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August 09, 2010

Craft, Community, and the Cost of Global Capitalism

By Kato, Hideki

At a time when baskets mass-produced in China can be had for a few hundred yen, who would pay a hundred times that for a similar basket—an everyday item, after all—laboriously hand-woven in conformance with traditional Japanese techniques? That consumer selection would weed out such items and doom them to extinction on the marketplace seems inevitable. "It's too bad," we say, "but that's life."

But before we dismiss handwork as a quaint relic of the past, we need to understand just what it is we are dismissing. The creation of a single hand-made object entails a multitude of processes, beginning with the gathering of materials. Hand-woven textiles, for example, require not just weavers but also people to spin the thread, dye it, and so forth. Those occupations shape the lifestyles of the people engaged in them, and those lifestyles differ from one another as a result. In the past, the need for all these different people to collaborate, interact, and deal with one another led to the development of complex social customs, rules, and mores. In time this interaction evolved into a network of social relationships—a community, in other words—in which people came together for festivals, celebrations, and solemnities. In this way whole cultures evolved.

Urbanization, economic globalization, and the triumph of money as the be-all and end-all of our economy and society have driven the hand-made object from our midst and in the process destroyed the foundation of communities and cultures that evolved over the centuries. Needless to say, this phenomenon is not limited to Japan. Leaving aside certain luxury goods produced for the wealthy—Kashmiri rugs, English furniture, Italian leather—cheap, mass-produced goods have taken the place of hand-made objects

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Kato, Hideki President of the Tokyo Foundation. Joined the Ministry of Finance in 1973. Served in several positions, including in the Securities Bureau, the Tax Bureau, the International Finance Bureau, and the Institute of Fiscal and Monetary Policy; resigned in September 1996. Founded Japan Initiative, a not-for-profit, independent think tank, in April 1997, serving as its president since then. Served as professor of policy management at Keio University, 1997-2008. Assumed the chairmanship of the Tokyo Foundation in April 2006. In October 2009 became secretary general of Japan's Council on Administrative Reform within the Cabinet Office, and in April 2010 became president of the Tokyo Foundation when the foundation became a public interest incorporated foundation.

in the daily lives of consumers around the world, and as a result, the communities that grew up around handicraft economies are now either extinct or endangered.

We need look no further than Tokyo to get a sense of where this trend leads. With money, one can do or get almost anything in Tokyo. But without money, one can do almost nothing, because the ties that once bound people to one another have all but dissolved. The harsh truth of this was driven home late in 2008, when thousands of temporary workers who had lost their jobs and homes in the wake of the October financial crisis converged on Hibiya Park seeking food and shelter to tide them over to the new year.

When a mass-produced basket replaces a hand-woven basket, little or nothing is sacrificed in terms of the basket's function. But something else is lost. In a series of articles, using a mundane basket as our starting point, a fast-disappearing way of life will be explored in an effort to better understand what it is we are losing and whether it is something we can really afford to lose.

About the series "Craft, Community, and the Cost of Global Capitalism"

In a world awash in mass-produced goods, hand-crafted articles seem destined to vanish from our lives, except perhaps as luxuries, curiosities, or hobbies. As handicraft industries succumb to urbanization and globalization, communities succumb as well. This series examines a vanishing way of life from a variety of angles; explores the implications of its disappearance for society, culture, and the environment; and raises serious questions about the costs of global capitalism.

Hand-woven baskets like these, most often made from bamboo, were ubiquitous in rural villages, where farmers, fishers, peddlers, and others used them to carry goods of all kinds on their backs. (Courtesy of Shikoku-mura)

August 04, 2010

The Upper House Vote and the Process of "Creative Destruction"

By Curtis, Gerald L.

The Democratic Party of Japan's setback in the July 11 House of Councillors election has produced "a political gridlock worse than anything Japan has experienced in half a century," notes Gerald Curtis, a Tokyo Foundation senior fellow and the Burgess professor of political science at Columbia University. This is part of a process of "creative destruction," though, that Japan must pass through to create an effective and responsive government.

QUESTION: How do you analyze the results of the July 11 House of Councillors election?

GERALD CURTIS: The election results have produced a gridlock worse than anything Japan has experienced in half a century. It's much worse than the situation the Liberal Democratic Party faced before it lost power to the DPJ, when it had a two-thirds majority in the House of Representatives. The Democratic Party of Japan doesn't have that now, so it will be unable to override a House of Councillors rejection to pass key pieces of legislation.

The DPJ will have to find other parties that will agree with it on specific pieces of legislation. The possibility of this happening, though, is very small. Much likelier is that the LDP, Minna no To (Your Party), and Komeito will resist making policy agreements with the DPJ because they will feel that if they vote with Prime Minister Naoto Kan, they'll be helping him out. So they'll take an uncompromising position, demanding that he swallow their position whole. Rather than make policy agreements, they are likely to put a lot of pressure on Kan to dissolve the Diet. This Diet is not likely to last for three

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Curtis, Gerald L. Senior Fellow of the Tokyo Foundation. Burgess Professor of Political Science, Columbia University. After earning a social science degree from the University of New Mexico in 1962, attended Columbia University, where he got his MA (1964) and PhD (1969) in political science. Went on to serve as assistant professor and associate professor at Columbia, where he was also director of the Weatherhead East Asian Institute from 1974 to 1990. Became a full professor in 1976. From 2000 to 2006 was a visiting professor at the National Graduate Institute for Policy Studies. In 2004 was awarded the Order of the Rising Sun, Gold and Silver Star, one of the highest imperial honors.

more years. This political standoff will prevent the country from dealing with many important issues, regarding both domestic and foreign policy.

What we're observing now in the Japanese government is part of a process of "creative destruction." Eventually a new political party system and new decision making mechanisms will emerge to replace the system that existed under nearly a half century of LDP rule, but to create something new means destroying things that currently exist. Right now it is easier to see the destruction than the creation but clearly Japanese politics is in a phase of major change and evolution. This may be good news for Japan in the long run, but the short term consequences are mostly negative. There's a very good chance that the next lower house election will result in an even more confused political situation. It is conceivable that there will be a major party realignment. This is likely to produce weak and ineffective governments for some time to come.

It would have been much better if the DPJ had won a majority in the upper house election. Then its responsibility for the government's performance would be clear and the voters would be able to hold it accountable in the next lower house election. Under this gridlock situation, each party will be blaming the other for the government's failure to deal with the nation's problems and the public will find it hard to choose among them.

Public unhappiness with the choices given them was evident in this election. The LDP won more seats, but the DPJ won more votes nationwide. Public opinion polls show declining support for the DPJ but no increase in support for the LDP. They're disappointed with the DPJ, but they're not attracted by the LDP either. The voters want to be led, they want a party that can persuade them about what needs to be done, but they're not getting it in any of the choices presented to them. The public is looking for politicians who have a compelling vision about where the country should be heading and how to get there.

QUESTION: What are the prospects of running into such a leader?

CURTIS: You never know who that leader is until he shows up. No one expected Junichiro Koizumi to be so popular. He wound up staying in office almost longer than anyone else in the postwar period. He was enormously popular but he was not a populist. He didn't tell the public what he thought they wanted to hear; he told them that the country needed to take risks, to do things differently in order to prosper. And the public believed in him and therefore supported his policies. Some people thought Kan might show a Koizumi-like determination and rally public support, but the way he raised and then waffled on the issue of increasing the consumption tax badly damaged his image.

QUESTION: Perhaps the lack of visionary political leader is a problem with the electoral system, with the campaign period being so short, so candidates aren't really tested before they enter office.

CURTIS: There no doubt are structural factors that contribute to the paucity of political leadership in Japan. The rapid turnover of prime ministers cannot be simply a coincidence. The mostly single-member district system is inappropriate for Japan. This is a society without deep social cleavages along the lines of religion, ethnicity, race, class, and so on, so that with a two-party system, the two major parties invariably wind up being very similar. That's why there have been these wide swings in voter support since the single-member districts were created.

In Britain or the United States, where you still have strong cleavages based on region, religion, and race, there's a core base of support for each party, and there's fundamental stability. But here, neither party has an anchor in society. Japan would be much better off going back to a modified system of multiple-seat districts or adopting a fully proportional representation system.

The election law's excessive restrictions on campaign practices keeps politicians campaigning as they did decades ago even though the society has changed enormously; Politicians are still going around with loudspeakers on their trucks blaring out their names and saying please vote for me. This is because most campaign practices that are usual in other countries are prohibited here: no door-to-door calls, limits on the written materials you can distribute, no freedom to use the Internet during the campaign period, and so on.

In recent years the LDP and the DPJ have adopted a policy where if the party president resigns the person chosen to replace him has to serve out the term of his predecessor and then stand for election again. So instead of Kan being elected to a regular two year term as DPJ president when Prime Minister Hatoyama resigned, he is serving out Hatoyama's term and has to face an election in September.

QUESTION: What can Kan do to stabilize the political situation?

CURTIS: There're only two things he can do. One is to appeal to other parties to support particular policy initiatives and compromise with other parties on key issues. There has to be a willingness on the part of Kan and the DPJ to make the Diet the central site for actual policy formulation and to find new ways to cooperate across party lines.

In Japan, the practice has been for the bureaucracy to draft policy and for the cabinet to submit it to the Diet, and the Diet either passes it or doesn't pass it. But the idea of actually writing legislation in Diet committees—or even revising them—doesn't happen here, or very rarely, so this is an opportunity to make the Diet an important site for actual policy formulation.

The second thing he has to do is find ways to appeal to the public for support. The key to effective political leadership in a democracy is the power to persuade. For American politicians this is common sense. President Barack Obama was tireless in trying to convince the public to support his health care reform and to use public support to pressure Congress to go along. But few Japanese politicians operate from this assumption. Koizumi did, but he was the exception. The question is whether Prime Minister Kan will be able to communicate to the public, build support for his policies, pressure the opposition parties to compromise and forge policy agreements across party lines. I am not very optimistic, and if he does not succeed, the political system will be immobilized.

QUESTION: Advances were made by women legislators in the most recent election, with Renho being one of top vote garners. Do you think this indicates a trend?

CURTIS: There are a couple of trends going on. One is that there are more professional women in Japan who are interested in careers in politics, such as Yukari Sato and Satsuki Katayama, both of whom were defeated in the last lower house election and came back and won in the upper house election. These are serious women who have had serious careers before entering politics. But the sample is still small because women have had few opportunities for advancement. The disadvantages of being a woman in Japan are still greater than in other countries.

The other trend is for parties to run women simply because they're pretty or because they have name recognition. This is demeaning to women. There are a lot of women in politics who are there because the LDP and the DPJ thought they could win for reasons that have nothing to do with politics. So, ironically, I think the larger number of the women reflects a kind of chauvinistic mentality.

Renho was a TV announcer, but she's also a serious politician. The motivation for running so many women, though, reflects values in this society that partly explain why women are disadvantaged in professional life.

QUESTION: What are the foreign policy implications of the DPJ administration? How will the alliance with the United States be affected?

CURTIS: The United States wants to have a good relationship with Japan and that means having a close and positive relationship with the Japanese prime minister. But ever since Koizumi left office, there hasn't been a prime minister who has survived more than a year in office. So while the desire to have a strong relationship is there, there is a natural reluctance to invest a lot of time and energy in developing personal relations with a government leadership unless you can be fairly confident that they're still going to around for awhile. The combination of political instability in Japan and the controversy that emerged over the issue of relocating the Marine Air Station at Futenma has made it difficult for the United States and Japan to engage with each other as fully as they should on larger issues, like the environment, energy, nontraditional security threats, and how to cooperate in ensuring stability in East Asia.

QUESTION: Talk of hiking the consumption tax probably cost the DPJ the election, but the fiscal situation is something that must be addressed. How should the public debt be dealt with?

CURTIS: Unlike the situation when Ryutaro Hashimoto or Noboru Takeshita was prime minister, the majority of Japanese seem to feel than an increase in the consumption tax is unavoidable. Unfortunately, because of the way Kan raised this issue, he actually set back the timing of introducing an increase.

Increasing the consumption tax without having some kind of strategy to increase growth, though, will only depress the economy. So this has to be part of a broader tax and spending reform package. One thing Japan could do to increase government revenue without a tax increase is to introduce a taxpayer identification system. If every taxpayer had the equivalent of the social security number used in the United States there would be far less tax evasion.

Coming back to the election results and the long-term positive effects of "creative destruction," last year's lower house election produced the biggest turnover of the members of parliament since the purge under the Allied Occupation. The LDP will no doubt increase its seats in the next lower house election and that too will bring in new people into the Diet, so over a period of five years or so, there's going to be hundreds of new Diet members. There are seventy to eighty DPJ politicians serving as cabinet ministers, senior vice ministers, parliamentary secretaries and the like. They are gaining experience in how to run a government and over time some of them will emerge as impressive political leaders. New blood in the Diet will result in changes in the relationship between politicians and bureaucrats, and the Diet will play a more central role in policymaking. In the long term, these are positive, creative developments, as the system will become more transparent and politicians will come to understand that you really have to persuade the public.

August 02, 2010

The Changing Face of the Obama Administration at Home and Abroad

By Kubo, Fumiaki

Domestic Policy

The passing of the health insurance reform bill and its significance for Democrats in Congress

With public opinion largely opposed to the health insurance reform bill immediately before voting in Congress began, views were divided on whether it was better for the Democrats to pass the bill or allow it to fail. In particular, there was considerable debate on the impact the bill might have on the midterm elections later this year. Two things need to be looked at in this context: the significance of the bill for Democrats in Congress, and its significance for the president.

For congressional Democrats, the situation is complex. Indeed, in a strict sense the calculus differs for each member of Congress. For members elected from districts with strong Democratic support, the passing of a bill with such historic significance was a major positive. But the situation is different for many members from conservative districts where Republicans enjoy strong support: for these members, their prospects in November's midterm elections might have been better if they had voted against the bill.

Of Democrats elected to the House of Representatives in the 2008 elections, 49 are from electoral districts in which John McCain polled ahead of Barack Obama (see "Analysis of Voting Patterns on Major Bills During the First Session of the 111th Congress," available in Japanese only). With Obama beating McCain by an average of 7 percentage points nationally (53% versus 46%), districts where McCain received a greater share of the vote

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tended to be traditionally conservative areas. These are districts that might normally be expected to elect a Republican to Congress.

With the winds of public opinion blowing strongly in their favor, the Democrats made substantial gains in the House elections of 2006 and 2008, winning seats far beyond their traditional areas of support, including conservative districts that had traditionally voted Republican, or where there had previously been close competition between the two parties. In a sense, these elections swelled the Democratic presence in the House of Representatives beyond its natural levels.

Would the Obama administration be better placed with these districts under Democratic or Republican control? The question is not black and white. Given the essentially conservative nature of these districts, it can hardly be expected that a Democrat representative will vote in support of all the party's basic policies. This is one of the biggest differences between a parliamentary cabinet system and the American presidential system.

But given the current ideological antagonism between the two parties, there is also little to no chance that a Republican will vote in favor of any Democratic proposals, and certainly no chance that such support will come from a member representing one of these conservative districts. At the very least, the administration can hope for some degree of support on some measures from a Democrat. The difference may seem small, but in a close vote it can make all the difference.

The midterm elections in November 2010 will be extremely tough for many congressional Democrats. Democrats who voted against the bill risk losing votes from faithful Democratic supporters, with little prospect of a corresponding increase in popularity among Republican voters. Meanwhile, Democrats who voted in favor of the plan can expect votes from committed supporters of the Democratic Party and President Obama, but will come in for stronger opposition than ever from conservative factions led by the Tea Party movement.

The passing of the health insurance reform bill and its significance for President Obama

For President Obama, on the other hand, the passing of the health insurance reform bill was a vitally important victory. Many people warned that Obama risked becoming "another Jimmy Carter" if it failed, unable to get any legislation through Congress at all.

Indeed, the bill seemed doomed to failure after the Democrats lost in January's special election in Massachusetts, thereby forfeiting its special majority in the Senate. But Obama was determined to block the opposition's attempted filibuster and push the bill through, demonstrating considerable confidence and strength. This is an important image for the US president to project. Having passed legislation that will aim to provide health insurance to all US citizens a full century after the idea was first put forward by President Theodore Roosevelt, Obama can lay claim to a historic achievement.

These successes may have little bearing on the midterm elections, but they will surely be important factors when the presidential elections come around again in 2012. "The cynics said it couldn't be done, but by working together the American people achieved a miracle"—we heard phrases like this many times in 2008, and we are likely to hear them again. We can also expect to hear similar remarks alluding to the agreement with Russia on nuclear arms reductions.

But it cannot be denied that getting the bill passed came at a high price. President Obama and his team of advisors and analysts worked hard to learn from the experience of the Bill Clinton administration, which failed at passing similar reforms in 1993–94. It was imagined that if a plan were drawn up in the White House first and then put before Congress, not even Democratic members could be relied on for support (this is in fact what happened in 1994). Instead, the president's team decided to leave much of the bill-writing process to Democrats in Congress.

Timing also played a part, particularly the high levels of support enjoyed by Obama early on in his presidency and the sense of crisis enveloping US society. The Obama administration hoped to tap into this feeling. The sense of crisis that followed the financial crisis gave the president and his team confidence that they could pass bills that would normally stand little chance of getting through. (The massive financial stimulus package approved in February 2009 was one example of this.)

Another consideration that seems likely to have played a part in the decision to entrust the process to congressional Democrats was a reluctance to avoid wasting large amounts of time cobbling together a White House plan, as the Clinton administration did. And President Obama had to conclude that neither he nor his staff had what it would take to draw up a proposal swiftly on their own.

It is now widely acknowledged that these judgments were substantially mistaken, and that as a result of the proposal the administration continued to hemorrhage support throughout the summer of 2009.

At a Tokyo Foundation seminar held on December 4, 2009, Simon Rosenberg, president of Washington-based think tank NDN, pointed to a middle way between the approaches taken by the Clinton and Obama administrations. Instead of putting together a plan behind closed doors in the White House, the administration could instead outline a number of basic principles and then leave the congressional Democrats to formulate a bill based on these. This is the approach being taken with financial reform, and Rosenberg suggested that this would be a more effective strategy.

Instead, Obama handed over the decision-making process to congressional Democrats and left them to formulate whatever plan they could agree on. It was a close-run thing, but the Democrats in Congress did eventually hammer out a bill, which passed. But this came at an extremely high cost in terms of public support. One reason was that the various proposals put forward by Democratic members of Congress—radical ones in particular—were attacked by Republicans as part of the "Obama plan." Another factor was the disconnect that existed between the government's determination to push ahead with healthcare reform and the desire of the electorate for a response to concerns about the economy and employment.

The administration strikes back

Starting in January 2009, the Obama administration tried to gain a degree of support from Republicans for its health insurance plans, but to no avail. Eventually, the bill squeezed through with Democratic support alone. Republicans griped that even President Lyndon Johnson had managed to achieve significant support from Republicans for his healthcare reforms. But it is essential to remember that the Republican Party in the 1960s still contained liberal elements, and was quite different from the party it has become today.

At this stage, there was an interesting development. In April 2009, Obama abandoned an election pledge and spoke in favor of drilling for oil in offshore areas. This represented a major concession to the Republicans, aimed at providing much-needed momentum to the energy and environment bill then languishing in Congress. Conservatives complained that the president's concessions were still not enough. But although the health insurance reform bill was eventually forced through with Democratic support alone, it would not be surprising if the administration had decided after this that similar tactics were unlikely to succeed again in the future. It is likely that the difficulties the administration experienced in getting the health insurance bill passed will bring about a dramatic change of tack.

Offshore drilling was a source of direct confrontation between Obama and McCain during the 2008 presidential election, when chants of “Drill, Baby, Drill” were heard at the Republican National Convention and at other venues throughout the election campaign.

The Obama administration’s recent shift in direction has been reported in some quarters as part of a compromise designed to win Republican support for its energy and environmental bill. Conservatives insist scornfully that the concessions remain insufficient. Democrat-friendly environmental groups, on the other hand, have been shocked and outraged by the move.

It is doubtful whether these compromises will achieve the hoped-for results. At the moment, it looks as though the bill will struggle to get through Congress. It is also possible that the oil spill that hit the Gulf of Mexico in April will harden public opinion against offshore drilling. Nevertheless, the administration’s recent changes of strategy provide significant hints of the kinds of measures it may resort to in the future when circumstances require it.

Diplomacy

Breaking with the previous administration

In pushing forward its domestic agenda, the Obama administration has regularly encountered stiff opposition from the Republican Party, with only a handful of Republicans in the Senate supporting the administration’s massive financial stimulus package.

Although the context is different, a similar tendency can be seen in foreign policy. In its early days, the administration’s basic approach was to emphasize the differences and discontinuities between the new government and the “arrogant” and “unilateral” foreign policy of the George W. Bush administration. The Obama administration was eager to show readiness to engage in dialogue and negotiation. Rather than showing the way or simply giving orders, the United States would listen carefully to what other countries had to say. This attitude was at the forefront of the administration's early efforts to engage with the world.

At a paper presented at this year's Brussels Forum, this attitude was characterized as reflective of a firm sense of faith in a "rational" world. One might call it a diplomacy of reason (see Constanze Stelzenmüller, "End of a Honeymoon: Obama and Europe, One Year Later," http://www.gmfus.org/brusselsforum/2010/docs/BF2010-Paper-Stelzenmuller.pdf).

This more open attitude in foreign policy was a major priority for the Obama administration at the time of its inauguration. Apart from anything else, the strategy was worthwhile from the point of view of a simple calculation of interests. As president, Barack Obama knew that there were gains to be made by emphasizing to the world and his fellow Americans (with the exception of Republican hawks) that another, different America existed. And he hoped that with luck, the goodwill toward Obama's America could be translated into soft power and might produce concrete benefits.

More concretely, Obama offered the possibility of direct negotiations with Iran and North Korea, reached out to the Islamic world with a speech in Cairo, and threw himself into peace mediations in the Middle East. In Asia, the new president showed an attitude of respect and dialogue toward both Japan and China. Symbolic of this approach were the visit by Hillary Clinton as secretary of state to the inner area of the Meiji Shrine in Tokyo and President Obama's respectful bow to the Japanese emperor.

It would be difficult to deny that there was an aspect of naiveté to these initiatives. But probably there is more to it than that. The approach is genuinely different from what it might have been if the administration had adopted a tough stance from the outset, and can reasonably be expected to produce different results. Firstly, there is the impact within the United States. The bedrock of Obama's support is on the left wing of the Democratic Party. These supporters are likely to be more amenable to tough policies once they see that a more flexible approach has been tried and has not produced results.

The approach may have a similar effect internationally. Widespread backlash against the United States would have been likely from a number of countries and powers had the Obama administration used sanctions or the threat of them from the outset. People would have objected that the new government's policies were no different from those under Bush. But if the tough approach comes at the end of a steady process, there is a good chance that at least some of these countries will accept the stronger measures.

But the approach is not without its own difficulties and dangers. If things do not go according to plan, when will the administration be able to change tack? The longer the delay, the more likely it becomes that the administration's initial approach will be dismissed as having failed. What about Obama's diplomacy?

A shift in approach

Obama's foreign policy is undergoing significant change at present. The administration has been taking a noticeably tougher stance—relatively quickly in the case of North Korea, and since the second half of 2009, toward Iran and China too.

This change is at least partly due to differences between Hillary Clinton and Barack Obama, and between the Department of State and the White House. The Department of State has supported tough conventional policies, while the White House has been in favor of trying a more innovative and flexible approach. During the battle to secure the Democratic nomination for the presidency, Obama claimed that he would be prepared to meet the leader of any country without conditions, while Clinton pointed out the naiveté of this approach and the risks inherent in it. Today, Obama is drawing closer to Clinton's position.

From the start, Obama had no intention of depending on a softly-softly approach alone, as shown by his hints to Israel of a deadline for progress in Iran by the end of 2009. But what are the reasons beyond the recent shift in tone of Obama's foreign diplomacy?

The chief reason is that his initial approach produced almost no results. This can be seen even in dealings with members of the North Atlantic Treaty Organization, America's most trusted and reliable allies. In spring 2009, President Obama made a round of visits to various European countries, calling for a massive economic stimulus package and increased contributions in Afghanistan. The results were disappointing (see Fumiaki Kubo, "Three Months of Obama Diplomacy and US Relations with Japan and Europe," http://www.tkfd.or.jp/topics/detail.php?id=136, available in Japanese only).

In her paper at the 2010 Brussels Forum, Stelzenmüller pointed out that even among allies of the United States (including Turkey and Japan), there is a lack of respect for Obama and the country he represents.

Some countries, of course, did not respond positively to the flexible approach at all. North Korea responded by launching missiles and carrying out nuclear tests. In Iran, opposition supporters were openly suppressed during the violence that followed the presidential elections, and there was no sign of progress in terms of Iran's nuclear weapons program. Although domestic considerations may have been the biggest reason, it is undeniably true that developments in these countries did not go the way the United States would have wanted.

China has proved a particularly difficult partner to deal with. The administration's approach was to play down the points of contention between the two countries, preferring to prioritize the need for cooperation and negotiation. Obama has looked for cooperation from China on a wide variety of issues. The most important of these issues was help on economic stimulus policies, but they also included currency, trade, North Korea, Iran, and the environment. The results of this modest approach, however, were negligible. China pushed through the large-scale economic stimulus policy it needed itself, but Obama's dialogue with citizens during his visit to China was edited before it was broadcast. In summer 2009, Obama decided not to meet the Dalai Lama. Despite this, China was distinctly chilly in its attitude to the United States in Copenhagen at the end of the year.

Meanwhile, the Obama administration began to adjust its approach to China. Trade frictions had already come to the surface during 2009, and at the end of the year the United States decided to sell weapons to Taiwan. In the New Year, after this decision had been made, the Google problem hit. Google announced that it was no longer prepared to cooperate with Chinese government censorship, and made clear that it would withdraw from the Chinese market if this policy was not accepted. There were also reports that the government had been monitoring the e-mail correspondence of human rights activists and was involved in attempted intellectual property infringements affecting at least 34 US companies (see "Google China Cyberattack Part of Vast Espionage Campaign, Experts Say,") http://www.washingtonpost.com/wp-dyn/content/article/2010/01/13/AR2010011300359.html).

These issues involved human rights, intellectual property infringements, and even—in the case of cyber security—national security. In other words, aspects of these issues impinged directly on the national interest in a number of ways. In a telephone interview from Washington in February, Chris Nelson of Samuels International Associates, Inc.

suggested that the friction could even result in a loss of support for China among pro-China factions in the US business world. Even allowing for exaggeration, there can be little doubt that the tensions must have reminded a number of companies of the risks they were taking by doing business in China.

There were good reasons for the Obama administration to take the problems seriously. Under Hillary Clinton, the Department of State was moving to use the Internet as a promotional and public diplomacy tool. This would make it possible to communicate directly with ordinary people around the world. Invited to speak at the Tokyo Foundation in December 2009, President Simon Rosenberg of NDN talked about the protest movement in Iran and how it had been able to communicate what was happening there to the outside world via the Internet. Rosenberg argued persuasively that the Internet would be of primary importance to American human rights diplomacy efforts in the years to come.

Secretary of State Hillary Clinton has appointed Alec Ross as senior advisor for innovation. Ross's particular priority is to optimize the use of the Internet in foreign relations.

This was the context behind a January 21, 2010 speech by Clinton on the subject of Internet freedom, in which she criticized China and other countries for Internet censorship, using terms such as "Iron Curtain" and "Berlin Wall." Under the Obama administration, the Department of State is treating the Google issue as a serious and important matter.

Ross and NDN's Rosenberg have been collaborators for some time. NDN recently invited Ross to give a talk (Japan's ambassador to the United States Ichiro Fujisaki also spoke at the same venue on April 7). Venues such as this provide insight into the Democratic Party's core networks (http://ndn.org/blog/2010/03/freedom-21st-century-alec-ross-speak-internet-freedom).

There was further tension with China in 2010 over appreciation of the renminbi, with the Chinese currency again pegged to the dollar since the financial crisis. Even more importantly the Obama administration, worried by dwindling levels of support, switched its domestic priorities from health insurance reform to job creation. In the United States, there were calls from both the executive branch and Congress for a revaluation of the renminbi.

Relations with China began to improve around the time of the nuclear security summit in April. The Obama administration agreed to postpone a decision on whether to cite China for currency manipulation, while the Chinese president agreed to attend the summit. China also moved closer to America on the subject of sanctions against Iran.

However, the United States has still not definitely decided not to cite China for currency manipulation, and Chinese cooperation on sanctions against Iran is lacking in substance. There is every chance the current thaw will be nothing more than a temporary improvement in relations.

Of course, the administration's stance toward China has not necessarily toughened because of a lack of results with previous methods. It is likely that the sale of weapons to Taiwan was part of a strategy decided in advance. However, Obama's meeting with the Dalai Lama in 2010 after refusing to meet him in 2009 can only have come about as the result of a deliberate change of policy.

The biggest dilemma facing President Obama is Iran. To date, Iran has not responded positively either to America's flexible overtures or to its more hawkish pronouncements. At present the United States is looking at imposing sanctions through the Department of the Treasury, and is planning to impose further sanctions through the UN Security Council. For this to happen, the United States would need the cooperation of China and Russia—and at the moment it is far from certain whether the kind of effective sanctions the Obama administration hopes for will ever become a reality.

Obama has already approved two separate increases in troop numbers in Afghanistan, and has demonstrated a determination to continue the fight. Even when accepting the Nobel Peace Prize, Obama continued to emphasize the importance of being prepared to fight. This is another issue that may have an important bearing on his chances of reelection.

Foreign policy achievements

Probably the biggest achievement of the Obama administration in nearly a year and a half since its inauguration has been the agreement with Russia on strategic nuclear arms limitations.

A quite different approach to relations with Russia was possible when the new government came into office in January 2009. The United States might well have decided on a policy of containment against Russia, owing to factors such as the head-on collision over America's plans to deploy an antimissile defense system, Russia's ongoing drift away from democratization, and its invasion of Georgia—one of a number of acts designed to reassert Russian influence over the country's previous zone of control. It is likely that many of McCain's advisors, at least the neoconservative faction among them, thought in this way.

The contending view was that reducing the number of nuclear warheads and the burden they imposed on the budget would bring benefits to both sides, and that with the right persuasion Russia might be a potential partner in dealing with Iran and its nuclear program. The Obama administration chose the latter option, announcing as it opened talks on strategic nuclear arms limitations that it was "resetting" the relationship between the two countries. Although the passage was rougher than expected, in the end the two sides did manage to reach an agreement.

Of course, it is still unclear whether the treaty will be ratified in the Senate. Some critics have hinted that the actual reductions will not be as substantial as the text of the pact suggests. And the United States and Russia have yet to reach any fundamental and substantial agreement on the deployment of missile defense systems in the future.

And yet if the new treaty is ratified, it is likely to become one of the Obama administration's major achievements, along with health insurance reform. In fact, it can be described as the administration's only real foreign success so far. It is likely that US–Russian relations would become more stable overall with the agreement in place than without it.

These achievements will probably play a very little role in terms of helping Democratic members of Congress in the midterm elections this November. Come the presidential elections in 2012, however, it is likely that President Obama will point to the administration's three biggest achievements so far—the massive financial stimulus package passed in February 2009, the national health insurance reform bill, and the strategic nuclear arms reduction treaty with Russia—as evidence that he deserves another term. Obama will probably try to sell himself to voters as a "can-do" president capable of getting things done.

In pushing through these latter two measures, Obama is seen in many quarters as having demonstrated strength. When the Democrats lost the Massachusetts special Senate election in January this year, many predicted that the health insurance reform bill would not pass. Overtures to the Republican Party failed to yield results. But President Obama persevered assertively with the work of persuading Democrats in Congress, and eventually succeeded in getting the bill passed, albeit by a narrow margin. People grumbled that negotiations with Russia were more difficult than expected, but here too Obama was eventually able to steer negotiations toward an agreement without being blown off course by the controversy surrounding US plans to deploy a missile defense system.

In the early days of his presidency, Obama was sometimes seen as “weak”—a gifted orator but a leader whose conciliatory attitude made him prone to surrender and compromise. The president has succeeded in changing this image to some extent.

Evaluating Obama’s diplomacy

Obama’s foreign policy cannot be easily summed up in a few words, particularly as the administration’s approach to diplomacy is currently undergoing substantial change.

In the early days of his presidential campaign, Obama made opposition to the Iraq war a central pillar of his foreign policy, relying on the left wing or antiwar faction of the Democratic Party for the bedrock of his support. It was the antiwar aspect of his approach that stood out first. His claim during the election campaign that he would be prepared to meet the leaders of Iran and North Korea without conditions was part of this same approach.

At the same time, however, the president regularly emphasized the need to continue fighting decisively in Afghanistan. From the beginning, in other words, Obama was never a straightforward dove. Some claim that the president was forced to take this approach in order to defeat first Hillary Clinton and then John McCain, regardless of his own view. But the Nobel Peace Prize acceptance speech makes it more likely that the president believes in the idea of a just war.

It has become clear by now that Obama is in some respects a realist, or that there is a pragmatic tendency to his strategy. In fact, these tendencies were noted from the very beginning of his administration. Obama was quick after his inauguration to contact people such as Colin Powell and Brent Scowcroft. Powell is well known for having officially endorsed Obama during the final stages of the election campaign. Obama reappointed Robert Gates, a famous pragmatist, as secretary of defense, and chose James Jones to be his national security advisor.

In an article published in the *New York Times* on April 14, 2010, Peter Baker argued that Obama's foreign policy represented a shift to *realpolitik* from the human-rights-focused diplomacy of Democratic predecessors such as Jimmy Carter and Bill Clinton (Peter Baker, "Obama Puts His Own Mark on Foreign Policy Issues," April 14, 2010, *New York Times*).

In the article, Obama comes in for praise for his diplomacy at the nuclear security summit involving 47 countries in April this year, where it was widely believed that Obama proactively provided positive leadership rather than simply underlining the differences between himself and George W. Bush. A former diplomat was quoted as saying that Obama's "legacy in domestic policy is likely to be health care. But his legacy in foreign policy is likely to be this nonproliferation agenda."

Probably Obama has come to understand the limits of what can be achieved by persuasion. Obama himself has acknowledged that he underestimated how difficult it would be to bring about an agreement between Israel and Palestine, and that his policy of engagement has failed to inspire any cooperation from Iran, where he remains stuck in the same impasse as his predecessor.

According to the Baker article cited above, one major difference between Obama and his predecessors is the weight he gives to relations between the traditional great powers. His predecessors tended to make controversial points like human rights and democracy a priority. Obama's Chief of Staff Rahm Emanuel has said that Obama will probably be seen as a realist in the mold of the 41st president, George H.W. Bush.

A former official in the Bush administration says Obama's pursuit of a "great powers" strategy is remarkable for a president with his origins in the liberal wing of the Democratic Party: "It's almost Kissingerian. It's not very sentimental. Issues of human rights do not loom large in his foreign policy, and issues of democracy promotion, he's been almost dismissive of."

The current tendency is to emphasize the realist aspects of Obama and his foreign policy. However, Obama met the Dalai Lama this year, and Secretary of State Hillary Clinton gave a highly critical speech on the subject of Internet freedom. Thus, there remain some aspects of his foreign policy that are less than wholly pragmatic. In Afghanistan, for example, he seems to assign a significance to the war that goes beyond narrow national interest.

It is safe to say that the biggest point of conflict in foreign policy for the foreseeable future will be Iran. Persuading China and Russia to cooperate will be a crucial test for the Obama administration's "realist" approach to foreign policy. But even if Obama does achieve a degree of support from Russia and China, putting an end to Iran's nuclear program will not be easy. For this to happen, the administration may have to resort to harsher measures than those normally implied by the word "realist," or else may be forced into the more difficult and radical option of having to contain (and at the same time coexist with) an Iran that holds nuclear weapons.

One thing is certain: Both at home and abroad, President Obama faces more difficult challenges than he can have expected when his administration took office. (*This is an almost literal translation of an essay originally written in Japanese for a Japanese readership*.)

July 14, 2010

Corporations in Evolving Diversity: Cognitions, Governance, and Institutions

By Aoki, Masahiko

Topics of pressing interest since the financial crisis of 2008 have been a reconsideration of the role of financial markets and the reestablishment of the fundamental relationship between financial and nonfinancial companies. The Tokyo Foundation's Virtual Center for Advanced Studies in Institution (VCASI) has been conducting research into corporations to address this issue, one recent product of the project being Corporations in Evolving Diversity*, published by Oxford University Press. The following are excerpts from the book's Introduction.*

Corporations are undoubtedly one of the most important societal devices that human beings have ever invented. Although the legal concept of corporations has been said to have originated in the Roman era, it was in medieval Europe that the corporation was initiated for various social functions and started to flourish in a variety of domains: religion, learning, politics, philanthropy, trade, and crafts.

Access to the corporate form was limited at this time to the elite, but this decentralized institutional innovation prepared "doorstep conditions" for Europe, allowing it to get one step ahead of other regions and to make an earlier transit to the modern democratic state and corporate economy.

As a reference point, a minimalist conceptualization of corporations can be verbalized as follows: Corporations are voluntary, permanent associations of natural persons engaged in some purposeful associative activities, having unique identity, and embodied in rule-based, self-governing organizations.

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A corporation is a permanent entity that can do what individuals with limited biological longevity cannot do. The corporate ability to own property, backed up by the institution of share ownership and share transferability, makes the permanence of business corporations secure.

Actions, physical and cognitive, are also relevant, as corporations can organize associative activities among its members and can cognize and store what a mere collection of individuals cannot. The first prominent types of corporations that emerged in the early medieval period, such as universities and the Roman Catholic Church, were those founded for the encouragement and support of religion and learning. The primary functions of these types of corporations were to understand or interpret the world, accumulate, theorize, and bestow knowledge for future uses and advancement, and sustain culture as common knowledge.

The primary purpose of modern business corporations is to make money, not to learn. But even for them, the reasons why incorporation is vital for religious and learning activities are not entirely irrelevant. As knowledge use and creation (that is, innovation) become more important for the competitiveness of business corporations, this point cannot be overlooked.

Orthodox economic theory of contracts is premised on the idea that cognition can take place only within the mind of individuals, which lies at the heart of micro economics that theoretically supported the shareholder-oriented view of corporations in past decades. However, the recent development of experimental economics, cognitive neuroscience, and related areas increasingly provides evidence and theories that human cognition also takes place in more interactive ways at the group level. The way in which business corporations are organized as systems of associational cognition deserves no less attention than the financial aspects of the corporation.

The orthodox contract theory of the firm considers the human aspects of the business corporation only in terms of authority relationships between the management and the workers. This treats workers merely as “hands.” But in his classical treatise, Concept of the Corporation, Peter Drucker posited the idea of “knowledge workers” who can supply brains, not merely hands.

In a business corporation, cognitive activities, such as information collections, processing, uses, and storage are systematically distributed and interrelated between the management and the workers, as well as among the workers, while the investors supply cognitive tools to them. Such cognitive relations inside the corporate organization can be referred to as associational cognition.

If the potential importance of associational cognition is recognized, the questions that follow are: How are cognitions to be distributed and related among the members? How are they related to the system of tools of cognition, such as computers, the Internet, robotics, machines, digital files, and so on? Are the workers simply the bodily extension of the manager's brain? Focusing on this aspect of corporate architecture appears to be particularly important in the era of information technology.

The question of what represents "purposeful activities" for a contemporary business corporation constitutes the crux of the matter we are concerned with: "What do corporations do?" Does it operate "exclusively for profit" as the shareholder-oriented view dictates or for something broader, as the stakeholder-oriented view claims. The proper answer theoretically depends on ways in which a system of associational cognition is architected in corporate organizations.

The shareholder-oriented model is one viable model under certain conditions, but there can also be another model that does not fall into the simplistic classifications of "management-oriented" (traditional American), "labor-oriented" (traditional German), or "state-oriented" (traditional French and Japanese). This model involves rather novel three-way relationships between management, workers, and investors, whose presence may grow with the rising importance of human cognitive assets in business.

It is telling that pre-business corporations, such as the Roman Catholic Church and municipalities, were not the immediate creations of the modern national state. They were voluntarily created, even though some of them needed the explicit or implicit approval of the rulers. As members of voluntary organizations, corporate participants must basically have consented to obey its own rather than any external authority.

This has implications for the inquiry into the nature of business corporations. We may inquire what kind of general rules for governance can be agreeable to and consented to by the constituent members of the corporation. Then we may ask whether those endogenous rules can be consistent with general rules prevailing in society. Without the first property, people would not participate in corporations voluntarily, while without the second property, corporations would not be sustainable in society. They are interrelated.

Social interactions are all games, regardless of whether payoffs are exclusively self-regarding, material-oriented, hedonistic, or otherwise. Those games recursively played in society can be called societal games, although there are different kinds of domains of play. Viewing the societal order as stable patterns of game playing has been expounded by many authors. I follow this tradition but try to go beyond a mere analogy by differentiating the discrete domains of societal games that embed corporate organizations—commons, economic, social, and polity—by discerning mutually distinct game forms and examining the interrelationship between those games and the organization games played internally within business corporations by their members, including workers.

One great advantage of the application of game theory is its ability to analyze mutual relationships between embedding society rules and corporate self-governing rules as stable outcomes of play, that is, as equilibrium phenomena, of the societal and organization games as linked.

“Equilibrium” refers to the stable and mutually reinforcing aspects of the societal order and its impacts on the structure of business corporations. However, nothing in the societal order is static in a strict sense. Business corporations adapt their associative activities in response to evolving market and society environments, while evolving corporate behavior impacts on the latter. The recent contributions of epistemic game theory suggest that in order for a stable societal order to evolve, something more may be needed, say, common backgrounds in information and inference, as well as various social cognitive categories, such as social symbols carrying some meanings, public propositions, such as laws and regulations acting as focal points for cognition, culture as common priors, and so on. In order to understand the basic nature of institutional evolution, the ironclad methodological individualism needs to be laid to rest.

Japan’s “Lost Decade” triggered by the 1992 burst of the financial bubble is a meaningful reference to the societal cognitive crisis than just the economic consequences of macropolicy and banking failures: That is, the state in which traditional rules could not be taken for granted any more. No consensus has yet emerged as regards what the new rules could be. Behind the crisis, the Japanese corporate landscape underwent a tremendous change, and it can no longer be characterized by a single “Japanese model” stereotype. This diversifying phenomenon is not necessary an isolated event limited to Japan, but there is a suggestion of similar phenomena evolving globally, albeit each one in a path-dependent, unique manner.

Evolving corporate diversity is not so much due to national characteristics but a ubiquitous phenomenon across economies exhibiting to differing degrees. It can thus be considered a product of global economic integration.

In order to derive the potential gains from the global process of a "convergence to diversities," the global financial markets need to co-evolve as an infrastructure that will accommodate this evolutionary path, rather than exercise sovereign control over nonfinancial business corporations. The 2008 credit crisis revealed that relationships between financial intermediaries and nonfinancial business corporations are still uneasy. The painful process of a corporate recovery is to become a process of a search for a mutual fit between the two.

July 08, 2010

The Second End of Laissez-Faire

(6) Money Has No Market of Its Own

By Iwai, Katsuhito

About the Series "The Second End of Laissez-Faire"

This series features an academic paper prepared by Professor Katsuhito Iwai for the Interdisciplinary Workshop on Money at the Free University of Berlin, June 25-28, 2009. The original title of the paper was "The Second End of Laissez-Faire: The Bootstrapping Nature of Money and the Inherent Instability of Capitalism." The 14-chapter paper is being posted on the Tokyo Foundation website on a chapter-by-chapter basis.

Once money enters an economy as the general medium of exchange, however, this reciprocal unity of supply and demand is split into two separate acts of purchase and sale. A purchase represents a demand for a commodity in exchange for money, while a sale represents supplying a commodity in exchange for money. One can then "buy" any commodity one demands, so long as one can find someone else to supply it (at a certain price). Likewise, one can "sell" any commodity one supplies, so long as one can find someone else to buy it (again, at a certain price). It does not matter when, where, and with whom one carries out the transaction, insofar as the other party is accepting the same money as the general medium of exchange. The intermediation of money thus burst through all restrictions of time, space, and knowledge about trading partners imposed by the double coincidence of wants, and triggered a phenomenal expansion in the temporal, spatial, and social spheres of economic exchange, the end result of which is

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the capitalism that now covers the entire globe. In other words, money is the original source of the efficiency in our capitalist economy.

At the same time, however, it is also the original source of the instability in that same system.

No one can sell unless someone else buys. But no one has to buy immediately after she has sold. She can simply hold on to some or all of the money made from the sale. No one can buy unless someone else sells. But no one has to sell immediately before he will buy. He can simply spend part of the money he already holds. In our capitalist economy, a supply does not necessarily create a demand, and neither does a demand create a supply. Indeed, when people for some reason or other decide as a whole to increase their money holdings by refraining from spending on commodities (a situation Keynes called an increase in liquidity preference), the aggregate demand for all commodities (exclusive, of course, of money) falls short of the aggregate supply of all commodities (again, exclusive of money). When, on the other hand, people as a whole decide to decrease their money holdings by rushing to spend on commodities (a decrease in liquidity preference), the aggregate demand for all commodities exceeds the aggregate supply. In a capitalist economy, "Say's law," which insists that aggregate demand will always be equal to aggregate supply, breaks down. In fact, when aggregate demand rises above aggregate supply, we say that the economy is in a boom, and when aggregate demand falls short of aggregate supply, we say that the economy is in a slump.

Neoclassical economists would probably object at this point that, even if it were theoretically possible for aggregate demand and aggregate supply to deviate from each other, this disequilibrium would soon be wiped out by the "invisible hand" of the price mechanism, just as it would be in the case of an imbalance between demand and supply of a commodity. It is true that a disequilibrium between demand and supply of commodities as a whole is no more than a mirror-image of a disequilibrium between demand and supply of money.[1] But, unlike all the other commodities, money does not have its own market.

To sell a commodity is to give that commodity to someone else in exchange for money, and to buy a commodity is to receive it from someone else in exchange for money. We

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[1] According to Walras' Law summing up all the consumers' budget equations, when there is an excess demand (supply) for the commodity as a whole, there must be an excess supply (demand) of money with equal value.

can “sell” money only by buying commodities in their markets; likewise, we can “buy” money only by selling some other commodity in a market. As the general medium of exchange that mediates the sale and purchase of all the commodities in all the markets, money cannot have a market of its own. To be sure, there is a market that is often called a money market. But in reality this is nothing more than a financial market for short-term lending and borrowing, and not a true market for money itself.

In the case of a non-monetary commodity, it has its own market to adjust the disequilibrium between supply and demand. In the case of money, however, the disequilibrium can only be adjusted indirectly by drawing on all of the commodity markets. It necessarily becomes a macroeconomic phenomenon.

Robert Malthus and Karl Marx both attacked (the former timidly, the latter vehemently) Adam Smith, David Ricardo, Jean Baptist Say and other classical economists for their blind faith in Say’s law. However, they failed to develop a theory that took full account of the breakdown of Say’s law. It was Knut Wicksell who first succeeded in working out the macroeconomic consequences of a disturbance in the equilibrium between aggregate demand and aggregate supply in his 1898 publication Interest and Prices. [2]

[2] Knut Wicksell, *Interest and Prices*, first English edition, 1936, (Reprinted by Kelly: New York, 1962);--------, *Lectures on Political Economy, Vol.2 Money*, English edition, (Routledge & Kegan Paul: London, 1935). For a more formal representation of Wicksellian cumulative process, see Part I of my *Disequilibrium Dynamics – A Theoretical Analysis of Inflation and Unemployment*, in which I attempted to reformulate Wicksell’s theory by explicitly incorporating firms’ decentralized price-formation process into a monetary theory of macroeconomic dynamics.

July 07, 2010

Postal Reform and the Fiscal Investment and Loan Program: Toward Democratic Control of Government Finances

By Tanaka, Hideaki

On April 30 this year, the cabinet of Prime Minister Yukio Hatoyama voted to submit to the Diet postal reform legislation intended as a "course correction" for the postal privatization plan adopted in 2005. The bill hit several snags during the drafting process, as divisions surfaced even within the cabinet over such proposed changes as raising the per-customer deposit ceiling for postal savings and providing special corporate tax exemptions for the postal system's financial services. Because the basic idea behind the reform bill is for the government to play a bigger role than that envisioned in the original privatization plan, most of the criticism thus far has centered on concerns that the rest of the finance industry will be put at an unfair disadvantage.

Although the fundamental ideological issue may be private versus national control of the finance industry, the proposed "correction" also raises important questions pertaining to the management of the postal-savings and postal-life-insurance funds. The problem relates not just to risk but also to reform of the Fiscal Investment and Loan Program—often called "the second budget"—and the principle of democratic control of government finances. To better understand the current situation and how it developed, we need to go back about 125 years.

The Postal System and Public Finance

In 1875, the Meiji statesman Hisoka Maejima, known as the father of the Japanese postal system, introduced a postal savings program to stand alongside the new system's mail delivery and money remittance services. Maejima hoped the system would expand rapidly and promote thrift among the general populace, but postal savings accounts were slow to catch on. In time, however, deposits grew—thanks in part to the incorporation of "savings education" in the grade school curriculum—and in 1885, they were placed in the account of the Deposit Bureau, newly established within the Ministry of Finance. At the

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beginning, the Deposit Bureau invested the bulk of those funds in government bonds under the ministry's Deposit Rules. Beginning in 1907, however, the Deposit Bureau's investment of postal savings funds began to include direct loans to the national treasury's general account and special account and the purchase of special bank bonds (used by prewar government financial institutions, such as the Industrial Bank of Japan and the Bank of Chosen, to raise capital). This was the origin of the Fiscal Investment and Loan Program legislated after World War II.

During the Taisho era (1912–26), the Deposit Bureau stepped up its purchase of special bank bonds and its loans to special banks to help fund domestic programs and foreign investment. Thus postal savings, channeled through such institutions as the Industrial Bank of Japan and the Bank of Chosen, were used to finance such projects as the Seoul-Busan Railway on the Korean Peninsula, and the Kirin-Changchun Railway and Taiji Mine in northeastern China. Since there was nothing in the Deposit Rules circumscribing the Deposit Bureau's investments, the bureau operated at the discretion of the government, and as a consequence problems emerged almost from the start. A typical example was the trouble surrounding the so-called Nishihara loans, ostensibly private loans extended to a Chinese warlord during 1917 and 1918 with the help of Deposit Bureau funds. The borrower defaulted, and the Japanese government was obliged to assume the debt, paying both interest and principle. In short, the postal savings fund was being used for private overseas investments, and the state was covering the losses.

Accountability for the Special Accounts

Such problems led to calls for tighter controls. In 1925 the government enacted legislation establishing the rules governing the management of the postal savings fund.[1] That was when the special account budgets began to be submitted to the Diet every year.

The third basic service of the postal system, life insurance, was introduced in 1917 with the establishment of the postal life insurance program, known as Kampo. The Kampo fund was managed independently until 1943, when it, too—with the exception of money loaned to prefectural governments—was placed under the management of the MOF Deposit Bureau.

[1] *Yokinbu yokin ho* (Postal Savings Deposits Law) and *Okurasho Yokinbu tokubetsu kaikei ho* (MOF Deposit Bureau Special Account Law).

After World War II, new legislation passed in 1951[2] put the MOF Trust Fund Bureau in charge of fund management and laid the groundwork for integrated management of government funds under the Fiscal Investment and Loan Program, or FILP. Beginning in 1953, MOF was required to submit to the Diet an annual Fiscal Investment and Loan Plan covering all government-operated funds—including the Kampo fund, which at that time was again being managed independently—as information to support budget deliberations. Over time, FILP grew so large as to earn the appellation "the second budget." Through this system, public funds collected via the postal savings and Kampo programs (as well as the public pension system) were pooled into FILP and used to finance quasi-governmental bodies, the special account, local governments, and so forth.

When FILP first came into being, the Diet had no role in deciding how the funds were invested, that is, which entities received loans. However, legislation enacted in 1973[3] made the Fiscal Investment and Loan Plan subject to Diet approval every year. More accurately, it mandated that all loans or investments with terms of five years or more be included in the special account budgets. The rationale was that, even though FILP used financial instruments in raising and spending funds, much like a private bank, it was still allocating resources as a tool of government policy. For that reason, it should be treated in the same way as the general budget, which is financed by taxes, and subject to Diet approval via the budget process. Underlying this decision was the principle of democratic (parliamentary) control of government finances, one of the key concepts enshrined in the Constitution of Japan.

Although FILP has come under frequent criticism in recent years, it played a key role after World War II in the development of social infrastructure essential to Japan's economic development by financing the construction of national expressways and airports, promoting housing construction, subsidizing social welfare facilities, and supporting local public works projects. With the end of the rapid growth era, however, FILP's function and character began to change. During the post-bubble recession of the 1990s, the government relied on FILP spending to stimulate the economy. By 1996, annual lending under the Fiscal Loan and Investment Plan had reached a peak of 40.5 trillion yen, and by the end of fiscal year 2000 the program's assets totaled 417.8 trillion

[2] *Shikin Un'yobu shikin ho* (Trust Fund Bureau Fund Law) and *Shikin Un'yobu tokubetsu kaikei ho* (Trust Fund Bureau Special Account Law).
[3] *Shikin Un'yobu shikin oyobi Kan'i Seimei Hoken no tsumitatekin no choki un'yo ni taisuru tokubetsu sochi ni kansuru ho* (Special Measures Law for Long-term Appropriation of the Trust Fund Bureau Fund and Postal Life Insurance Reserves, or Long-term Appropriation Law).

yen. At a time when General Account spending was under harsh constraints, FILP assumed much of the burden.

FILP under Fire

Since the basic source of FILP funds was postal savings and other interest-paying deposits, FILP was required as a rule to invest in programs or projects that promised a certain minimum return. But in some cases the government used a combination of direct spending and FILP loans to fund quasi-governmental corporations set up to administer programs that, while not profitable, meshed with policy objectives. An example is the interest subsidies paid to the old Housing Loan Corporation, which provided low-interest home loans to the public.

As FILP grew in scale and boosted its lending to such public corporations, those "FILP agencies" came under increasing attack for inefficiency and wasteful spending.

Strictly speaking, the agencies' management problems were separate policy issues, not a FILP issue per se. But the climate in which FILP functioned had changed dramatically over the years. The system may have functioned fairly efficiently at a time when demand exceeded supply and funds had to be lent selectively. But once supply began to exceed demand, it was all too easy to lend the funds indiscriminately and inefficiently, without regard to priorities.

The problems surrounding the agencies through which FILP funding was channeled became a major impetus for reform of the FILP system. The Administrative Reform Council, chaired by the late Prime Minister Ryutaro Hashimoto, recommended "fundamental reform of the Fiscal Investment and Loan Program" in its final report (December 13 1997). Reforms were also deliberated within the Ministry of Finance, which administered the program. The report released by MOF's advisory council (November 27, 1997) enumerated FILP's problems, noting that its ballooning scale and ever-expanding fund encouraged wasteful loans, that its escalating investment in short-term assets and Japanese government bonds was creating distortions in the financial market, that its long-term fixed lending rates were incompatible with market principles, and that evaluation of the programs it financed was lax.

Reform was finally accomplished with the enactment of the relevant legislation in May 2000. The law put an end to the compulsory deposit of postal savings and pension reserves in the MOF Trust Fund Bureau and required that FILP raise funds, on an as-needed basis, by floating "FILP bonds" (essentially Japanese government bonds) on the market. The new system was designed to ensure that demand drove the supply of funds (raised via the capital markets) instead of letting the supply of funds (from sources like postal savings) determine lending. The postal savings, Kampo, and pension funds were to be managed independently via the financial market by investing them in FILP bonds and FILP agency bonds (issued by public corporations, etc.) on the basis of portfolio considerations. This severed the direct flow of funds between the postal savings programs and government agencies via FILP. As a consequence of these reforms, lending under the FILP Plan dropped by 63% between fiscal 1996 and 2006, from 40.5 trillion yen to 15.0 trillion yen.

The Diet's Role and Postal Privatization

Under the new system, an exception was made for loans to local governments, which are often hard-pressed to raise adequate funds through local taxes. This allowed the independently managed postal savings and Kampo funds to provide direct financing to local governments within the frameworks of the Local Government Bond Plan and the FILP Plan. However, the amounts were to be determined not through separate negotiations with local governments but on the basis of allocations approved by the Diet through the budget process, and the loans were to have uniform terms set by the government in keeping with market principles. In this way, FILP funding as a fiscal tool remained subject to Diet approval via the budget process. Because lending to local governments functions as a tool of policy through allocation of resources, the annual FILP Plan was required to disclose all such lending, including loans from the postal savings and Kampo funds, in a consistent tabular format. The fiscal 2006 FILP Plan, for example, includes 170 billion yen from the postal savings fund and 310 billion yen from the Kampo fund among its disbursements to local governments.

With these changes, FILP reform was basically complete. But reform of the postal savings and life insurance systems continued. Japan Post was established as a special public corporation in April 2003, and the cabinet of Prime Minister Junichiro Koizumi forged ahead with his plans for postal privatization. The project hit a temporary setback when the House of Councillors rejected the government's privatization bills in June 2005, but Koizumi called an election of the House of Representatives over the issue, and in October 2005 the privatization bills were finally passed in a special session of the Diet.

Under the privatization plan, Japan Post was reborn as a joint-stock company, Japan Post Group, in October 2007, and the rules requiring Diet approval for loans from the postal savings and Kampo funds to local governments were scrapped. From fiscal 2007 on, resources from the postal savings and Kampo funds were no longer itemized in the FILP Plan; instead, loans from those funds to local governments were treated the same as financing from private banks.

After the Democratic Party of Japan unseated the Liberal Democratic Party in August 2009, the new administration decided to correct perceived problems in the 2005 postal privatization plan. The specifics of this "course correction" are contained in the postal reform bill that the Cabinet submitted to the Diet at the end of April. A detailed examination of the legislation is beyond the scope of this paper. My focus here is on how the latest reform would impact investment of the postal savings and investment funds.

Risk and Accountability

The current reform plan would raise the upper limit on postal savings deposits per depositor, as well as the upper limit on individual insurance policies, a change that has drawn considerable criticism. But one aspect of this policy that needs more attention is how the government intends for these much augmented funds to be invested.

On April 20, at an internal meeting organized by the Ministry of Internal Affairs and Communications with DPJ politicians, Internal Affairs and Communications Minister Kazuhiro Haraguchi submitted a written proposal calling for more effective use of postal savings deposits and life insurance reserves. The proposal stresses the need to change the current portfolio, which invests money mainly in JGBs, in order to "boost returns, while giving due consideration to security issues and keeping investment sound through risk management." More specifically, the document suggests the following:

1. Investment and financing targeted to growth areas

(1) Investment and financing via cooperation, etc., with overseas funds:

> Investment of assets in creditworthy projects carried out under intergovernmental agreements, etc. (investments in and loans for infrastructure projects or venture businesses relating to high-speed rail, toll roads, water supply, etc.)

(2) Investment in and financing of projects implemented under public-private partnerships:

> Development of social capital (bridges, hospitals, schools, and similar facilities) through PFIs [private finance initiatives] and PPPs [public-private partnerships]

(3) Investment and financing in future growth industries:

> Medicine/nursing, environment, information and telecommunications

2. Foreign bonds

3. Loans to individuals

> Home loans, personal loans

At the same time, the proposal insists that "investment decisions would be left to the independent judgment of Japan Post Bank and Japan Post Insurance."

On April 27, moreover, the daily *Asahi Shimbun* reported that Haraguchi, in anticipation of the new postal reform legislation, had ordered his agency to study the possibility of investing something on the order of 10 trillion yen in postal savings and postal insurance funds in growth areas in Japan and abroad. Haraguchi was quoted as saying that the investments would be aimed at strategically supporting Japanese firms working in infrastructure development and other overseas programs. "Japan Post Holdings, Japan Post Bank, and Japan Post Insurance will make their own decisions; we will just assist strategically," Haraguchi explained. "It will all be according to the business judgment of private management, so it isn't like a sovereign wealth fund," he maintained, adding that they were thinking in terms of "about ten trillion yen to start."

In an editorial, the Asahi expressed concern that "the funds' investment activities could be hidden from the public eye and could incur losses for which the taxpayers might end up bearing the cost." A number of critics have lashed out against the plan, warning that it could end up reviving the old, pre-reform FILP system and the wasteful spending associated with it. They are troubled by similarities between some of the investment categories in the aforementioned proposal and those financed with postal savings and Kampo funds prior to the 2000 FILP reforms.

Public or Private?

Article 13 of the postal reform bill before the Diet stipulates that "postal operations shall be carried out with a view to contributing to the healthy development of regional economies and to the economic vitality of the private sector, as by nurturing small and medium-sized businesses," and it identifies "services that contribute to local communities" as one of the responsibilities of the new Japan Post companies. In addition to the basic postal and financial services mandated by law, they would be free to make use of the nation's post-office network to develop new areas of business oriented to improving the lives of local residents, merely by notifying the government of their intentions. As long as they could explain how their new enterprise meshed with the objectives of the new postal reform law, they would be at liberty to branch out into all kinds of businesses.

The bill enumerates the companies' new operating principles, including security, soundness, and profitability, but it does not answer the big question of how those principles square with one another and which are to take priority. In asset management, there is generally a tradeoff between risk and returns. Haraguchi's stated intention to break away from reliance on JGBs suggests that the new policy will tolerate greater risk for the sake of higher returns. Yet the emphasis on services that "contribute to local communities" suggests a more public orientation, which generally demands lower risks and lower returns. Is the management policy Haraguchi envisions that of a for-profit business or that of a public service? If both, how does he intend to strike a workable balance given their conflicting priorities?

At this point, the structure and approach that will govern the new companies operations remain a question mark, but where investment of the postal savings and insurance funds is concerned, the government must make a fundamental choice: public or private? Is the plan for each company to make its own investment decisions from the perspective of a private financial institution, even though it has certain public responsibilities, such as universal service? Or are these decisions to be shaped by government policy? A case can be made for or against either option. This is a policy decision, but if the government goes with the latter option, then there is a need for rules and regulations to preserve democratic control of government finances.

The role of government is to fund programs and projects that are too unprofitable or risky for the private sector. Government programs are by nature unprofitable or risky. To be clear, I do not rule out the idea of allowing a higher level of risk in the investment of postal savings and postal insurance funds, but if policy considerations are driving these risky investments, then they must be subject to democratic control, and this is done through the Diet's deliberation and approval of the budget. This is our system for allocating resources in ways that the market cannot accomplish. The Japan Finance Corporation, established in October 2008 through the merger of the National Life Finance Corporation, the Agriculture, Forestry, and Fisheries Finance Corporation, and similar bodies, is a joint-stock company, but because it provides the financing that our political leaders deem necessary to carry out their policies, its outlays are subject to Diet approval just like those of its predecessors.

FILP was criticized for adding to the public burden by supporting wasteful projects and spendthrift public corporations, but at least it extended loans with the approval of the Diet, not at the sole discretion of the administration. When questions were raised about the management or finances of a public corporation, such bodies as the House of Representatives Committee on Audit and Oversight of Administration, the Board of Audit, and the Ministry of Internal Affairs and Communications were empowered to investigate. If the current postal reform eliminates the role of the Diet on the grounds that Japan Post Bank and Japan Post Insurance are joint-stock companies, yet allows the government to interfere in the allocation of their resources on policy grounds, it will be turning the clock back 100 years. Without suggesting that the situation today is analogous to that existing a century ago, we should nevertheless ask ourselves if we can afford to repeat the mistakes that gave rise to the Nishihara loans.

Learning from the Past

Under the current reform legislation, the Japan Post Group would remain wholly government funded for the time being. Future plans call for the government to retain more than a one-third stake in the parent company, Japan Post Holdings, and for Japan Post Holdings to control more than one-third of Japan Post Bank and Japan Post Insurance shares. While Haraguchi claims that investment of the postal savings and investment funds would be left to the business judgment of these joint-stock companies, there is no denying that the government (or its representative in the person of the minister of internal affairs and communications) will retain tremendous influence over their management. How can the companies be expected to make independent business decisions in defiance of the minister of internal affairs, knowing that the minister has the power to appoint and dismiss their directors?

Such an arrangement also raises the specter of preferential financing for specific agencies or organizations out of political considerations. Yet if a company lost money on such a loan or investment, the politician behind it all could evade responsibility on the grounds that any investment by a joint-stock company was strictly a business decision.

Let me repeat: The issue here is not whether postal services should be privatized or what form of management is most appropriate for these services. My point is that, if postal savings and insurance funds are to be employed for the purposes of public policy, we must maintain a mechanism for democratic control, whether by Diet approval or some other means. The FILP system came under criticism for loans that were never recovered even those its activities were subject to oversight by MOF officials, the Diet's budget and audit committees, and the Board of Audit. How can we expect a more judicious allocation of resources to emerge from the "business judgment" of a joint-stock company—or, more accurately, a quasi-governmental body with a public function—that is free from such oversight? Up to this point, democratic control over the government's investment and loan activities has been gradually strengthened through the Fiscal Investment and Loan System. Now, postal system reforms threaten to reverse this progress.

The government's postal reform bill stops short of delineating the new companies' business operations and activities on the grounds that much of this should be left to the discretion of management. Theoretically, such vague provisions would leave the companies free to do virtually anything they chose, providing it did not run counter to the goals and principles of the reform bill. Taking risks that most would consider excessive could be justified by the principle of profitability.

If the purpose of the latest postal reform is to correct the 2005 privatization plan by strengthening the government's hand and utilize the postal savings and insurance funds for policy purposes, then a mechanism for democratic control is necessary. At the very least, the government needs to propose specific rules and guidelines for fund investment and gain a public consensus for them. Those who would overhaul a major public institution have a responsibility to base those efforts not only on factual analyses of the present situation but also on a full understanding of the historical processes that brought us to this point—lest they condemn us to repeat the mistakes of the past.

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Political Leadership and the Policymaking Process

By Tanaka, Hideaki

Half a year has passed since the Democratic Party of Japan came to power. A change of government offers a remarkable opportunity to break existing molds, and the public hoped the new administration would do so. Unfortunately, however, in the area of policymaking, the transparency of government operations has actually declined except in a few areas, such as program review. I have no argument with the DPJ administration's direction for politician-led government, but I question whether it is truly desirable to have a policymaking process in which the policy decisions are made just by the ministers, senior vice ministers, and parliamentary secretaries of each ministry. In the manifesto that it issued before last year's lower house election, the DPJ set forth a number of policies with a major impact on the economy, government finances, and people's living conditions, including a child allowance, an individual household income support system for agriculture, elimination of expressway tolls, and a review of the privatization of the postal services. But the new administration has not fully analyzed and considered these policies in preparation for their inclusion in the budget for fiscal 2010 (April 2010 to March 2011). In this series of articles I will review the policymaking process of earlier administrations and discuss problems with the process under the current administration, with reference also to the approaches taken in other countries.

Traditional Policymaking: A Joint Endeavor

During the long period of rule by the Liberal Democratic Party (including the years when it was the main party in the ruling coalition), the key to the policymaking process was held by the divisions of the party's Policy Research Council. There was a separate division for just about every ministry and agency, and each bill and institutional change that the government proposed had to be vetted and approved by the relevant division or divisions. This was generally called "prior screening." Sometimes even cabinet ministers found it hard to disagree openly with the LDP division heads. So the responsible officers in the ministries and agencies often provided explanations to key figures in the party divisions

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even before they explained matters to their own minister. Ultimately, under this system of prior screening, the government proposals needed to be approved not just by the relevant divisions but also by the LDP's General Council. Meanwhile, the ministries and agencies had outside experts participate in councils and other forums to debate and consider proposed measures, but in most cases the reports that emerged from their deliberations reflected not so much independent analyses and considerations by experts as the interests of the ministries and agencies in question. The councils were often criticized as being manipulated by officials so that their interests are reflected. The consideration of proposals by the ministries and agencies was conducted simultaneously with consideration by the councils and by the LDP divisions, and the final adjustments were made through moves to reach agreement between the government organs and the party divisions. Since these final adjustments were not carried out within the cabinet or the Diet, it was not necessarily clear who was making the decisions.

This traditional policymaking process was reformed by the creation of the Council on Economic and Fiscal Policy(CEFP) as part of the overhaul of central government organs implemented in January 2001. The CEFP was set up with the prime minister as its chair and with members consisting of the chief cabinet secretary, the minister of state for economic and fiscal policy, the minister of internal affairs and communications, the minister of finance, the minister of economy, trade, and industry, the governor of the Bank of Japan, and four private-sector members (two from the business world and two from academia). The council's main responsibility was to study and deliberate important matters concerning economic and fiscal policy as directed by the prime minister, including basic policies for management of the economy as a whole, for management of government finances, and for compilation of the budget.

The CEFP played an active role during the administration of Junichiro Koizumi, who became prime minister in April 2001 and held the post through September 2006. Prime Minister Koizumi took the lead in formulating policy, setting the agenda for the council and having it conduct open discussions so as to achieve his own policy goals, such as privatization of the Japan Highway Public Corporation and of the postal services. The council became involved in the drafting of many key government documents, including the annual basic policies for economic and fiscal management and structural reform (nicknamed the *honebuto no hoshin*, or "basic policies"), the overall framework for the budget, and basic policy for budget compilation. At meetings of the CEFP, ministers were required to participate in the discussions using their own words (rather than simply reading aloud from memos prepared by bureaucrats), and the minutes of the discussions and the materials distributed at the meetings were made public, heightening the level of transparency in the policymaking process. The CEFP is legally an advisory council, not a decision-making organ, but with the prime minister as its chair, in practice it took control over policymaking.

Though the CEFP did bring about reform of the policymaking process, including increased transparency and decision making led by the prime minister, it faced limitations due to its nature as an advisory council. If it had been like an ordinary council, just a panel on which experts voiced their opinions, there would not have been much friction, but the more it became involved in making decisions concerning structural reform and other important policy matters, the more it became necessary to coordinate and adjust its decisions with the parties of the ruling coalition (the LDP, the New Komeito, and, until November 2003, the New Conservative Party). For example, in formulating the *honebuto* basic policies, on top of the process of coordination within the government, the initial draft prepared by the CEFP was modified on the basis of adjustment with the ruling parties. The daily newspaper Nikkei reported as follows on June 27, 2003, regarding the formulation of that year's *honebuto* policies: "The original proposal to limit the latent national burden [the ratio to national income of the sum of taxes, social security contributions, and the budget deficit] to around 50% was substantially watered down. The final wording ended up presenting it as what might be taken as an example rather than a target." "It was decided to reduce government subsidies by ¥4 trillion over a three-year period, but in the face of resistance from the ministries and agencies, not a single piece of the contents was decided." "Neither Prime Minister Koizumi nor anybody else from the government, bureaucracy, or private sector managed to exert leadership, and matters on which there are bound to be differences with the ruling party have been put off to be handled as part of the year-end budget compilation and tax reform processes."

The CEFP does not include senior members of the ruling party, so the process of adjustment between the government and the ruling party takes place outside of this council. Since the government requires the cooperation of the ruling party in enacting or revising legislation to implement the policies adopted by the cabinet, if the CEFP is to function as a de facto decision-making body, coordination with the ruling party is obviously necessary. Even though the prime minister chairs it, the CEFP is no more than an investigative and deliberative organ. In the approach to integrated reform of expenditures and revenues, which was on the agenda in the latter part of the Koizumi administration, the LDP's Policy Research Council became actively involved in the drafting of a concrete proposal, and instead of the earlier top-down process led by the CEFP, deliberations were conducted as a joint effort by the government and the ruling parties. In specific terms, on May 22, 2006, a Council for Comprehensive Financial and Economic Reform was established, composed of six cabinet members, including Minister of State for Economic and Fiscal Policy Kaoru Yosano, Minister of Finance Sadakazu Tanigaki, and Minister of Internal Affairs and Communications Heizo Takenaka, and 19 officials of the LDP and Komeito. This council was effectively placed above the CEFP. The LDP, which had been sidelined under the Koizumi administration, thus rejoined the policymaking process. This was because the realization of policy was not possible without the involvement of the LDP. The newly created council considered practical cuts in spending.

Leadership by the Cabinet and Formulation of Policies

The CEFP played a major role in Japan's policymaking process, but Koizumi's successors as prime minister lacked the will to make active use of this council, and so its role receded. The relationship between the government and the ruling party within the policymaking process has still not been properly settled. It was in this context that the DPJ took power after a landslide victory in last summer's House of Representatives election. The DPJ administration proclaimed its intention of eliminating bureaucratic leadership and replacing it with government led by politicians. In concrete terms, it abolished the ruling party's policy councils and put the top-ranking politicians in each of the ministries and agencies—the minister, senior vice ministers, and parliamentary secretaries—in the center of the policymaking process. Also, it set up policy councils in each ministry to gather the opinions of ruling party legislators, and it created ministerial committees for specific topics to reconcile differences among the ministries and agencies. In addition, the DPJ manifesto included a promise to put more than 100 Diet members in government posts to effectively draft and make decisions on policy; the relevant legislation has been submitted to the current session of the Diet. The DPJ administration proposes to abolish the CEFP, the symbol of the Koizumi reforms, and all but a few of the government's other councils have been put on hold.

The DPJ administration insists that politicians should be at the center of the policymaking process. I do agree with the idea of replacing the two-track system involving the government and the ruling party with a unitary system in which decisions are made by the cabinet. The previous set of arrangements did not make it clear who was to take responsibility. But I question whether it makes sense to leave the process of discussing and reaching decisions on policy just up to the politicians in the top three positions in each ministry. In its electoral manifesto, the DPJ set forth a number of policies with a major impact on the economy, government finances, and people's living conditions, including a child allowance, an individual household income support system for agriculture, elimination of expressway tolls, and a review of the privatization of the postal services. But how has the new administration gone about considering these policies and including them in the budget for fiscal 2010? Next I would like to review the policymaking process as it was applied to the child allowance, which involves the largest amount of money among the new policies.

A Look at the Policymaking Process

The Democratic Party of Japan's 2009 electoral manifesto outlined the child allowance that it proposed to implement as follows:

- Introduce a "child allowance" of ¥312,000 per annum (¥26,000 per month) for all children until they finish middle school (half this sum in fiscal 2010).

- Change from tax exemptions, which favor those with relatively high incomes, to cash benefits that favor middle- and low-income families.

- Cost: Approximately ¥5.3 trillion.

Government expenditures related to social welfare in Japan are disproportionately directed toward the elderly, including outlays for medical care and pensions; only a small portion goes toward child care and support for families. According to data from the Organization for Economic Cooperation and Development (OECD Social Expenditure Database 2007), family-related government expenditures (which include cash benefits, child care and preschool education, benefits for maternity and child-care leave, and allowances for families) as a proportion of gross domestic product in 2003 stood at 3.54% for Sweden, 3.02% for France, 2.93% for Britain, and 2.01% for Germany. By comparison, Japan's total was 0.75% of GDP, and that for the United States was 0.70%, a figure even lower than Japan's. It is only natural that public expenditures are lower compared to Sweden and France, where the combined burden of taxes and social security contributions are higher (as a proportion of GDP, the combined burdens were 56.0% for Sweden, 50.5% for France, and 31.7% for Japan in 2005, according to the *OECD Economic Outlook*, no. 86, 2009). Allocating more resources for families, though, is no doubt the right strategy if Japan is to create a child-friendly environment. The previous child allowance was subject to income testing (for example, a salaried employee with three dependents was subject to an income ceiling of around ¥6.5 million). It provided allowances of ¥10,000 per month for children under age 3, ¥5,000 per month for the first two children aged 3 and over, and ¥10,000 per month for every additional child thereafter. This compares poorly with other countries. (For example, in France, while there is no allowance for the first child, the monthly allowance is equivalent to roughly ¥15,000 for the second child and around ¥20,000 for every additional child thereafter.) The policy of eliminating tax exemptions that favor high-income earners is a logical means of financing the new child allowance.

Expanding financial support for child care is a good idea in principle; the problem lies in designing the system by which this is to be done. Various discussions concerning the introduction of the child allowance took place during the process of compiling the fiscal 2010 budget, which was concluded in late December 2009. The salient points are listed below.

・What is the purpose of the child allowance? Is it a measure to support low-income earners, a measure to address the declining birthrate, a means of boosting the economy, or something else?

・Should the allowance have an income ceiling? In the face of a deepening budget deficit, should it be paid even to wealthy households?

・How will the government finance the roughly ¥5 trillion for its cost?

・Would it not be better to expand child-care centers and other services than to distribute cash benefits that may end up being used for parents' consumption?

・What is the basis for setting the monthly allowance at ¥26,000 per child?

・Won't eliminating income tax exemptions increase the burden on some households, such as those supporting disabled adults?

These arguments even resulted in differing opinions among members of the cabinet. For example, Mizuho Fukushima, head of the Social Democratic Party of Japan and minister of state for consumer affairs and food safety, social affairs, and gender equality, argued that more resources could be allocated to child-care centers and other services by reducing the amount of the allowance. And according to one newspaper report, even as the budget compilation process was drawing to a close, opinions had yet to converge on the issue of an income ceiling (*Yomiuri Shimbun*, December 19, 2009). At a press conference, Kenji Yamaoka, chair of the DPJ's Diet Affairs Committee, remarked that the idea of setting the income ceiling at around ¥8 million was unreasonable, saying it should properly be something like ¥20 million." As Yamaoka is an influential Diet member with close ties to DPJ Secretary General Ichiro Ozawa, the view spread that the government was leaning toward setting a ¥20 million ceiling. In the end, however, the issue was decided by Prime Minister Yukio Hatoyama's political decision: At a press conference held on December 21, he announced his intention not to introduce a ceiling on income (and his decision to modify the DPJ campaign manifesto with respect to repealing the provisional tax on gasoline, among other items).

In tandem with these moves inside the government, newspapers and magazines provided reports on the net effects of the increased tax burdens resulting from eliminating exemptions based on income brackets and family makeup and the increased payments from the new child allowance—that is to say, they published winners and losers by income level. These calculations, however, were simply based on a model analysis that covers only a small proportion of households; the government did not provide a comprehensive analysis of the entire population. A discussion paper by Noriyuki Takayama and Kosuke Shiraishi ("Kodomo teate donyu koka no maikurosimureshon" [A Microsimulation of the Effects of the Child Allowance], Discussion Paper 454, Hitotsubashi University Center for Intergenerational Studies, Institute of Economic Research, 2009) was more comprehensive, based on the 2007 National Livelihood Survey (Ministry of Health, Labor, and Welfare) and analyzing the effects of the DPJ's plan to introduce a new child allowance and eliminate benefits like tax exemptions for spouses. According to their analysis, of the country's more than 50 million households, 38% would enjoy a net increase in income, 43% would see no change at all, and 19% would experience a net increase in their tax burden. The authors' extensive analysis also incorporated such aspects as a breakdown of the child allowance's impact according to annual income and family makeup, as well as the effects of reinstating tax exemptions for the elderly.

However, data and analyses of this sort have not been forthcoming from the government—that is to say, the Ministry of Health, Labor, and Welfare. The government's newly established Tax Commission released provisional calculations and data concerning the impact resulting from the elimination of income tax exemptions and the institution of a new exemption for certain adults (the special exemption for adult dependents). But no data has been released either on the net impact of introducing the child allowance or concerning the resulting changes to the poverty rate and inequality. Although the child allowance is a major policy measure requiring over ¥5 trillion in funding, the draft of the fiscal 2010 budget approved by the cabinet in late December last year revealed only that half the allowance would be disbursed in the initial year and that no income ceiling had been set. The government failed to sufficiently address the earlier-stated points of contention. Did it simply assume that it was merely fulfilling the promise it made to the public in its manifesto, so that processes like analysis and review were unnecessary? Properly speaking, the government needs to examine the present state of income distribution and of matters relating to child care and clearly analyze what the problems are, whether it is cash or more services that are needed, where the inequalities lie, and so forth. Perhaps this task should be entrusted to outside independent experts. The government should then undertake discussion that involves the public with respect to things like what measures are needed and in what direction to take them, and work to achieve consensus.

Generally speaking, reforming systems related to social welfare results in both winners and losers, making it easy for interests to clash. Thus what is needed is a process that enhances transparency, coordinates among different interests, and leads to consensus. By no means is this to say that the old approach, wherein the debates took place within the policy divisions of the ruling Liberal Democratic Party and the councils set up by government ministries and agencies, was better. But at least a reasonable amount of data was disclosed through this process. And after the Council on Economic and Fiscal Policy was established in 2001, debate among cabinet members and other discussions was made public. But there was no such disclosure during the formation of the current budget. Decisions were made through "political leadership" by the cabinet ministers responsible for such organs as the Ministry of Health, Labor, and Welfare, the Ministry of Finance, and the National Policy Unit and by the secretary general of the DPJ. And the issue of whether to continue paying the current child allowances emerged to confuse matters near the end of the budget compilation process. Individual ministers and the cabinet as a whole should of course bear responsibility for decisions on policies and creating new systems, but once introduced, these policies are not easy to change. This makes it all the more necessary to analyze the current systems, define the objectives and impact of new policies, and subject them to thorough verification before they are adopted.

The Australian Approach

I have thus far identified current problems in Japan. Now I shift my focus to the question of how public policy is formulated by governments in other countries. Since it is impractical to present the approaches of every industrialized country in the Organization for Economic Cooperation and Development, I have chosen to narrow my focus. The efforts being undertaken in Britain and other English-speaking countries provide special insight, as they include the implementation of analyses and various consultations by independent experts concerning policy drafting and institutional reforms. In Japan, the issues of the child allowance and tax exemptions are now being debated, and moves are afoot to undertake integrated reform of the tax and social security systems. Here I will introduce the case of Australia, where similar reform efforts are currently underway (see the following website for details: http://taxreview.treasury.gov.au/Content/Content.aspx?doc=html/home.htm).

Australia's Treasurer Wayne Swan announced the plan to undertake an integrated review of tax and social security systems in May 2008. To this end, a review panel was established, headed by Departmental Secretary to the Treasury Ken Henry and including Jeff Harmer (Departmental Secretary, Department of Families, Housing, Community Services, and Indigenous Affairs), John Piggott (professor, University of New South Wales), Heather Ridout (chief executive, Australian Industry Group), and Greg Smith (adjunct professor, Australian Catholic University). A committee to review reform of the country's pension system was established at the same time. Here it must be borne in mind that Australia differs from Japan in that ordinary civil servants as high up as secretaries are expected to be professional experts and maintain strict political neutrality.

These panels are comparable to the councils set up by Japan's government ministries and agencies, but a major difference is that, unlike the government councils in Japan, they are set up on an ad hoc basis, operating under terms and conditions defined in advance by the government with respect to such matters as the objectives, scope, methodology, and timetable for the review. Another difference from Japan is that experts from the private sector do not serve as regular panel members and act as mouthpieces for the bureaucracy. Here are some of the conditions that were established for the Future Tax System Review: "The review should take into account the relationships of the tax system with the transfer payments system and other social support payments, rules and concessions, with a view to improving incentives to work, reducing complexity, and maintaining cohesion" and "The review panel will consult the public to allow for community and business input."

The process of review began in earnest in August 2008, when the government published "Architecture of Australia's Tax and Transfer System," a discussion paper analyzing the problems and conditions of this system. From August to October the review panel invited opinions from the public by presenting them with specific questions, and exchanged opinions regarding the tax and transfer system with representatives of various industries, experts, community figures, and others. The opinions put forward, both from organizations and private individuals, were posted to the panel's website.

Based on these opinions and other considerations, in December 2008 the review panel released a set of consultation papers that presented analyses of newly defined problems and other matters, providing materials for conducting further review, public hearings, and consultations. From then until mid-2009, opinions were invited with regard to both the tax and transfer system and the pension system. Public meetings to exchange views were attended by representatives of various industries, experts, and other interested parties, and public hearings were held in the each of the state capitals.

The deadline for the public to submit opinions was May 2009, and the following month a large conference on tax and transfer system policy was held in Melbourne. May was also the month in which the government released its report on the retirement income system. From June until November, the review panel undertook further consultations and review meetings with related organizations. Finally, in December 2009 the panel submitted its first report to the treasurer. In advance of this, a Pension Review Report based on the review being undertaken concurrently with the review of the tax and transfer systems was issued in February 2009. The report provided an analysis of the problems and conditions of the pension system, as well as recommendations for the direction of reforms.

In Australia, a panel of experts spent approximately one and a half years working toward integrated reform of the tax and social security systems, conducting evidence-based analyses of the current situation, holding consultations and public hearings directed at the entire country, clarifying the problems, and offering recommendations for the direction of reforms. These recommendations will be taken into account when the government submits its proposal for reform to the federal parliament. This is a major set of reforms, and the entire process from review to enactment will require more than two years. Japan's new child allowance is a measure to redistribute income intricately related to its tax system, and it is a significant policy undertaking that will eventually require over ¥5 trillion in funding. But in Japan's case, no data has yet been made public, nor has there been anything in the way of consultations with experts or the public. So far, the only definite outcome has been its inclusion in the fiscal 2010 budget.

Transparency and the Decision-Making Process

Why has Australia adopted this sort of policy review process? It is not from an abstract commitment to "improving transparency" as an important value; rather, it is an approach adopted in order to avoid failure in policymaking. If the policy fails, it is the public's welfare that suffers. The reason for gathering a broad range of opinions and building consensus is that tax and social security reforms are likely to cause conflicts between differing interests. The U.K., the United States, and the Scandinavian countries also share in this approach. Countries like the U.K. and Australia are generally seen as having strong political leadership, but this is not to say that policy there is discussed and decided solely by politicians. Naturally, final decisions should be made by a cabinet composed of politicians elected by the public. The issue lies in the decision-making process. In Japan the government—particularly the bureaucracy—has been considered infallible, but actually this attitude has led to problems such as the failure of the medical care system for the elderly and miscalculations in estimating demand for expressways and airports. Back during the postwar period of rapid economic growth, the expanding economy would eventually fix the problems from such failures, but now the situation has changed. We should approach the process of policy review by assuming that a government often fails.

Even in Japan, we have had cases like the reform of the pension system in 2004, which—however one may evaluate the policy itself—did involve a variety of studies and deliberations. The Social Security Council's pension committee launched its review in January 2002. In September 2003, written proposals were compiled and Minister of Health, Labor, and Welfare Chikara Sakaguchi issued a draft proposal concerning the benefits and burdens that would result from reform. Based on this, the ministry drafted its bill in November that same year. It then passed through an advisory panel and the ruling coalition's deliberation committee, and in February 2004 the relevant legislation was presented to the Diet. The child allowance, involving as much as ¥5 trillion in spending, is a policy of significance on par with that of pension reform, but the process of considering it was concluded after only roughly four months starting from September 2009. What is more, basic data concerning the plan was not released, nor was public opinion invited. Unfortunately, one can only conclude that the policy formation process in this case was less transparent than in the past. In the case of Australia's integrated reform of its tax and social security systems, the process of formulating a proposal began with an analysis of the current situation and took one and a half years.

The public voted for the Democratic Party of Japan with the expectation of a change of government. A change of government increases the chances for reform, but does not guarantee that the reform will be successful. According to recent newspaper reports, support for the administration has been decreasing significantly. This is because the credibility of the government is being called into question. The government is expected to show new policies that are different from those of the previous government and improve its credibility. This is one of the most important conditions for a lasting administration. The new administration is planning to establish a panel to consider reform of the pension system, so it is still not too late. The government should work to make the decision-making process for the child allowance and other important policies based on its manifesto more transparent. That, above all, will contribute to improving the welfare of the public.

In conclusion, I offer the following three proposals for the future shape of policymaking in Japan, with reference to the initiatives taken in Australia and other considerations.

(1) Disclosure of data and calculation methods

The government should make public the various data relating to matters such as income redistribution and the supply and demand for services, or make this data easier to access.

(2) Wide-ranging consultation

Rather than establishing permanent advisory councils, the government should set up ad hoc review panels composed of agenda-specific experts and ask them to carry out an objective analysis. Furthermore, it should invite opinions widely from both organizations and individuals (needless to say, the government will need to respond to these opinions) and foster debate.

(3) Use of ministerial committees

Decisions should be made after substantive debate has been conducted among the relevant cabinet ministers concerning details of policy content and system design, based on facts and data.

May 24, 2010

Where the Market and Morality Intersect: A New Approach to World Poverty

By Novogratz, Jacqueline

In April the Tokyo Foundation presented Acumen Fund CEO Jacqueline Novogratz as guest speaker at the 32nd Forum. Sharing Ms. Novogratz's commitment to leadership development, the Foundation has partnered with the Acumen Fund since 2008, working in Japan to publicize the Acumen Fund Fellows Program and encourage potential applicants. At the Forum, Ms. Novogratz discussed her work and the practical and moral imperatives that drive it in her presentation, excerpted below.

When I was ten years old, my Uncle Ed gave me a blue sweater that I adored. It had a design of mountains right across the chest, and I wore it up into my freshman year in high school. By then, my adolescent contours were interacting with the design of the sweater in a way that one day inspired my high school nemesis to yell across the hall that the boys need not travel to the mountains to ski any more; they could just ski across the mountains on my chest. I think every teenage girl experiences a moment of intense humiliation that she never forgets, and this was mine. I ran home to my mother, who ceremoniously dumped the sweater in the Goodwill bin, and I assumed I would never have to lay eyes on it again.

About 10 years later and 5,000 miles away, I had abandoned a career on Wall Street and was working with a small group of Rwandan women to launch their country's first microfinance bank. One day I was jogging through the streets of Kigali, when I saw a boy about 10 meters in front of me, wearing a sweater that looked exactly like the one I had thrown away. I ran up to the child, grabbed the collar, turned it over, and sure enough—there was my name, written on the collar of his sweater. It was a kind of revelation for me, and ever since then, I have cherished this story as a metaphor for human interconnectedness, a vivid example of how our daily actions—or inaction—can impact people we may never meet, all around the world.

Novogratz, Jacqueline Founder and CEO of the Acumen Fund.

From Rwanda to Acumen

In this and other ways, I trace my journey to Rwanda. Living and working there was an extraordinary experience that taught me what a small group of people can do if they put their minds to it. We built the country's first microcredit bank, and today, 21 years later, it is still the largest such institution in the country. It was not always a heartening experience; returning to Rwanda after the genocide, I found that the women with whom I worked had been both victims and perpetrators. But in the end, I came away with three vital lessons that have informed all my efforts since then, particularly my work with Acumen Fund.

The first lesson is that markets, left to their own devices, will not solve the problem of poverty. The market is efficient, and it can function as an excellent listening device, but it is not by nature a force for equality or inclusiveness; to the contrary, left unhindered, it tends to exacerbate the gap between rich and poor, a tendency we have seen not only in the United States but all around the world in recent years. The second lesson is that the traditional top-down approach of charity or grant aid cannot solve the problem, either. Too often it fosters dependence and undermines human dignity. And if I have learned anything over the past 25 years, it is that dignity is more important to the human spirit than material wealth. That was the third lesson.

I founded Acumen Fund in 2001 in the belief that the key to breaking the cycle of poverty was to treat people with respect, as human beings and agents of change eager and willing to improve their lives through their own efforts. I felt there had to be a better way than laisser-faire capitalism on the one hand and top-down charity on the other.

The idea behind Acumen was to enlist the market and its tools to achieve long-term social change. For this, we would need "moral imagination," and we would also need what we call "patient capital." Patient capital is in it for the long haul, and it takes risks that traditional capital would shun. Patient capital makes it possible to adopt and build on promising innovations and best practices even if they offer no prospect for short-term profits. Our plan was to raise patient capital and use it for philanthropic investments in the form of equity or debt, to support promising enterprises committed to building solutions for their poorest customers. We were convinced there was a niche for such investment because of the billions of dollars that go toward philanthropy each year—$250 billion in the United States alone. Instead of just donating money, Acumen Fund proposed to invest it. We would be honest with our investors, sharing our failures as well as our successes, and we would measure success both in monetary terms—because we would need financial returns in order to reinvest—and in terms of social impact.

To date, Acumen Fund has invested approximately $40 million in projects oriented to basic services—water, healthcare, housing, alternative energy, and agricultural inputs—primarily in Pakistan, India, Kenya, and Tanzania. Locally, these investments have created about 25,000 jobs and delivered services to tens of millions of people. Moreover, we have seen more than $1.2 million come back to Acumen Fund this year alone, and we expect that to rise to $2.1 million by the end of the year. This is money that we can reinvest in the future.

Case Studies in Change

Of the 40 projects in which Acumen Fund has invested to date, I would like to present two that I regard as particularly instructive. One of our most successful investments has been carried out in partnership with a major Japanese corporation, Sumitomo Chemical. The company had developed a mosquito bednet impregnated with a long-lasting insecticide that could protect people from malaria for five years. Initially, the product was manufactured in Vietnam and China, but then Sumitomo had the idea of transferring the technology to African entrepreneurs, so that they could address Africa's problems themselves. The company linked up with Acumen, as well as with UNICEF, Exxon, and the Global Fund. We located an African entrepreneur in Arusha, Tanzania, who was willing and able to undertake a long-term project with significant risks—a venture of the type that traditional banks are generally unwilling to finance.

Using our patient capital, we extended a loan of $350,000 in 2002. At the time, my hope was that the investment would lead to the creation of 105 jobs and the manufacture of 150,000 nets per year. As of now, the company has created some 7,000 jobs, making it one of Tanzania's largest employers, and it manufactures 20 million bednets that protect 40 million Africans every year. This is a huge success story for Africa and an inspiring example of how entrepreneurship can bring about positive change.

Another business that is improving people's lives in East Africa is Ecotact, based in Nairobi, Kenya. In Kenya 50 percent of the population lacks access to sanitation facilities, and the problem is particularly serious in crowded, low-income urban areas. The government invested in public facilities in such areas back in the 1970s, but these low-quality facilities had become filthy, dangerous places.

A few years ago, a Kenyan entrepreneur named David Kuria came to Acumen Fund with a nonprofit model for building a high-quality public toilet system. Although we saw the rationale for a nonprofit venture, we decided to work with him to develop it into a public-private partnership that could work with the government while also gaining access to private capital. The plan materialized, and today Kenya has about 26 of these high-quality public facilities, which together serve 16,000 to 18,000 people per day.

Kuria's undertaking is particularly significant because, in addition to an important health issue, it addresses the issue of human dignity. It operates on the assumption that people of all income levels want a safe, clean, pleasant environment and are willing to pay a reasonable fee for it. The toilets cost five cents per use, but they are kept scrupulously clean and even provided with piped-in music. Ecotact plans to build some 200 of these public facilities over the next five years, and the governments of Tanzania and Uganda are studying the possibility of adopting the same model.

Fostering Leadership

The project above illustrates an important lesson we have learned over the last nine years, namely, that capital alone is not sufficient; we also need to build human capacity to make new systems work and change society over the long term. With this in mind, we launched our Acumen Fund Fellows Program about five years back in an effort to identify and develop leadership around the world.

As we see it, leadership requires not only business management skills but also "moral imagination"—being able and willing to envision the consequences of one's actions from a moral standpoint—because that, after all, is what this work is really about. We need leaders with the patience and insight to listen, to understand the needs of low-income people, and to build solutions for and with them. The Tokyo Foundation shares our belief in the importance of leadership development, and it has become a valued partner in this undertaking.

Each year we choose 10 people out of some 600–700 applicants. We introduce them to some of the best and brightest leaders around the world, and we take them through a curriculum that includes not only business management but also philosophy and ethics—great thinkers, from Plato and Confucius to Nelson Mandela and Martin Luther King, who stressed our duty to our fellow human being and the struggle for social justice as part and parcel of this human journey of ours. Acumen Fund fellows come from about 65 different countries and bring with them important skills and outlooks of their own. This past year, we were pleased to welcome Satoko Okamoto, who joined the Acumen Fund Fellows Program with the support of the Tokyo Foundation and contributed her own unique and valuable perspective.

Training such leaders is one of the most difficult things we do, but I believe it is also one of the most important. This is why we take our Fellows Program so seriously, and this is why it has been so gratifying to see the graduates of our program being recognized as promising leaders by major companies around the world.

Vision and Action

My immediate purpose in establishing Acumen Fund was simple enough—to address the problem of poverty. But defining poverty is not as easy as one might think.

Economists tend to define poverty in clear-cut monetary terms. But people in different societies may feel equally trapped and excluded from the mainstream economy even with widely disparate incomes. A person making $10,000 a year in rural South Carolina with no social supports and no prospects may be more desperate than someone in Bangladesh living on $3 a day but with a social network and a sense that things are going to get better. This is why I have come to view poverty fundamentally as a lack of choice. It may be about education. It may be about healthcare. It may be about having a voice.

Of course, when we see people struggling with basic issues of physical survival, our natural and correct response is that we need to find ways to solve those problems. But it seems to me that true moral imagination derives from an awareness that we are all interconnected—the lesson of the blue sweater, if you will. This is why, over the years, I have stopped thinking of the world in terms of developed versus developing, or “my nation” versus “your nation.” I feel we have reached a point in history where it is incumbent on us to think in terms of a single, interconnected world.

My ultimate goal for Acumen Fund is to overthrow the prevailing model of development—which veers between pure charity on the one hand and an unfettered free market on the other—and treat the poor as full-fledged human beings, looking at the situation from their perspective. We have a lot of work to do before we reach this seemingly simple goal. But the last 25 years has taught me how much we really can accomplish once we commit ourselves.

In Japan I was told that many young people admire that sort of optimism, but most are realists and reluctant to tackle risky ventures, especially in these economically uncertain times. My answer to that is that every action we take entails risk, but inaction has its risks as well. It seems to me that, particularly when one is young, the risks of not following one's dreams are much greater than the risks of trying and possibly failing.

My own generation is largely to blame for this reluctance, I think. We have defined success in financial terms and equated happiness with security. Perhaps it is time to rethink these assumptions. As I see it, the secret of happiness is a sense of meaning and purpose, and that comes from committing oneself to something bigger than oneself. You can see the difference this makes in people, especially as they get older. Those who are living lives of meaning and purpose sparkle with energy and optimism, even if they happen to be going through difficult times. They have built something inside themselves that no one can take away.

For those who feel overwhelmed by the challenges, who despair of making a difference, I would stress the importance of taking one step at a time. I have spoken with young people who seem to think that they need to become CEOs overnight in order to make a difference in the world—when all they really need to start is to add one tool to their toolkit. Remember, "A journey of a thousand miles starts with a single step." I would urge young people everywhere to take that first step, because the world has never needed you more than it does right now.

As they say, if not us, who? If not now, when?

May 21, 2010

The Urgent Task of Lowering Japan's Corporate Tax Rate

By Morinobu, Shigeki

Japan must consider lowering its corporate tax rate, which is among the highest in the world, to protect jobs and address the needs of a graying population. EU member states have actually seen tax revenues rise by lowering corporate taxes and expanding the tax base, and this offers valuable hints on how Japan can proceed with its own tax reform.

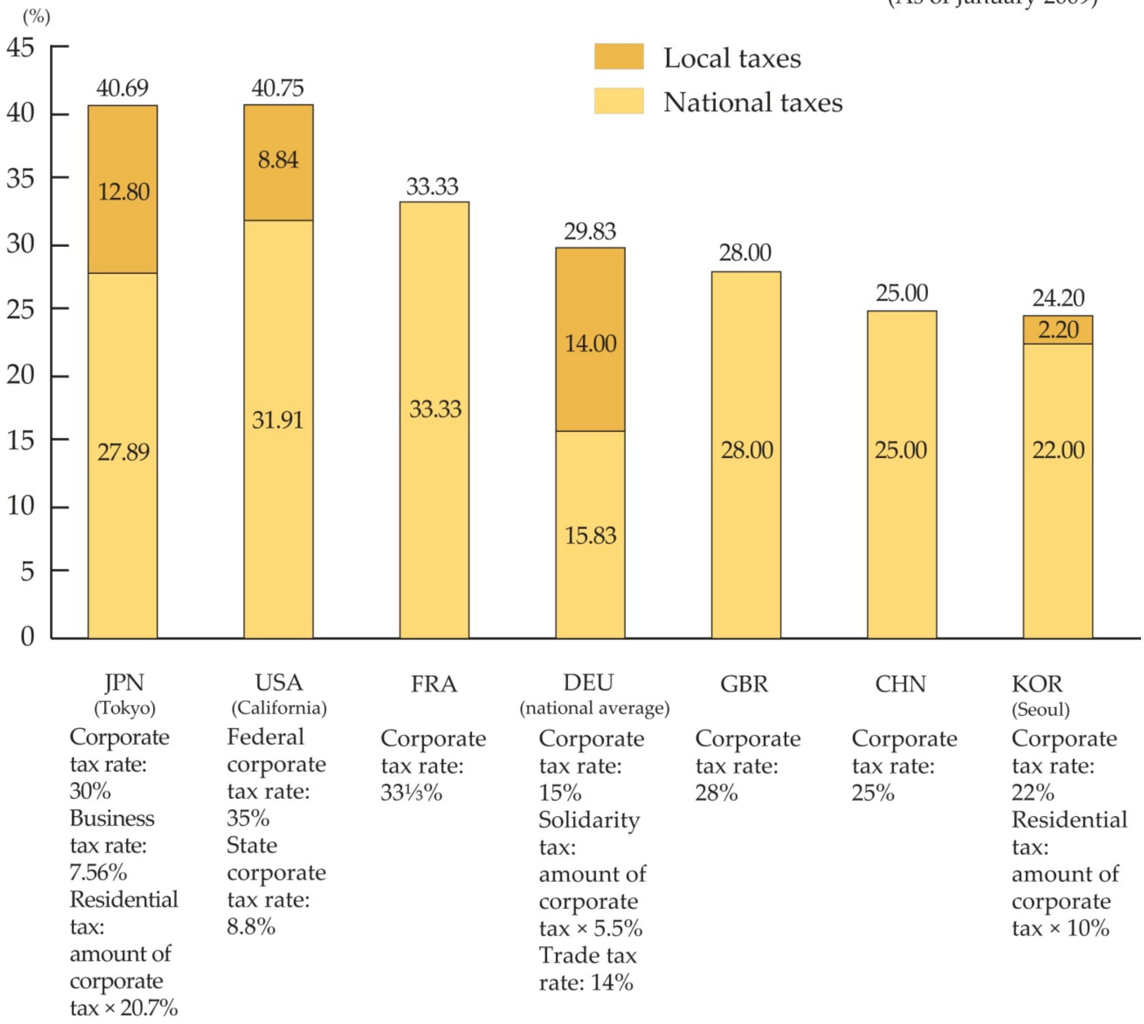
1. The Need for Reform

Remarking in the Diet on March 12 that corporate tax rates "should rightly be guided lower," Prime Minister Yukio Hatoyama hinted that he would launch discussions on reducing the rates. His Democratic Party of Japan had been criticized for lacking a growth strategy, so many welcomed the remark as the first bright news in a long time.

An international comparison of nominal and effective corporate tax rates reveals that the statutory rate in Japan and the United States are around 40%, some 10 percentage points higher than other industrial countries (Figure 1). This, as will be described below, is the result of repeated efforts by countries other than Japan and the United States to lower their rates and attract foreign businesses.

Morinobu, Shigeki Senior Fellow of the Tokyo Foundation. President, Japan Tax Institute; professor of law, Chuo University. After earning a law degree from Kyoto University in 1973, joined the Ministry of Finance. Served as advisor to the Minister of Finance of Japan in London (head of the London Representative Office, Japan Center for International Finance); head of the Research Office, Coordination Division, Securities Bureau; director of the Coordination Division, Tax Bureau. Has been a professor at the School of Law of Osaka University and director general of Tokyo Customs, and has taught at Princeton University. Has also been president of the Policy Research Institute, MOF (2005–6), visiting professor at the University of Tokyo, and visiting scholar at Columbia Law School. Retired from MOF in 2006. Is a doctor of law.

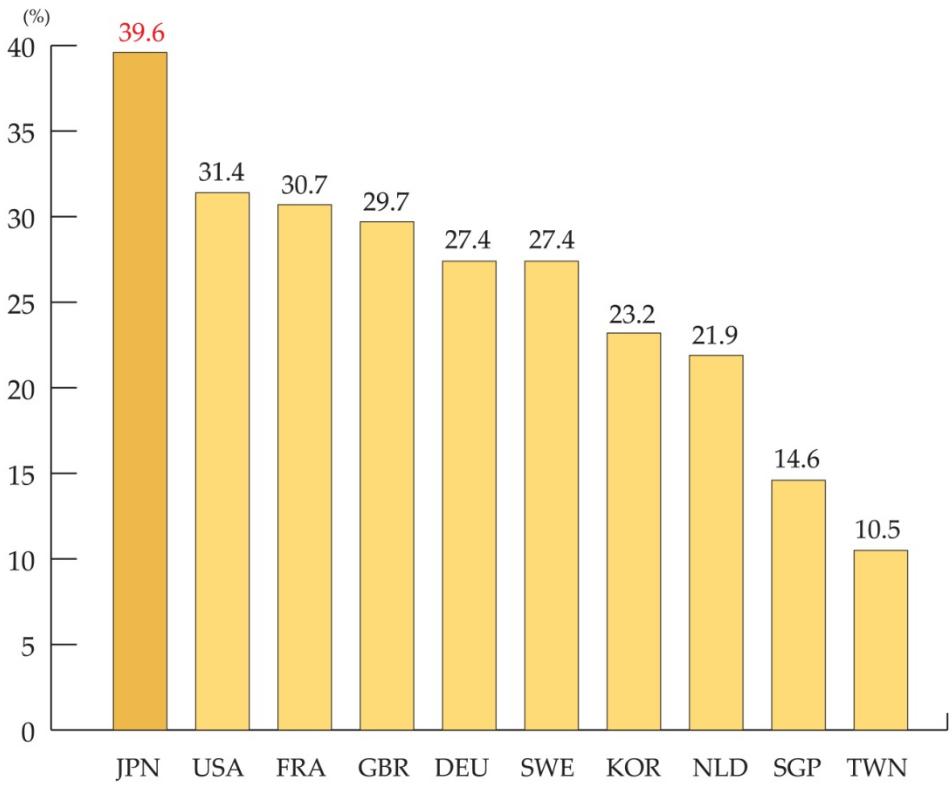
Figure 1. International Comparison of Statutory Corporate Income Tax Rates
(As of January 2009)



The general feeling in Japan is that there is no need for lower rates since they are on a par with the United States. But this is quite misleading, for a look at the effective tax rate (corporate taxes as a share of pretax income) in Japan and the United States reveals that it is nearly 10 points lower in the United States.

Why is this so when the statutory rates in the two countries are essentially the same? Part of the reason is that in the United States, taxable profits are calculated according to a different set of rules from those used in the calculation of profits in financial statements, but a much bigger factor is the aggressive tax planning efforts made by US businesses.

Figure 2. International Comparison of the Tax Burden(Effective Tax Rates), Fiscal 2004–06



Notes: (1) Average for fiscal 2004-06, consolidated basis. (2) Tax burden = corporate tax (after application of accounting for income taxes) ÷ pretax earnings. (3) Companies covered here are those included in the Nikkei 225, S&P 500, Europe 350, and S&P Asia Pacific 100 indices and whose financial data were available.
Source: Calculated using S&P's Compustat corporate financial database.

An increasingly popular method of transferring income is to establish an intangible property company (IPCO) in a low-tax country to collect and manage royalties from the licensed use of intellectual property rights, which are a major source of income for many businesses. Multinational pharmaceutical and beverage companies receive huge sums for the use of registered patents and trademarks, and many of them now retain such profits in low-tax countries.

Even among Japanese companies, there is a growing trend to view taxes as costs, particularly with the rise in the share of foreign shareholders and such deregulatory moves as amendments to Japan's Companies Act. Some are transferring or retaining their income in low-tax countries, leading to the drain of the country's added value and the loss of employment and tax revenues. Under the tax system revisions of fiscal 2009, income that had been retained by an overseas subsidiary can now be transferred back to Japan tax-free, but this has the possibility of actually encouraging more companies to retain their earnings at their foreign subsidiaries.

This is not difficult to foresee when one looks at the partner countries of Japan's foreign direct investment and inward direct investment (Figure 3). The country with the largest balance of direct investment in Japan was the United States, as of the end of 2006. In second place was the Netherlands, with the Cayman Islands coming in fourth and Singapore seventh. As for Japan's direct investment in other countries, the list was topped by the United States, followed, similarly, by the Netherlands in second place, the Cayman Islands in fifth place, and Singapore in seventh place. Both the Netherlands and Singapore offer preferential tax rates as a way of attracting foreign capital, and many companies in the industrial world are evidently conducting their investments via these countries. The Cayman Islands are famous as a tax haven. This shows that direct investment to and from Japan is already being conducted via low-tax countries and also that the tax system is a major factor in investment decisions today.

Figure 3. Direct Investment to and from Japan

From Japan

(¥ hundred million)

	Country, territory	Balance of foreign direct investment (end of 2006)	Direct investment (flow)	
			2005	2006
1	United States	186,004	13,599	10,834
2	Netherlands	54,012	3,620	9,940
3	Britain	37,595	3,221	8,424
4	China	36,052	7,262	7,172
5	Cayman Islands	25,469	4,260	3,347
6	Thailand	17,647	2,355	2,307
7	Singapore	16,969	634	444
8	France	15,536	607	978
9	Australia	14,486	693	547
10	South Korea	12,688	1,966	1,768
11	Belgium	11,452	-224	163
12	Brazil	9,310	1,069	1,654
13	Hong Kong	9,247	1,963	1,755
14	Malaysia	9,232	590	3,455
15	Indonesia	8,868	1,341	864
16	Germany	8,818	304	1,312
17	Canada	8,108	1,189	1,028
18	Taiwan	7,525	914	571
19	Philippines	5,058	470	427
20	India	2,753	298	597

To Japan

(¥ hundred million)

	Country, territory	Balance of foreign direct investment (end of 2006)	Direct investment (flow)	
			2005	2006
1	United States	49,933	85	140
2	Netherlands	14,478	2,663	-8,612
3	France	13,734	-88	322
4	Cayman Islands	9,989	1,218	-51
5	Britain	5,929	155	2,093
6	Germany	5,449	259	-622
7	Singapore	5,001	679	1,265
8	Switzerland	3,139	-908	369
9	Canada	2,716	-1,098	-3,209
10	Hong Kong	2,293	1,129	-2,467
11	Belgium	2,260	-1,407	1,024
12	Luxembourg	1,945	396	-18
13	Taiwan	1,754	-34	128
14	Sweden	882	-72	778
15	Italy	588	7	56
16	Australia	577	-125	41
17	South Korea	503	32	126
18	Spain	232	48	47
19	China	119	13	14
20	Russia	54	-	-

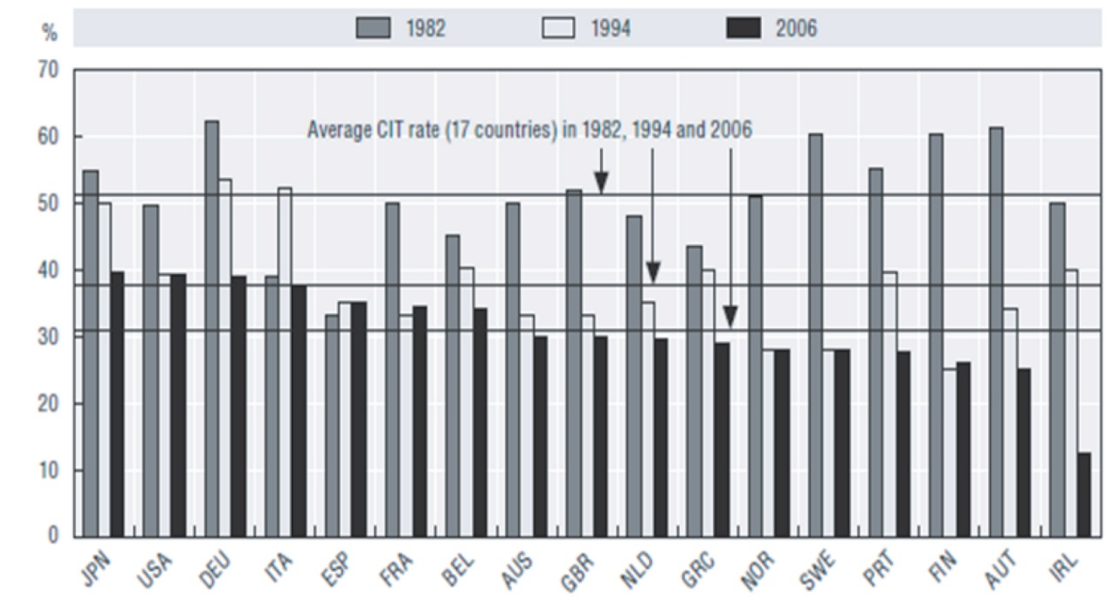
Note: Negative figures for the flow of investment indicate that the amount collected exceeded the amount invested in that year.
Source: Balance of payments statistics aggregated by the Bank of Japan.

To protect jobs in the face of international competition and to finance the necessary costs of an aging population despite a falling birthrate, Japan must not only prevent domestic companies from moving abroad but also attract greater foreign direct investment from other countries. This state of affairs is the chief reason and offers ample justification for lowering the corporate tax rate. Most arguments for a lower tax burden to date have focused on the impact it would have in encouraging capital investment and economic activity. The international competitiveness argument is more compelling; Germany, for instance, has been implementing corporate tax reform to enhance the competitiveness of operating in the country and to reclaim the tax revenue that that had been flowing to the Netherlands and Ireland.

2. Essence of the Tax Reduction Race

The Organization for Economic Cooperation and Development has published the results of an interesting study on the correlation between tax competitiveness and tax revenues.

Figure 4. Statutory Corporate Income Tax Rate, 1982–2006



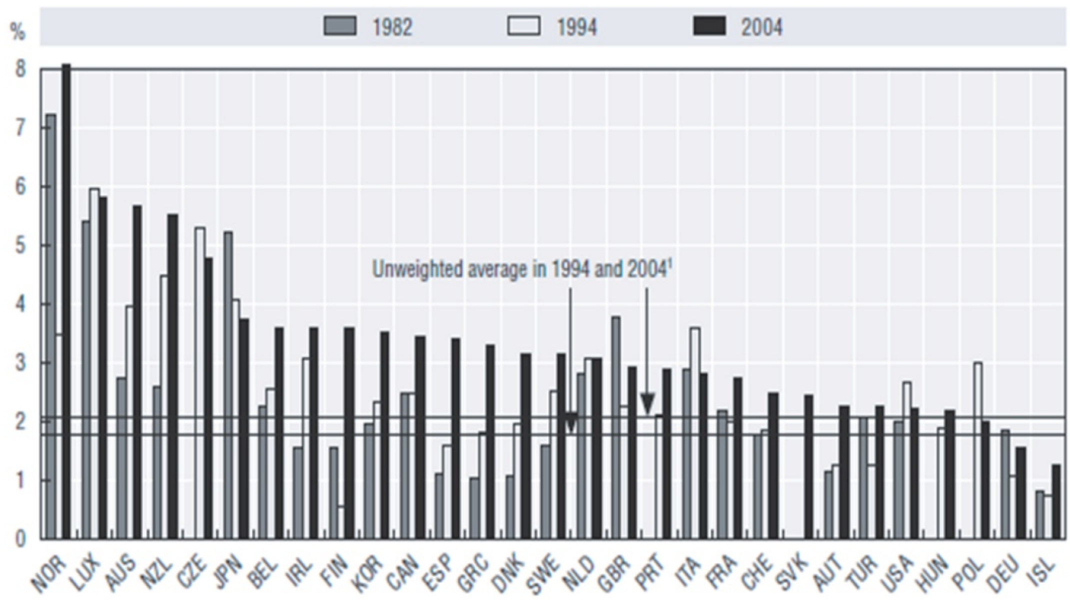
1. Data for 1982 was only available for 17 OECD countries (Japan, the US, Germany, Italy, Spain, France, Belgium, Australia, the UK, the Netherlands, Greece, Norway, Sweden, Portugal, Finland, Austria and Ireland). In the case of Ireland, there was a reduced corporate tax rate of 10 per cent for the manufacturing sector in 1982 and 1994.

Source: Institute for Fiscal Studies (IFS) and OECD Tax Database.

The closer integration of the European Union has engendered an extremely fierce race for lower corporate taxes among the member states over the past decade, with the tax rate declining by several points, as mentioned above. East European states lowered their rates in an attempt to attract German and French businesses and expand employment. This incited a “race to the bottom,” as the West European states reacted with lower rates of their own to keep domestic companies at home and to attract foreign ones. Figure 4 shows how the rates have declined over this period.

The OECD study shows, though, that while the EU member states have been cutting their corporate tax rates, corporate tax revenue as a percentage of gross domestic product has actually been rising. This seemingly paradoxical relationship between corporate tax rates and tax revenues has elicited great surprise and interest among the member states.

Figure 5. Taxes on Corporate Income as a Percentage of GDP

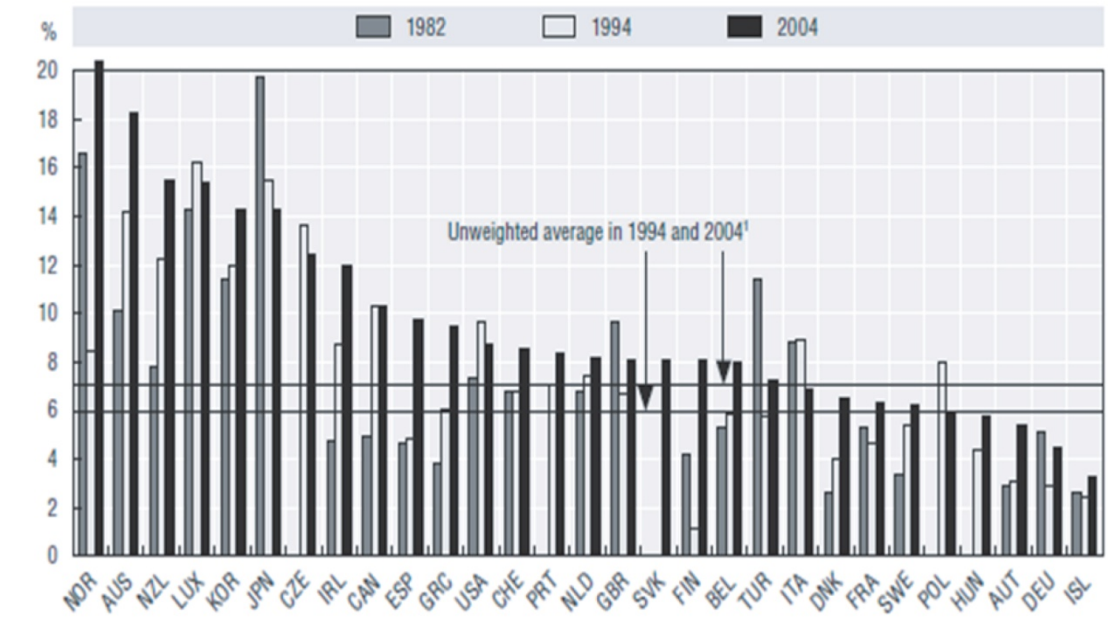


1. Missing data in 1982 for the Czech Republic, Portugal, Slovak Republic, Hungary, Poland and Mexico; in 1994: the Slovak Republic and Mexico; in 2004: Mexico. The unweighted average does not include Norway.

Source: Revenue Statistics 1965-2005.

Figure 5 shows taxes on corporate income as a percentage of GDP. indicating that the percentage rose from 1994 to 2004. Corporate tax revenue as a share of total tax revenues (Figure 6) has also risen between 1994 and 2004.

Figure 6. Taxes on Corporate Income as a Percentage of Total Tax Revenue



1. Missing data in 1982 for the Czech Republic, Portugal, Slovak Republic, Hungary, Poland and Mexico; in 1994: the Slovak Republic and Mexico; in 2004: Mexico. The unweighted average does not include Norway. For Portugal: 2003 instead of 2004 information.

Source: Revenue Statistics 1965-2005.

Why have lower tax rates resulted in higher revenues? The OECD report and researchers in the EU point to the following factors. They have analyzed trends in all member states by identifying three components of the tax-revenue-to-GDP ratio.

The first component is what is called the effective tax rate, which has remained relatively steady in most countries. It is this component that has been most affected by the lowering of corporate tax rates and the accompanying expansion of the tax base.

The second component is the corporate share of all added value in the economy. This percentage has been rising gradually in many countries, which is believed to have been caused by a shift from the personal sector to the corporate sector owing to the lower tax rates of the latter.

$$\frac{\text{Corporate tax revenue}}{\text{GDP}} = \frac{\text{Corporate tax revenue}}{\text{Corporate operating profit (first component)}} \times \frac{\text{Corporate operating profit}}{\text{Operating profit of entire economy (second component)}} \times \frac{\text{Operating profit of entire economy}}{\text{GDP (third component)}}$$

The third component is corporate profits as a share of GDP, which rose in many countries during the first decade of the millennium. This has been explained as a reflection of the many new companies that individuals established stirred by the spirit of entrepreneurship.

This analysis has produced two major conclusions. The first is that in many countries, corporate taxes were lowered together with an expansion of the tax base, such as through a reexamination of special tax measures and depreciation methods. This approach is typified by the taxation reforms carried out in Germany and Britain.

The second conclusion is that the tax-cutting race seen during the past decade resulted in an increase in business start-ups. The lower tax rates gave people incentive to start their own business, offering empirical proof of vitalized economic activity.

3. Steps to Follow

Debate on reforming the tax system is likely to begin in Japan as well. The links between corporate tax rates and business behavior is quite complex, though, with the statutory rate believed to affect the overseas transfer of profits and the effective rate influencing investment decisions. The Hatoyama administration has announced it is freezing the consumption tax rate for at least four years, so the prospects of a lower effective tax rate within the framework of reforms for the tax system as a whole remains rather opaque.

Given such murky prospects, it may be a good idea to first reform the corporate tax system and lower the tax rate, combined with an expansion of the tax base. Because such reforms would be tax neutral and result in lower rates, there should be little resistance from the general public. They may have the added benefit of encouraging entrepreneurship—invigorating economic activity and leading to higher tax revenues, as was seen in the EU—and of dampening corporate plans to shift operations to low-tax countries.

Ways of expanding the tax base include reexamining the special tax treatment now available in some cases; shifting the method of tax depreciation from one based on fixed rates to that on fixed sums; placing limits on deductions for interest payments, and abolishing preferential rates for stock transactions.

The next step would be to lower the effective corporate tax rate as part of comprehensive reforms that would also include the consumption tax. There would be a need to cover any revenue shortfalls resulting from a lower effective corporate tax burden, so any adjustments would have to be considered in conjunction with discussions of a consumption tax hike.

The reluctance to reforming corporate taxes comes from the perceived individual-corporate dichotomy. It should be remembered, though, that businesses and individuals are on the same boat and in a state of mutual dependence. In their capacity as employees, creditors, and shareholders, individuals are provided with the added value generated by businesses in the form of wages, interest, dividends, and capital gains. Thus, corporate tax reform in Japan would not be aimed at helping Japanese business firms but at enhancing the competitiveness of basing corporate operations in Japan and of generating the necessary revenue to address the graying of the population. An early start to the tax reform debate would be most welcome.

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The Long Road to Fiscal Stabilization

By Kobayashi, Keiichiro

Japan's fiscal 2010 budget is the largest ever, and there are growing concerns that long-term government bond prices could crash, sending long-term interest rates soaring. Are such fears about Japan's public finance warranted?

The chances of a fiscal collapse or a crash in the bond market are probably quite low over the next few years—and no doubt over the next decade as well unless there is a fundamental breakdown in Japan's industrial structure. But there will surely come a time four or five decades hence when instability in the bond market will impact quite negatively on the Japanese economy.

There are bond-related concerns over the short, medium, and long term. I will deal with each of them in turn.

As for the short term, the likelihood of a crash in the bond market is closely linked with trends in the foreign exchange rate. Should investors lose confidence in Japanese bonds, faith in the yen will also falter. As the yen grows progressively weaker, investors may opt out of yen-backed bonds in favor of more profitable foreign assets. Should such a situation continue, the bond market could very well nosedive.

Cyclical Mechanism

The yen, though, is unlikely to remain weak for long. A slight depreciation will make Japanese exports cheaper, leading to a bigger trade surplus. This will cause the yen to appreciate and subsequently make yen-denominated assets more attractive again. Investors will be more inclined to purchase Japanese government bonds (JGBs), pushing

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up their prices. It is thanks to such a cyclical mechanism that the JGB market should remain stable for at least the next several years.

This assumes that Japan's export industry will remain competitive. Should it begin to totter in the future, prompting both domestic and foreign investors to project perennial trade deficits for the country, the market will come to assume that the yen will depreciate and stay weak. This will make foreign assets more attractive than yen-denominated ones, and investors will begin dumping JGBs. This will cause bond prices to tumble and significantly diminish the value of the yen.

This assumes, of course, a structural weakening of Japan's export industry, as indicated, for instance, by several consecutive years of negative economic growth. Such a turn of events could trigger a collapse of the bond market.

It is inconceivable that the economy would become that feeble, though. Even if growth slows down, there would surely be at least some growth, so a financial collapse and a bond market crash are probably not very likely.

This is not to say, however, that there is no need for concern. Even if the economy continues to grow, the bond market would remain precarious. The government is so heavily in debt today that raising taxes would do little to reduce such debts right away, as interest payments would continue to snowball. Achieving fiscal stability will take around two to three generations.

A condition where expenditures equal revenues is called primary balance. An estimate made a few years ago by Keio University Professor Takero Doi at the Research Institute of Economy, Trade, and Industry shows that even if fiscal discipline was implemented so that revenues exceeded spending by a significant margin for over 40 years, it would still take about 100 years for government bonds to stabilize.

This is because the primary balance does not include expenditures for the amortization of bonds. Even after the achievement of primary balance, therefore, huge interest payments would still have to be made, so revenue shortfalls would continue, and government debt would keep accumulating for several more decades. Even if the government cuts back its programs and starts living within its means, it already has so much accumulated debt that it will keep running up deficits.

In this scenario, the government's net liabilities—calculated by subtracting total assets from outstanding debt—will continue to grow through the first half of this century, ballooning to three times the country's gross domestic product around 2060 before beginning to contract. It will be about 2100 when total government debt will finally diminish to an equivalent of the country's GDP.

Burdening Future Generations

The total financial assets held by Japanese people in bank deposits and other instruments are only around three times GDP. This means that should the government's net liabilities exceed this level, then it will become impossible for the Japanese people alone to finance the debt; foreign investors will inevitably come to make up a substantial share of JGB holders.

One reason that Japan's stock market is so sensitive to trends in US stock exchanges today is because foreign investors account for a big share of the transactions on Japanese bourses. Should foreign ownership of Japanese government bonds rise, trends in the bond market will likewise come to rely heavily on the decisions of foreign investors.

What this suggests is that a minor rumor could have a major impact on market psychology, and the dumping of government bonds would become commonplace. Bond values would fluctuate wildly, resulting in the destabilization of both long-term interest rates and inflation and impacting negatively on both the corporate and household sectors. It may even lead to a vicious circle that could enfeeble the Japanese economy. Such economic and fiscal precariousness would expose the next generation of Japanese—and the one after that—to the kind of economic crises that afflicted Argentina and is now threatening Greece.

It is important to take heed of our responsibilities toward future generations and chart a long-term course toward fiscal rehabilitation.

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