more risk.
  2. The attainment of a variety of lifestyles and economic activities
    - Construction of tax systems which do not distort selections of work, marriage, and childbirth.
  3. The realization of equality within and between generations.
    - Supporting people who are genuinely in need of public help, eliminating the immobilization of inequalities between generations.
  4. Building safe and sustainable schemes of tax and social security
    - Deliberation on social security reforms and countermeasures for the declining birth rate should be started, based upon several plans as to the size of benefits and burdens.
    - Stable revenues are secured if spending cuts are not enough to cover the increase in social security services costs. New burdens are not transferred to future generations.
  5. The decentralization of the government
    - Considering the disparity of corporate local tax revenues among local governments, tax resources between the central and local governments should be reexamined in order to narrow the disparity.
  6. Ensuring the government’s credibility among taxpayers, and constructing an equal and efficient tax collection system.
    - Deliberation on the introduction of a taxpayer identification number system.

Source: “Basic Policies 2007” (June 19<sup>th</sup>, 2007). Translated by the author.

“The acceleration of economic growth led by innovation and open economic system” refers to the reinforcement of economic growth and productivity growth by constructing

tax systems including capital income taxes to boost risk money by urging people to take more risk. The “attainment of a variety of lifestyles and economic activities” refers to tax systems in which taxes do not distort selections of work, marriage, and childbirth. “Building safe and sustainable schemes of tax and social security” includes social security reforms and countermeasures for the declining birthrate, as well as deliberation on plans regarding the size of benefits and burdens. However, as noted before, there are no concrete plans on social security reforms and long-term fiscal estimates. Lastly, to “ensure the government’s credibility among taxpayers, and construct an equal and efficient tax collection system, the Basic Policies 2007 proposes the deliberation on the introduction of a taxpayer identification number system.

Meanwhile, the policies proposed in the “decentralization of the government” include a “New decentralization bill” which must be submitted to the Diet within three years and the deliberation on local tax reforms and fiscal system reforms based upon the “Basic approach for promoting decentralization reform: nation building initiated by the local governments” (released on May 30<sup>th</sup>, 2007) by the “Decentralization reform committee” (**Figure 6**). The integrated reforms of subsidies, local allocation taxes, transfer of tax revenues, and the release of interim reports on the “Regional system” are also proposed.

**Figure 6 : Decentralization of power of the government in Basic Policies 2007 (Excerpt)**

1. A “new decentralization bill”
  - “Decentralization reform plans” are made based upon the “Decentralization Act,” and a “New decentralization bill” will be submitted to the Diet within three years. The “Decentralization reform committee” will reexamine the role of the central government and local governments, and will submit interim reports this fall.
2. Local tax reforms
  - Integrated reforms of subsidies, local allocation taxes, transfer of tax resources.
  - Given the disparity of corporate local tax revenues among local government, tax resources between the central and local governments should be reexamined to narrow the disparity.
  - Deliberation on a tax system in which taxpayers can support hometowns or local governments.
3. Reforms of local branches of government
4. The acceleration of the deliberation on the “Regional system.”
  - Interim report on philosophies and grand visions of the “Regional system.”

Source: “Basic Policies 2007” (June 19<sup>th</sup>, 2007). Translated by the author.

As to local tax reforms, the deliberation on the “hometown taxes<sup>3</sup>” and reforms of local corporate taxes are proposed. The Basic Policies 2007 addresses “hometown taxes,” proposing “the deliberation on a tax system in which taxpayers can support hometowns or local governments.” Regarding reforms on corporate local taxes, the Basic Policies 2007 proposes “the deliberation on reforms which eliminate disparities in tax revenues among local governments.” However, since the Basic Policies 2007 does not provide any concrete plan as to “hometown taxes” and reforms on corporate local taxes, the course of corporate local tax reforms will depend completely upon discussions this fall.

The drawback of the proposals on local taxes is that they do not include principles on corporate local taxes. While principles on national taxes are provided, principles on local tax are not presented. It is essential to consider “hometown taxes” and corporate local tax reforms from the viewpoint of local tax principles. One of the principles on local taxes is that local taxes should be borne by those who take benefit because local taxes are to cover costs of public services provided by local governments. This is referred to as the “cost-benefit principle<sup>4</sup>.” Meanwhile, the shift of tax burdens to non-residents is called the “tax exporting.” Local taxes should be designed to meet the cost-benefit principle and to fend off tax exporting.

Under the “hometown tax system,” local governments must provide public services to residents who transfer a part of their tax burdens of individual local taxes to other local governments. Since the use of “hometown taxes” by residents serves to impair the cost-benefit principle, hometown taxes are undesirable as local taxes.

Current corporate local taxes also violate the cost-benefit principle. To understand this, it is necessary to consider the incidence of corporate local taxes. When corporate local taxes are levied on firms, firms must absorb the tax burden in some way. Firms would shift the tax burden to workers, investors, or consumers, by way of lowering the wages of workers, reducing dividends or raising prices of products. However, workers, investors, or consumers do not necessarily inhabit the local area which levies corporate local taxes. Rather, it is natural to think that many of these workers, investors and consumers are non-residents. Thus, the cost-benefit principle fails, and many non-residents in effect pay corporate local taxes to a particular small number of local governments. This is a basic mechanism of spawning revenue disparities among local governments. Therefore, corporate local tax reforms that meet the cost-benefit principle would narrow the disparity substantially.

Regrettably, the Basic Policies 2007 perceives the challenges regarding corporate

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<sup>3</sup> One proposal of “hometown tax” is that taxpayers can transfer a part of their individual local tax (10% maximum) to any prefecture that they wish.

<sup>4</sup> Or, the “principle of sharing of the tax burden.”

local taxes only as disparity problems and does not discuss the challenges from the point of local tax principles. This perception does not produce any obvious criteria of how local tax systems should be reformed, hence often leading to proposals on taxes which come in conflict with local tax principles. The idea of hometown taxes appears to come from the fact that the administration perceives problems on local taxes only in light of revenue disparities among local governments.

However, given that the disparity problems of tax revenues among local governments stem from violations of the local tax principles, it is obvious that the next necessary step is to construct local tax systems that meet local tax principles. The disparities among local governments which remain even after the local tax reform should be adjusted by subjective judgments upon fiscal equality among local governments. However, the current situation has not reached the level at which such subjective judgments are necessary to settle the disparity problem on tax revenues. The administration must clarify the local tax principles that are not mentioned in the Basic Policies 2007, and to construct local tax systems that meet these principles.

## **5. Conclusion**

Although the Basic Policies 2007 includes a variety of reforms, it does not necessarily represent the administration's strong position on structural reforms. Regarding fiscal consolidation, it is commendable that the administration has presented a firm attitude of continuing to cut spending. However, the administration failed to provide even a basic stance for long-term fiscal issues including social security reforms. The Basic Policies 2007 is also insufficient for its failure to point out that disparities in tax revenues among local governments are caused by the violation of local tax principles. Furthermore, the lack of transparency in the budget-making process remains a challenge.

The remaining challenges mean that the assessment of tax and fiscal reforms of the Abe Administration depends upon the results of reforms not clarified in the Basic Policies 2007. The government should tackle the remaining challenges in a proactive manner in discussions this fall.

