

## **Opportunities for a DPJ-led government to achieve sustainable fiscal reform**

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### **Inside the DPJ: change that Japan can believe in?**

After nearly fifty-five years in power, there is a significant probability that Japan's Liberal Democratic Party (LDP) will be unseated as the largest party in Japan's House of Representatives and replaced in government by the opposition Democratic Party of Japan (DPJ). With less than three weeks until the general election, the LDP trails by a substantial margin in public opinion polls: a recent *Yomiuri Shimbun* poll showed that the DPJ enjoys considerable support in both single-member districts and regional proportional representation blocks, while recent *Sankei/FNN* poll found respondents overwhelmingly concerned with issues seen to favor the DPJ, namely social security and economic countermeasures to overcome the recession.

The voting public has the social safety net and the state of the economy at the top of its agenda. Meanwhile, it may be argued that Japan's postwar economic model and thus its system of government is broken. The legacy of Japan's all-too-recent deflationary past, combined with the present global economic crisis has created deep fissures within the leading party over its platform; LDP leaders are divided over whether to reinforce urban-based neo-liberal party desired by former Prime Minister Koizumi Junichiro or to return to the rural-based, culturally and economically traditionalist LDP of old. In fact, many expect maverick reformer Koizumi himself to assume a role in the opposition, although conveniently he is leaving office this year. "It's not so bad to take the position of the opposition party every once in a while," he said.

In the face of a barrage of criticism of its governing credentials and lack of experience in leadership, it is possible that the merits of a DPJ leadership (rather than the LDP's forfeit of executive power) have been underestimated. The DPJ, only a decade old, has arguably become a legitimate contender for power. Its victory in the 2007 upper house elections made the DPJ the upper chamber's largest party, at the height of the most recent economic cycle; in July 2007 the Abe Cabinet judged that consumption and business investment were "increasing" while corporate profits and employment were "improving". As such victory in the Upper House itself was no economic cry for desperation, but could be seen as a "pro" vote for the DPJ, the result of a lengthy process of remaking the DPJ into a pragmatic, center-left party geared towards winning elections.

Much of the credit for the party's transformation goes to former party president Ozawa Ichiro. From the time Ozawa merged his Liberal Party with the DPJ in 2003 he has worked to remake the DPJ into a more competitive party. He refocused the party's attention on rural areas in which the party had done poorly in the past. He drafted pragmatic, centrist candidates with experience in local and prefectural legislatures, the national bureaucracy, and the private sector. He forged a compromise with the party's left wing on foreign policy, which has proved durable.

Meanwhile, the DPJ's unity as a political party (and not merely the opposition) may be under-estimated. There are several reasons for the party's unity. First, the notion that the party is simply comprised of exiles from the LDP and the former socialist parties is vastly overstated. The vast majority of the DPJ's incumbent members of the lower and upper houses have spent their entire careers as DPJ members. Former LDP and SP members may be overrepresented in the party's executive and shadow cabinet, but there is a simple reason for this: the party's most senior members by necessity began their careers in other parties, recalling that the DPJ has only existed for a decade. For instance, Party President Hatoyama Yukio may have begun his career as an LDP member, but has spent a greater part of his political career out of the LDP than in the LDP.

Moreover, as the opposition party, the DPJ has worked to forge a consensus on matters of central concern to the Japanese public. The party touts the importance of administrative reform. As we saw under the Koizumi administration, reform has become one of the Japanese electorate's consistent demands. The

party's signature plans for direct income support for farmers and for child allowances answer directly to expressions of public concern; social security reform (motivated for in no small part by Japan's graying population) likewise occupies a central part of the DPJ agenda. The party is visibly divided on foreign policy yet the importance of this division may be overstated. So long as economic and fiscal reform occupies the DPJ's central agenda, the party is likely to favour maintaining status quo on foreign policy. The importance of success in 2010 upper house elections (which could potentially win the DPJ an outright majority) must not be overlooked; it is highly likely that the DPJ will expend limited political capital on foreign policy during its first year in office, at least. Additionally, the Obama administration's inclinations to refrain from exerting pressure on Japan for troop contributions in Afghanistan (an issue that would be controversial within the DPJ) will probably help to keep foreign policy low profile for now.

One of the key factors distinguishing the DPJ from the LDP in its potential effectiveness as a political party is that the DPJ leadership is strong relative to the party's backbenchers. Importantly, the DPJ has not copied the LDP's system of committees that parallel the government's administrative structure to facilitate deliberation of policy (and compromise) with bureaucrats. The DPJ moreover lacks the LDP's general council, a council of party elders that has wielded a veto over cabinet decisions. Practically speaking, a DPJ-led government would face fewer veto players within the party capable of stalling government policies or rendering them "toothless". The leadership's power vis-à-vis backbenchers is further reinforced by the gap in years of service between the party's leaders and its backbenchers. In fact, the gap might only increase following a DPJ victory in general elections as party's ranks swell with new first-term members.

The party plans even further to strengthen leaders' power over backbenchers by appointing more than 100 ruling party politicians to government positions, in effect giving party leaders a tool to discipline members. The DPJ also plans to weaken the power of the ruling party in policymaking relative to the Cabinet by "unifying cabinet and ruling party," bringing leading party politicians into the cabinet. Policy deliberations would effectively take place among cabinet ministers instead of between cabinet ministers and ruling party politicians outside the government's formal chain of command.

Favouring a Westminster-style parliamentary cabinet, the DPJ plans not only to expand the power of the prime minister's office (the aim of reforms undertaken under Prime Ministers Hashimoto and Koizumi) but also to make the cabinet the locus for national policymaking, transferring decision-making authority from the bureaucracy to the Cabinet. Most important among those powers is the power to formulate budgets. This is possible without constitutional reform, as Japan's constitution does formally assign budget-making authority to the cabinet. In practice however bureaucrats in the finance ministry and other ministries have wielded considerable power for most of the postwar era. The Council on Economic and Fiscal Policy (CEFP), an advisory group attached to the prime minister's office established in 2001, shifted some responsibility for budgeting to politicians and civilian advisers, creating a "fast track" for decisions reached in the Council to implementation (within one fiscal year). The DPJ plans to replace the CEFP with a national strategy office, headed by a cabinet member that among other responsibilities will draft an outline for the budget. The DPJ intends to create an NSO during its first months in office, although it might well have to wait for tax revenues to recover in excess of debt service costs before it consolidates general and special accounts under such a body.

Clearly, a revolution in how Japan is governed will not be achieved in a single Diet session or even a single four-year term, and will not be accomplished simply by passing laws. If victorious, the DPJ must be prepared for a long, patient struggle to implement new customs and informal practices in the relationship between governing politicians and bureaucrats. As such, the DPJ will probably benefit from the presence of a number of retired bureaucrats among its ranks, prepared to make some tactical compromises. Accordingly, in the weeks leading up to the election, senior party leaders have been meeting regularly with the administrative vice ministers of the leading ministries, the finance ministry in particular. For its part the finance ministry has been trying to establish a modus vivendi in advance of a DPJ government, which implies that some co-operation might be expected from the bureaucracy's most formidable body with a new leadership.

It is also clear that the DPJ will face considerable challenges in implementing its plans for Japan's

government. One major obstacle exists within the party: Ozawa himself. It is unclear what the DPJ will do with Ozawa should it win the general election. If Ozawa remains in a party post but does not enter the cabinet, he could potentially undermine the new leadership's efforts to close the gap between cabinet and ruling party. If Ozawa were to disagree publicly with the government whilst occupying a DPJ (but not government) post, furthermore garnering support from party loyalists, he might effectively wield an external veto over government policy, which would undermine the DPJ's plans for transparent, centralized government, reverting to the negotiations between ruling party and cabinet characteristic of the current leadership.

On the other hand, if Ozawa is included in the government, the DPJ will face the challenges of according him a position of importance as a political strategist free from the day-to-day administrative duties of a minister, without undermining Hatoyama's position as prime minister. The DPJ does not appear to have a ready answer for this challenge and the risk remains that Ozawa will use his clout to undermine the cabinet as he pursues an independent agenda.

Another challenge for the DPJ remains its balance of power with the bureaucracy. Although the leading government ministries are preparing for a DPJ government and appear disposed to cooperate, the DPJ will likely be challenged by spending ministries, like the ministry of agriculture, forestry, and fisheries (MAFF). The DPJ has already engaged in a war of words with MAFF's administrative vice minister, who earlier this year said that the DPJ's plans for agriculture were "unrealistic", prompting Hatoyama to retort that in Britain — the DPJ's model of choice — he would be sacked for political interference. Should the DPJ take over, there remains a risk that the bureaucracy's more disgruntled constituents might retaliate by waging a media war to scuttle the government.

Ultimately the task facing a DPJ government is clear. For Japan to meet the challenges of the age, in power the DPJ will have to limit the influence of veto players to influence the government's agenda. These include bureaucrats, ruling party barons and backbenchers, opposition parties, interest groups: these actors, who under the LDP's traditional system of government have wielded, arguably, excessive power to interfere with policymaking and halt or reverse reform. On one hand, the times demand a government that is free to experiment, to float trial balloons, launch test programs, and otherwise search for a way to transform Japan's economy for a new age. On the other hand, a DPJ government will be under time pressure to show some tangible results, by achieving a return to sustainable, non-deflationary economic growth.

### **Towards a new basis for growth**

If the DPJ actually wins on 30 August, it will be afforded a significant opportunity to supplement Japanese growth by introducing small but effective efficiencies in fiscal policy, creating a more solid platform for longer-term structural reforms. The task, as DPJ secretary-general Okada Katsuya stressed in a meeting with Keidanren, Japan's leading industrial organization, will be to turn to a growth model centered on domestic demand.

The DPJ's disposition toward laissez-faire market policies and embrace of BOJ autonomy is the first step in weaning Japan off of interventionism designed to reinforce export-led growth. The DPJ's realist approach to market policy is timely, given the potentially permanent change in one formerly predictable contributor to Japanese growth. Before the DPJ can proceed in fixing Japan's economy however, it is necessary to diagnose its ailments correctly. Earlier this year, Japan's shockingly negative growth readings popularized Japan-bashing. Doomsayers pointed to Japan's two quarters of double-digit contraction, on an annualized basis the steepest in the OECD. These fears were reinforced by the trade-led decline of Japan's current account into deficit territory.

There were, however, two mistakes in interpreting the record decline in Japanese exports as the demise of the country as a whole. Japan has been a surplus nation for decades, which has allowed it to build an adequate buffer for an external shock such as this one. The Japanese household, for instance holds 1.5 times Japanese GDP in cash savings alone. Although many argue that Japan, in the wake of its own crisis, has

never allowed consumption — nearly 60% of GDP — to drive growth, it is probably more relevant to argue that with external demand (responsible for 11-16% of Japanese GDP) effectively and predictably acting as an engine for growth, Japan has never *needed* to allow such a shift to happen — at least, until now. Notice how quickly drivers of negative growth shifted from exports to private investment between the fourth quarter of 2008 and the first quarter of 2009, even though exports continued to experience the largest percentage declines year-on-year. The dip was driven moreover by radical cuts to production and inventories by Japan's most competitive industries, which by no coincidence are also Japan's largest exporters, and replenishment of inventories is likely to make a positive contribution going forward. Yet with exports still at half year-ago levels and orders still volatile, Japan can ill-afford to remain passive in the expectation that recovery in overseas demand to restore growth to above-potential levels.

The challenge facing Japan's government is obvious: diversifying the Japanese economy's base of growth from over-dependence on expansion of external demand. The financial crisis has indeed undermined Japan's postwar economic model, yet has created the potential for a reform-oriented administration to tap Japan's plentiful private-sector wealth. If elected, the DPJ might find itself heir to a fortunate legacy; fiscal stimulus enacted in the supplementary FY08 and FY09 budgets, totaling roughly 5% of GDP, represents a large pool of capital ripe for optimization to raise low Japanese productivity and close its output gap. With potential GDP languishing at around 1%, the bar is low. But first the opposition must correctly identify where stimulus might have its greatest effect on growth.

### **Understanding Japan's crisis**

Working in Japan's favor is that the current financial crisis is not endemic to Japan. As Prime Minister Aso Taro has repeatedly stressed, the crisis began in America, which also happens to be the market that provided Japan with many years of export surpluses. Although certainly affected by the global financial crisis it is not Japan's. Japan is in fact more resilient in the face of the current crisis precisely *because* it only recently overcame its own crisis, which ended in 2003, after total losses realized on bank NPLs peaked. Since then, the reluctance of banks to increase risk-taking has at once sheltered their balance sheets from the crisis overseas and limited investment in Japan's services sector, which comprises 70% of GDP.

Understanding the taxonomy of Japan's crisis and its recovery is important to understanding Japan's current resilience in the face of the ongoing external shock. Following the double shocks in the Japanese property and stock markets, private sector Japan was forced to deleverage, creating the conditions for a "balance sheet recession" in the words of Nomura economist Richard Koo. The government was then compelled to compensate for the rise in private-sector savings (and corresponding drop in consumption and private investment) by engaging in consumption and investment of its own, which while sometimes of dubious long-term value, did staunch the rise in unemployment and prevented the destruction of gross domestic product.

Government-bankrolled support for employment however bore a limited multiplier; productivity declined, and with it, potential growth. The OECD and BOJ both estimate Japanese potential GDP growth at around 1%, versus nearly 4% in the late 90's. The drop in potential GDP was one contributing factor to a rise in excess capacity, which bred a deflationary environment, upon which consumption grew dependent, in a low-productivity environment. The unsustainability of a deflationary environment became apparent as asset deflation undermined banks' balance sheets and hence confidence in the banking sector, encouraging further hoarding of cash. Government funds were then tapped to prevent the banking sector from compounding the negative spiral, pushing the fiscal balance further into the red. Ultimately, the government's aid to the banking sector was successful in putting an end to the crisis when non-performing assets were transferred at market value, allowing banking sector assets to trough. The government has since recovered over 70% (as of 2007) of its non-performing bank assets. Nevertheless, by offsetting investment and consumption foregone by the private sector during Japan's post crisis era, the government's balance sheet ballooned — on a gross basis to nearly 200% of GDP and net (more consistently with OECD measures) to near 100%.

The task is no longer one of how to staunch the hemorrhaging of private sector wealth, but one of disbursing amassed wealth to contribute positively to sustainable growth, preferably whilst returning select portions of the government's balance sheet to the private sector; ostensibly those assets that might be more productively employed by commercial interests. Incorporating reduction of the government's balance sheet would be one very tangible fiscal benefit of the DPJ's smaller government approach.

### **How the DPJ can restore growth — and fiscal stability**

While the DPJ has gone a long way to prepare itself to take power — refining its manifesto, devising transition plans, forming a shadow cabinet — there are still shortcomings in the party's policy plans. Economic and fiscal policy may be the biggest hole in the DPJ's election manifesto. In response to criticism that greeted the release of its manifesto, the DPJ made some edits that stressed certain preexisting policies (child allowances, free secondary education, toll-free roads) at components of the party's economic growth strategy aimed at increasing households' disposable income.

These proposals are a start, and they suggest that the DPJ understands the nature of the challenge, but they do not go far enough — and as critics have suggested, create new holes in the budget that will have to be filled if Japan is to control its finances. What follows are several proposals to address the twin challenge of shifting the bases for economic growth while fixing the government's finances, imperative as Japan's population ages.

Comprehensive fiscal reform might require the better part of a decade, as former LDP Prime Minister Koizumi Junichiro learned in his own reform efforts. As the DPJ itself the opposition is unlikely to prove able to loosen the bureaucracy's grip on public coffers in one fell swoop. The necessity for reflation before wide-scale structural reforms (at least those of the public balance-sheet reducing variety) that confronted the Koizumi administration following the banking crisis is likely to remain a necessity for the DPJ's own approach. That said, there is significant scope for the DPJ, utilizing measures already approved under the current administration, to make headway on the economic recovery requisite to structural reform. While far from exhaustive, keys to success most likely include the following:

- **A target for balance:** The DPJ should retain the basic balance as a benchmark for fiscal policy success.— while unrealistic to assume a surplus in 2011 as projected pre-crisis, they key is to create measurable annual targets for reduction of the basic balance deficit. Formation of such targets will help to balance goals of spending with increases in revenues. This way, there also remains some allowance for interim increases in debt servicing costs, which come from the special account (ex basic balance) rather than the general account, thus delaying the drag on finances from eventual rate rises. Meanwhile, a rise in tax revenues from newly profitable firms should increase tax revenues, decreasing the need for new debt issuance. Greater financial sector revenues might eventually provide a windfall for the government, if banks are able to increase margins on lending following recovery in the wider economy. Gradual attenuation of the special account and incorporation of its revenues into the general account might progress as tax revenue growth accelerates beyond the rise in debt service costs.
- **Indefinitely postpone consumption tax hikes:** Despite the need to increase tax revenues, the DPJ should demonstrate familiarity with principles of equivalence, by eschewing discussions of consumption tax hikes until consumption is firmly in positive territory. Widening the corporate tax base (as discussed in point 4) might enhance tax revenues, but disposal of government-owned assets is perhaps the quickest win to boost public coffers in the interim.
- **Clean up the government's balance sheet:** Perhaps most importantly, the DPJ should continue with the IPO of Japan Post in FY2010. Controversy over postal privatization is superficial where in regard to Yucho and Kampo (postal savings and insurance, respectively). While these institutions are currently 100% government-owed, their massive pools of assets are managed on behalf of the private

sector. The benefits of privatization are manifold. First and foremost, the IPO will be one source of revenue for a cash-strapped government, without cutting costs or raising taxes. Secondly, a newly profitable private sector entity will now become taxable, making Yucho/Kampo a source of tax revenues rather than expenditure. Thirdly, this will create more opportunities for private-sector asset managers, who will be tasked with increasing returns on pools of previously government-controlled assets. Fourth, privatization-related IPO's historically have been enormously supportive of the Japanese stock market. Recall the effects of privatization of Japan Railways and NTT in the late eighties. Asset appreciation is anti-deflationary; stock market gains will translate to household investment income increases, which if significant should bolster household wealth and thus consumption.

- **Broaden the corporate tax base:** The DPJ could partner with the private sector on fiscal reform, to increase multipliers and limit taxpayer burdens. Both encouragement of foreign inward investment as well as reward-based incentives for greater productivity for SMEs are relevant here. The Japanese services sector, which comprises roughly 70% of Japanese GDP, represents a much less productive face of Japanese industry than the ultra-competitive export-oriented manufacturing sector. SMEs, disproportionately hard-hit by the financial crisis, are much more prevalent in the non-manufacturing sector. The low productivity and thus profitability of the SME-dominated services sector has a negative fiscal impact. One need only refer to the OECD's statistics on the Japanese tax base: only half of large Japanese corporates pay taxes, only one-third of Japanese firms overall. The solution is to widen the corporate tax base even if this means lower the tax rate, as to incentivize companies to become profitable. This also means, of course, that a DPJ government would have to work harder to enforce collection. The other part of the solution is to encourage sustainable tax revenues, by ensuring that greater fiscal assistance to SME's links with greater productivity. To do this, the DPJ must establish productivity metrics for incentive-based SME grants, loans and subsidies.

The goal of this program must be one of *sustainable* growth: instead of hurling populist rhetoric about "market fundamentalism," the DPJ should be developing a sustainable model for Japanese capitalism in the twenty-first century. It should be sustainable in several ways. Firstly, the model should be environmentally sustainable, geared towards reducing Japan's environmental footprint. It should be socially sustainable, in that it ensures that the Japanese government has revenue sufficient to meet the Japanese people's demands for social security. It should be globally sustainable, in that it incorporates the strategic use of foreign capital and labor to by Japanese businesses — without completely throwing open Japan's doors, which in any case is politically unacceptable. Finally, it should be regionally sustainable, in that it ensures adequate growth to sustain the populations remaining in depopulating rural areas.

A DPJ government will not be able to implement this vision over the course of a single term. But a historic change of government is the perfect opportunity for Japan to begin the hard work of overhauling its economic model. The choice does not have to be between preserving the old model that drove Japan to its position as the world's second-largest economy and embracing neo-liberalism wholesale. Should the DPJ successfully implement its administrative reforms — an indispensable first step to structural reform — it will have the ability to chart a new course for the Japanese economy. Sustainable growth should be the watchwords for the refurbished model