

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

Japan's Budget Process

by Mieko Nakabayashi, Research Institute of Economy, Trade and Industry

A little before US Congress received the FY 2004 budget request from President Bush, Prime Minister Koizumi's Council on Economic and Fiscal Policy announced its policy priorities for the new year on January 20. High on the Council's priority list is Fiscal Structural Reform – though budget discipline is important to Washington policymakers, Japan's situation is far more dire.

Necessary Fiscal Structural Reform

Deficit financing by the Japanese Government has been the worst among the major industrial countries for some time. Seemingly blinded by hopes for a fast business recovery, the government failed to implement effective measures to address the burst of the bubble economy in the early 1990s, while conditions ever-worsened.

The government has not been entirely idle; since August 1992, large-scale economic measures have been undertaken, more than 12 supplemental budgets adopted, permanent tax cuts implemented, and an economic stimulus plan to boost public investment was enacted. But none produced the anticipated economic effects.

Faced with this grim reality, the Council on Economic and Fiscal Policy this year finally put fiscal structural reform as the nation's top priority.

Achieving systemic reform will not be easy, however – resistance from politicians and government bureaucrats is deep-rooted. But as long as Japan continues accumulating huge deficits, the budgeting system as a whole must be reconsidered.

Japan's Budget Process

Japan's annual budget is adopted through a parliamentary/cabinet system. Unlike in the United States, where the Congress has Constitutional authority over formulation of the budget, in Japan that authority resides in the Prime Minister's cabinet. Thus, when the budget document is submitted to the Diet during the end of January, it is not the beginning of budget

formulation, as in the United States, but rather the final result of budget deliberations following the completion of negotiations among the majority political parties and the ministries.

Work on the budget for the next fiscal year (which commences on April 1), begins months in advance. Once the budget has been enforced, the settlement of accounts takes place during the following fiscal year. Thus, one entire budgetary cycle requires approximately three years.

The process of formulation typically begins in June of the previous year; and the submissions of preliminary estimate documents by the various ministries are made at the end of August of that year. In order for the budget to be passed by the Diet during that fiscal year, the budget needs to be approved by the House of Representatives at least 30 days prior to the start of the new fiscal year (i.e., the beginning of March). To allow for sufficient deliberation, the cabinet should submit the budget proposal to the Diet in January.

The Finance Ministry's Budget Bureau has primary authority to formulate the budget, a role roughly equivalent to that of the US Office

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WTO Services Negotiations
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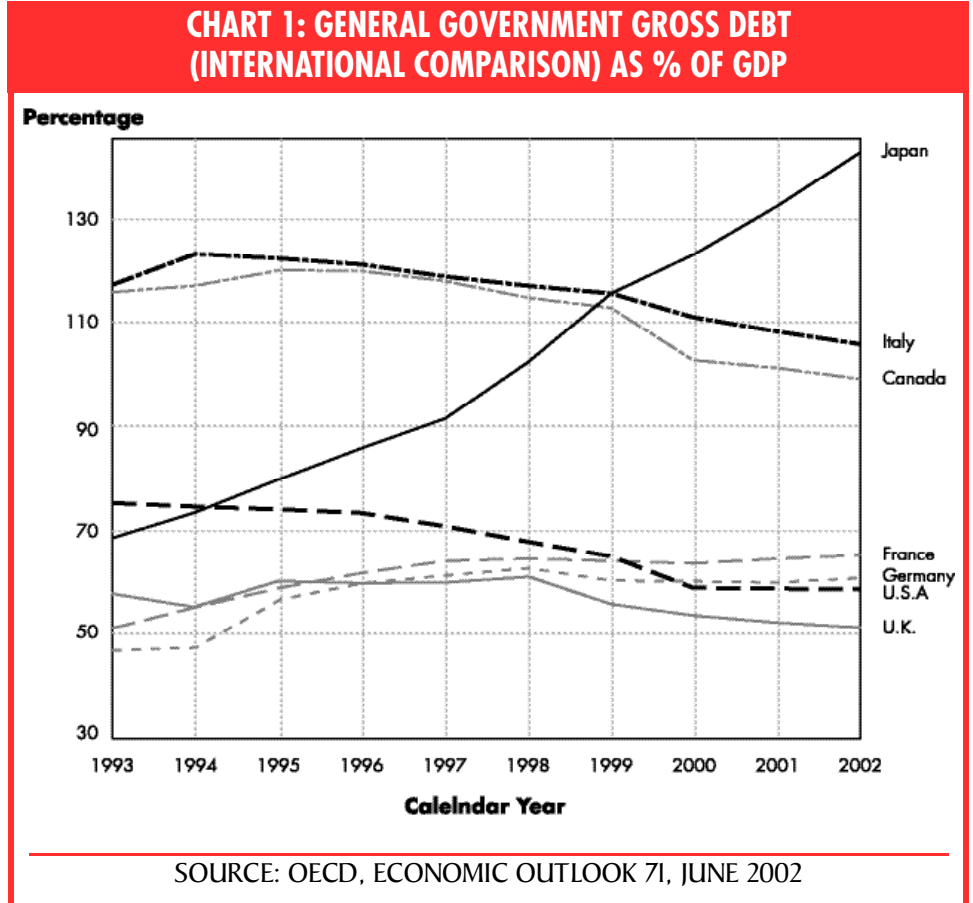
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of Management and Budget (OMB) and the budget committees of the Congress. Its primary responsibility is to incorporate the budget requests of the various ministries and agencies into a final budgetary framework.

In carrying out this function, the Finance Ministry sets forth the basic principles that are then used by the various ministries and agencies to roughly estimate their budgets. These estimates are then reviewed to weigh whether their financial effects will be neutral or stimulative to the business climate and to calculate income and taxes.

After adjustments are made within the scope of anticipated finances, the Finance Ministry presents its unofficial first draft of the proposed budget. In parallel, anticipated revenues including taxes and income from the issuance of government securities are calculated. Minor adjustments to expenditure levels are worked out through "revival negotiations" with the ministries and agencies, after which the proposed budget is submitted to the cabinet for decision. Once the cabinet has issued its approval, the proposed budget is then submitted to the Diet for consideration.

This budgetary formation process underwent some changes following



the restructuring of the ministries and agencies during 2001. One key change was the creation, within the Cabinet Office, of the Council on Economic and Fiscal Policy, which was tasked with taking the lead on making recommendations on basic policies, from the time of basic drafting through final budget formulation. Whether or not the Council's proposals are adopted as policies is left to the discretion of the Prime Minister. This results in some cases in which there are competitions with the Finance Ministry, which formerly held the

main role in budget formulation, and/or with policy drafting councils within the ruling political parties.

In the United States, the President exercises control over the executive branch through political appointments. But in Japan, the Council on Economic and Fiscal Policy cannot readily bring the ministries, agencies, and ruling political parties' councils into line.

When the budget document is submitted to the House of Representatives, it is subject to deliberations in the Budget Committee and hearings before

being voted upon. Upon approval, it is sent to the House of Councilors for consideration. But if the upper house is unable to build sufficient consensus for a vote within 30 days, or if the House of Councilors drafts a different proposal that a joint conference is unable to reconcile, then the original vote of the lower House of Representatives is the final word.

In the US, the Senate and House each present a budgetary resolution and this necessitates an effort to reach consensus through a joint conference committee. But in Japan, the deliberations in the Diet are not so substantial. Those of the Budget Committee frequently involve politicking, such as the revelation of scandals. This may perhaps stem from the fact that prior to the budget document's having reached the Diet, all negotiations between the ruling political parties and the ministries/agencies have been completed.

In the US, the Congressional committees are staffed with technical experts who are engaged in legislative work. But in Japan, it's the bureaucrats themselves draft legislation. Collaboration and competition among political parties within the law-drafting committees, which characterizes the U.S. system, hardly exist in Japan. Furthermore, Japan's legislative arm does not have

budgetary support institutions dedicated to the Diet comparable to the U.S.'s Congressional Budget Office or the General Accounting Office.

At the close of the fiscal year, following review by the Board of Audit, the Cabinet submits the relevant accounting documents, together with its report, to the Diet's Committee on Audit. But because the settlement of accounts does not require a vote, even if there is criticism concerning the execution of the budget, the effect is minimal. Thus there is no incentive in trying to reduce expenditures.

In principle, should a surplus occur in a certain program as a result of the settlement of accounts, it can be carried over as available revenue for the following year. But in reality, because fiscal law stipulates that no less than half of that surplus must be used as revenue to reduce the public debt, it is clearly more rational for the ministries and agencies if the money is not saved, so it is difficult to make the claim that this system results in saving money.

Make-up of the Budget

There are four types of budgets in Japan: the general account budget, special account budgets, budgets for government-related organizations, and the Financial Investment and

Loan Plan (FILP). Each is submitted to the Diet by the Cabinet for deliberation.

Budgets not subject to parliamentary consideration are those for the various types of public corporations, quasi-government corporations, and government-sanctioned corporations; these are subject only to monitoring and oversight by ministries and agencies. Huge subsidies (approximately 3 trillion yen for FY2002) have been injected into these special corporations; and the government is recently showing efforts to conduct reforms, including privatization, to control costs.

The Japanese government has pooled huge funds since more than 100 years ago as the Meiji and Taisho era governments established postal savings accounts, postal life insurance and a postal pension system. Until FY2000, the Finance Ministry contributed most of the funding, primarily through government-related organizations.

But subsequently, due to unnecessary public works and economic stimulus measures involving FILP funds, these programs have wasted money. Thus the operating method for FILP was modified during FY2001 – henceforth, each components had

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to be independently managed within the financial markets.

Plenty of Japanese citizens continue to deposit in these institutions, however: postal savings at the end of March 2000 reached 255 trillion yen and postal life insurance funds registered 112 trillion yen. Although the FY2001 budget for FILP declined to approximately 33 trillion yen (from 53 trillion yen in 1999), compared to about 86 trillion yen for the general account budget, it was still enormous. Nor have criticisms about business inefficiencies, lack of transparency in the way money is distributed, balance sheet liabilities, and the hemorrhage of government funds resulting from lack of profitability abated. Public interest in improved information disclosure and rationalization remains high.

Another significant issue that Japan faces is the financial nexus between the local and central governments. The national budget for FY2002 was approximately 81 trillion yen, of which about 20 percent (17 trillion yen) was redistributed to local governments.

In the United States, state governments set their own corporate and consumption taxes. Japan, by contrast, has a virtually uniform nationwide local tax system that creates significant discrepancies in

the way that localities are able to obtain revenues, depending upon the regional economy. So, the central government distributes funds collected through national taxation on a variable basis to local governments in which the financial base is weak, in order to ensure certain levels of government services. Recently, however, some localities have attempted to manage more independently, partly because their budget deficits are exploding. Some local governments are beginning to make changes and even present requests to the central government to reform its relationship with the localities.

Budget formulation is the very foundation for national policy making. Deficit financing and cumulative debt, which Japan continues to expand at an alarming speed, increasingly restrict the government's options in dealing with the economic situation or the changing social environment, and are becoming a financial burden on future generations.

Public financing is not a matter of simply crunching abstract numbers. Instead, its function is to support the kind of country its citizens want and to sustain it into the future. For that reason, governments must listen to how its people say they want to live.

Recommendations

Japan would need an institution somewhat similar to the U.S. Congressional Budget Office if it wants to have healthier political and legislative debate among the political parties, including opposition parties, with budgetary cost estimates. "Sunshine" laws which open policy-making to public scrutiny helps citizens make informed judgments, would promote real competition between the political parties.

Finally, although Japan's budget is based on a single-year and cash accounting basis, review on a multi-year basis needs to be considered in order to make effective use of funds. In order to accurately assess the status of revenues and to calculate the costs of policies, the accrual method of accounting should be helpful. Including more emphasis on cost performance evaluation, a cool review of Japan's entire budget formulation process is long overdue. ■

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WTO SERVICES NEGOTIATIONS

by Linda Schmid, Coalition of Service Industries

Japan has established its leadership role in the World Trade Organization (WTO) as a member of the “Quad” group of leading economies that traditionally prompt action in the organization. Japan’s assumption of a leadership role is critically important because it will host the “Mini-Ministerial” meeting of WTO trade ministers in Tokyo February 15-16. For it is in Japan that every effort must be made to break the impending impasse on agricultural issues by a March 31, 2002, deadline so that real progress can be made on services – an area where Japan and the US have very important goals.

Services, essential inputs into the production of virtually all products, are of tremendous economic importance to the world economy. Services negotiations in the WTO will focus on the liberalization of inter alia audiovisual, distribution, education, energy, environmental, express delivery, financial, telecommunications, travel and tourism, and professional and business services.

Total world trade in services in 2000 stood at some \$2.3 trillion, about one-third of total trade in goods and services. The US current account that year recorded a surplus on trade in private services of \$78

billion, which offset 17.2 percent of the \$452 billion merchandise trade deficit.

US-Japan Services Trade

Bilateral private services trade in 2001 totaled \$30,182 million in exports and \$17,162 million in imports. “Affiliated transactions” (intra-firm trade within multinational companies), amounted to \$4,016 million in U.S. exports to Japan. “Unaffiliated transactions” (those with foreigners that neither owned, nor are owned by, the U.S. party to the transaction) amounted to \$4,821 million in U.S. exports to Japan. In turn, the U.S. imported affiliated transactions from Japan totaling \$2,656 million and unaffiliated transactions from Japan totaling \$1,076 million.

The US and Japan are both active participants in the WTO services negotiations. In the WTO, Japan has set forth proposals in energy services, movement of natural persons, and education services. It has also urged WTO negotiations in business, telecommunications, audiovisual, distribution, and financial services.

The Coalition of Service Industries (CSI) has prepared a Guidebook of services priorities that address these sectors and others for WTO negotiations.

Following are highlights of some top priorities, beginning with the most important: transparency in domestic regulation.

Transparency

CSI very strongly believes that WTO services negotiations should result in cross-cutting disciplines to promote greater regulatory transparency for services. Regulatory practice in the services sector has developed unevenly and often at odds with the market access and national treatment commitments of WTO members. As a result, industries in both emerging and developed markets have been frustrated with regulatory barriers, ill-defined rules, and red tape. A transparent and fair regulatory system is a precondition for the liberalization of services. In certain service areas, sectoral agreements or scheduling can be used to lay out additional transparency requirements.

This across-the-board approach would allow negotiators to respond flexibly to the particular needs of each sector while building on the transparency disciplines for all sectors. General transparency commitments should be sought in three areas: (A) Standard-setting; (B) the Regulatory Application

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Process; and (C) Judicial, Arbitral, or Administrative Tribunals.

Temporary Movement of Key Personnel

All global companies must send their workers to meet the needs of customers and clients around the world on occasion, and often on quick notice. The growing volume of international business requires the deployment of skilled personnel for short-term assignments. WTO members should provide for the multiple entry of key business personnel such as managers and highly skilled technicians with visas that allow for expeditious processing and entry to perform temporary work assignments.

Telecommunications

Efficient modern communications systems underlie dynamic service economies. In the WTO, countries should make commitments consistent with the GATS Telecom Annex and Basic Telecom Reference Paper (i.e. provide full market access and national treatment for basic telecom services, value-added network services, and computer and related services.)

Countries with phased-in commitments should implement them at the earliest date possible and ensure pro-competitive, cost-based interconnection and non-discriminatory access to unbundled

elements of basic telecommunications networks and services. They should also provide non-discriminatory, cost-based access to all communications platforms for value added services, and commit to ensuring rights of way, number portability, and resale. Countries should also commit to a fair, transparent, and pro-competitive regulatory process and to regulatory independence. And finally, they should allow new entrants and new technologies the freedom to respond innovatively without burdening them with traditional telecommunications regulation.

Banking, Securities and Related Financial Services

The stability of domestic financial markets is reinforced by the healthy participation of local and international firms on a non-discriminatory basis which encourages them to invest capital, talent and technology in markets that demonstrate regulatory strength and transparency. In order to maximize the significant contributions that financial services bring, negotiators should secure substantive commitments including:

- Removing barriers to the participation of foreign investors in the financial sector and allowing competitive operations through wholly owned subsidiaries, branches or other forms of presence.

- Removing “economic needs tests” and other geographic or product-specific restrictions.
- Committing to “grandfathering” (i.e. retaining) existing investment in operations and activities.
- Scheduling commitments to support financial services provided cross-border, without any reservations.
- Scheduling commitments to support the provision and transfer of financial information, financial data processing and the provision of advisory and software related services.

Countries should also implement “forward-looking factors” such as:

- Expanding the scheduling of commitments to improve market access and national treatment for asset management and pension fund services provided by the full range of financial services firms.
- Removing discriminatory treatment of capital requirements applied to foreign bank branches.
- Seeking commercially meaningful access commitments from countries in the process of WTO accession negotiations consistent with the 1997 Financial Services Agreement and the above goals.

Insurance

CSI has developed a “Proposed Model Schedule for Future Insurance Commitments by WTO Members” Schedule that provides a basis for seeking a structured pattern of minimum commitments on insurance and a template for assessing whether countries have offered an acceptable set of commitments. Aimed at giving greater specificity and predictability to the insurance sector, the CSI Schedule identifies commitments regarding market access and national treatment.

The text builds on existing commitments and incorporates certain specific obligations to remove ambiguities and to ensure those commitments are built into the more general obligations. And the Schedule sets forth obligations not addressed clearly in current schedules, including specified timeframes and standstill provisions to protect acquired rights.

The Schedule also addresses “Best Practices in Insurance” – additional commitments under GATS Article XVIII, including domestic regulation not addressed by the market access or national treatment provisions (transparency, solvency and prudential issues, regulation of monopolies, and independent regulatory authority).

Unlike the first part however, the best practices would be uniformly adopted by a critical mass of countries in the GATS negotiation, or by bilateral trading partners in free trade agreements.

Energy Services

Agreements on energy services should ensure the broadest possible market access commitments. Providers should have the opportunity to distribute their services through all four modes of supply. Classifications for energy services should be flexible and cover the full array of commercial activities to encompass repair and maintenance, as well as new energy activities and technologies.

Energy services providers should also be allowed to import, on a temporary duty-free basis, tools of the trade and equipment essential to the provision of those services. And finally, they should also be able to secure temporary entry of essential personnel.

Countries should adopt regulatory systems that provide:

- Transparency in the formulation, promulgation and implementation of rules, regulations, licenses, technical standards, and arbitration and judicial review;

- Non-discriminatory third-party access to, and interconnection with, energy networks and grids.
- An independent regulatory authority separate from, and not accountable to, any supplier of energy services.
- Transparent, objective and timely procedures for the allocation of scarce network resources, such as transmission capacity and rights of way.

Conclusion

The United States and Japan have common areas of interest in the WTO services negotiations; the governments of both countries should work together to eliminate those services barriers that impede international trade. With the upcoming mini ministerial of the WTO in Tokyo, Japan has the opportunity to clear the way for successful WTO services negotiations for all the WTO members. ■

Linda Schmid is Vice President of CSI, a business advocacy organization dedicated to the reduction of barriers to international trade in services (<http://www.uscsi.org>).