

**Current Japanese
Fiscal Conditions**
and
**Issues to be
Considered**

2005

Ministry of Finance

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I Current Fiscal Situation

1. General Account Budget for FY2005

Basic Principles in FY2005

With respect to expenditures, we will strive to promote thorough reforms, Through these efforts, the amount of general account expenditures totals billion yen, the latter dropping below the level of the previous year for the first time
The amount of new government bonds will drop below the level of the general account primary balance will continue to improve. Thus, we successfully

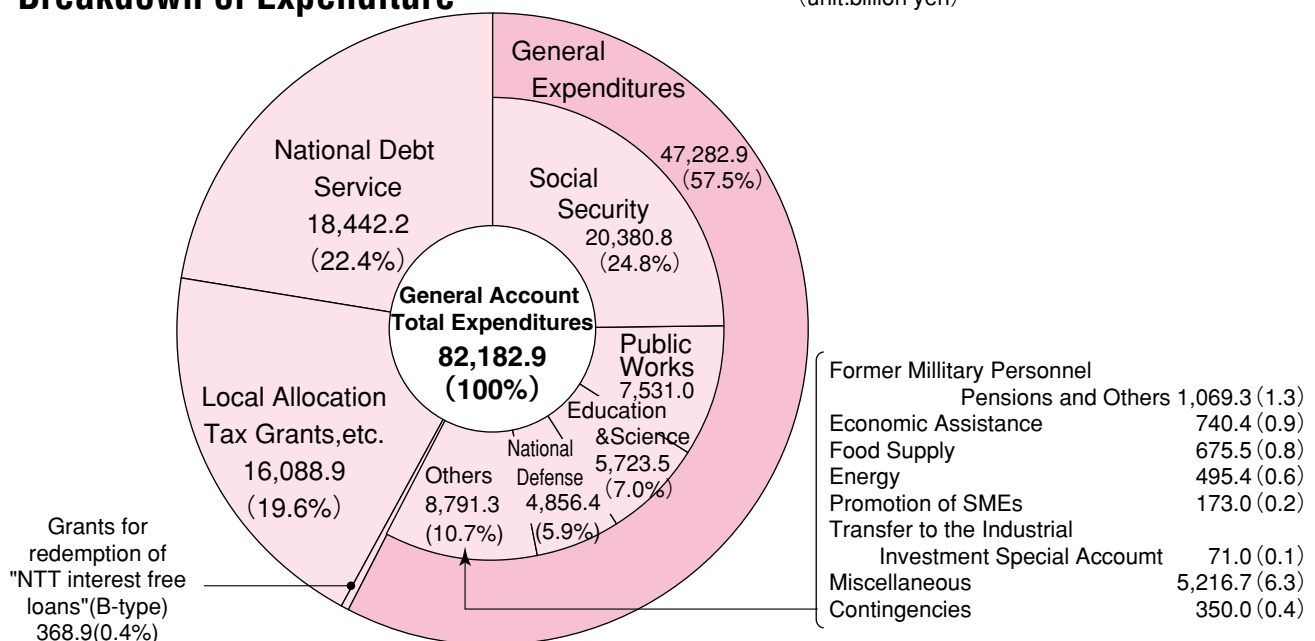
General Account Budget(FY2005 Budget)

	FY2004 (Initial)	FY2005 (Initial)
(Revenue)		
Tax Revenues	41,747.0	44,007.0
Non-tax Revenues	3,773.9	3,785.9
Government Bond Issues	36,590.0	34,390.0
[TOTAL]	82,110.9	82,182.9
(Expenditure)		
National Debt Service	17,568.5	18,442.2
Local Allocation Tax Grants	16,493.5	16,088.9
General Expenditures	47,632.0	47,282.9
Subsidies for redemption of 'NTT interest-free loans'(B type)	416.9	368.9
[TOTAL]	82,110.9	82,182.9

General Account expenditures for FY2005 are approximately 82 trillion yen.
Of this, national debt service (expenditure allocated to interest payment and debt redemption on government bonds) accounts for approximately 20%.
"General expenditures" are General Account expenditures minus national debt service, local allocation tax grants, etc. Social security related expenditures account for more than 40% of general expenditures.

Breakdown of Expenditure

(unit:billion yen)



while continuously pursuing and further strengthening expenditure reforms. 82,182.9 billion yen and the amount of general expenditures comes to 47,282.9 in three years. previous year for the first time in four years, down to 34,390.0 billion yen, and the implemented our policy of maintaining fiscal discipline.

(Finance Minister Tanigaki's speech on fiscal administration at the 162nd session of the National Diet, January 21st, 2005)

(FY2004→FY2005)	Note
2,260.0	Effect of additional transfer of tax resources: ▲691.0 Increase in tax revenues due to reduction in across-the-board tax credit: 185.0
12.0	Government bond issues to be reduced from the previous year,for the first time in the past four years.
-2,200.0	Bond dependency: 41.8% (FY2004 initial budget: 44.6%)
72.0	
873.7	
-404.6	Local allocation tax from General Account to be restrained through rationalization of local government expenditures.
-349.1	Amid the inevitable increases in social security expenditures, the amount of General Expenditures is down from the previous year for the first time in the past three years through reformes between central and local governments and review of all the expenditure items.
-47.9	
72.0	

Only about 50% of General Account revenues derive from tax revenues, while more than 40% (approx. 34 trillion yen) depend on government bond issues.

Breakdown of Revenues

(unit: billion yen)

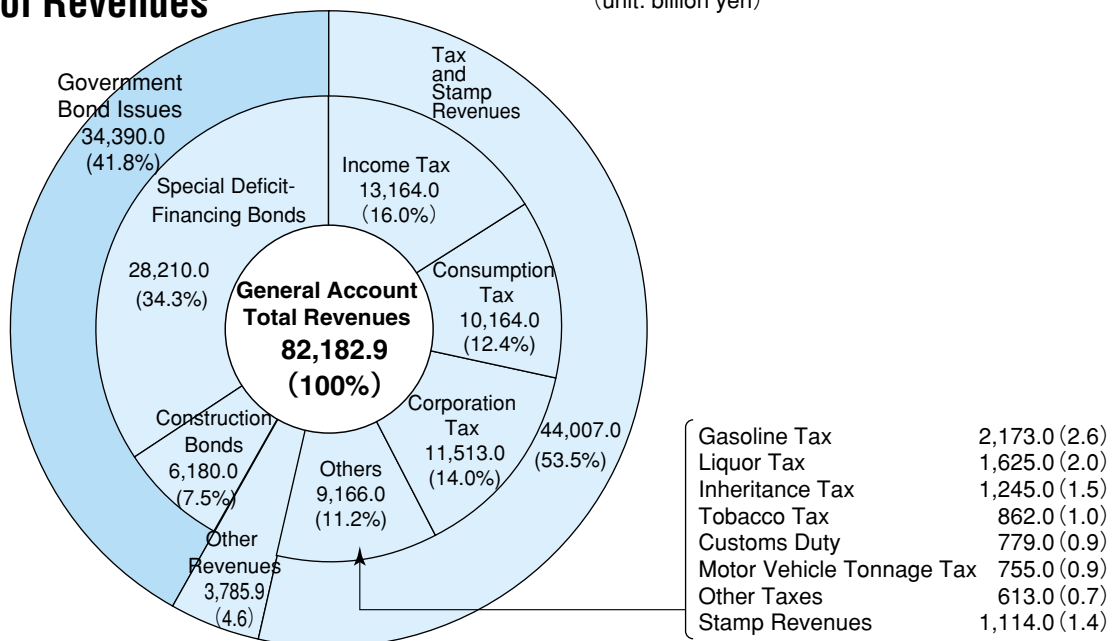


Chart V-1 Comparison of the Government Budget to a Household Budget

FY2005 Government Budget (General Account, trillion yen)		Household Budget (thousand yen)	
Tax + Non-tax Revenues (A)	47.8	Household Monthly Income (C)	approx.400
National Debt Service (B)	18.4	Principal and Interest Payment on Loans (D)	approx.150
(A) - (B)	29.4	Disposable Income ((C) - (D))	approx.240
General Expenditures	47.3	Household Expenditures	approx.390
Local Allocation Tax Grants, etc.	16.1	Monthly Allowance to Children	approx.130
Government Bond Issues	34.4	Short Fall = Borrowing	approx.280
Bonds Outstanding	approx. 538	Loans Outstanding	approx.53,000

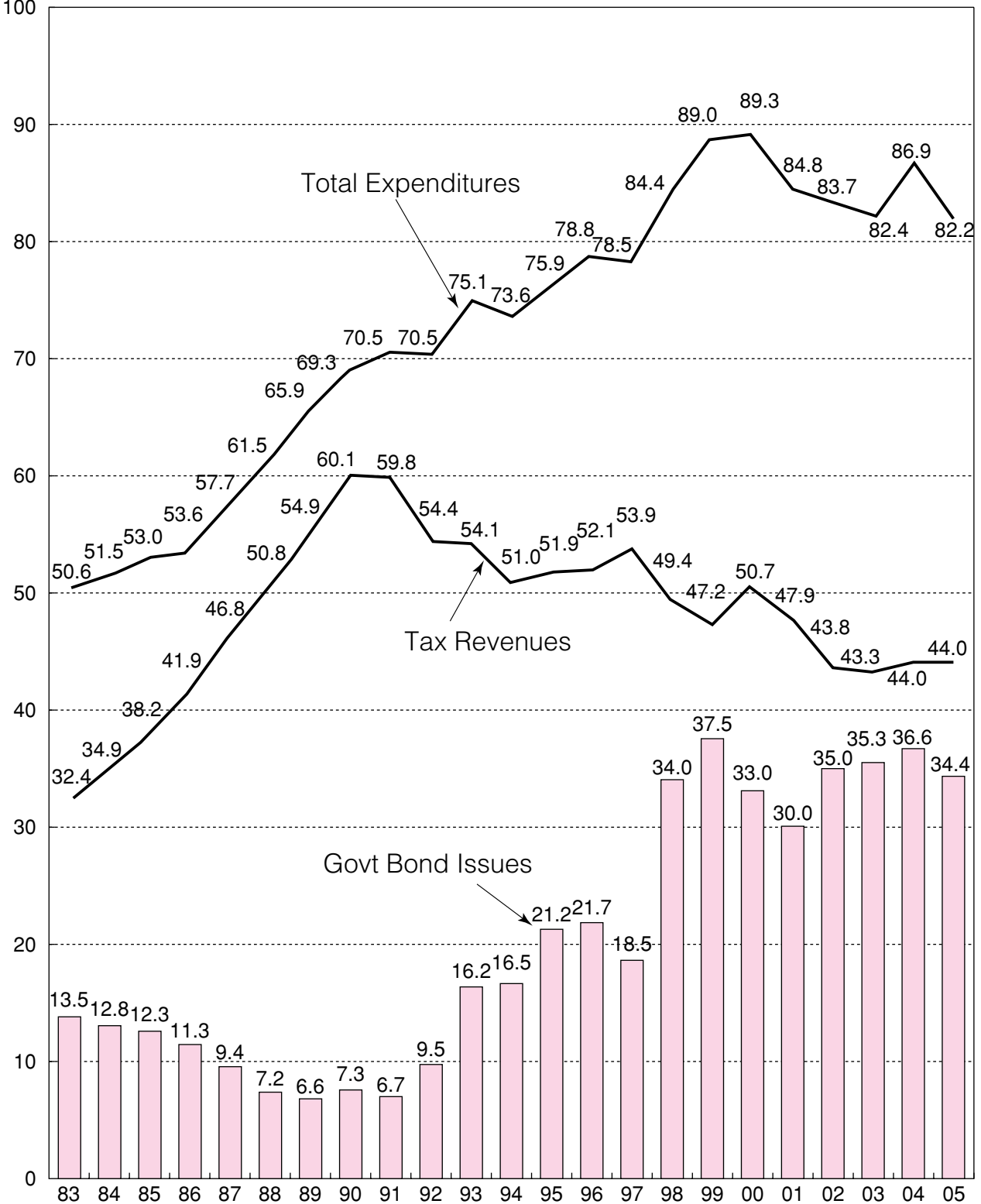
(Preconditions for the Family Budget)

The Household monthly income is estimated with reference to the average monthly after-tax income for a model case in the 2004 fiscal recalculation of national and employees' pensions. Other figures are calculated in proportion to each item in the Government Budget.

2. Trends in General Account Expenditures and Tax Revenues

There has been a large gap between general account expenditures and revenues (= fiscal deficit). The deficit is financed by government bond issues, and tax revenues account for only about half (53.5%) of General Account revenues in the FY2005 budget.

(Trillion Yen)

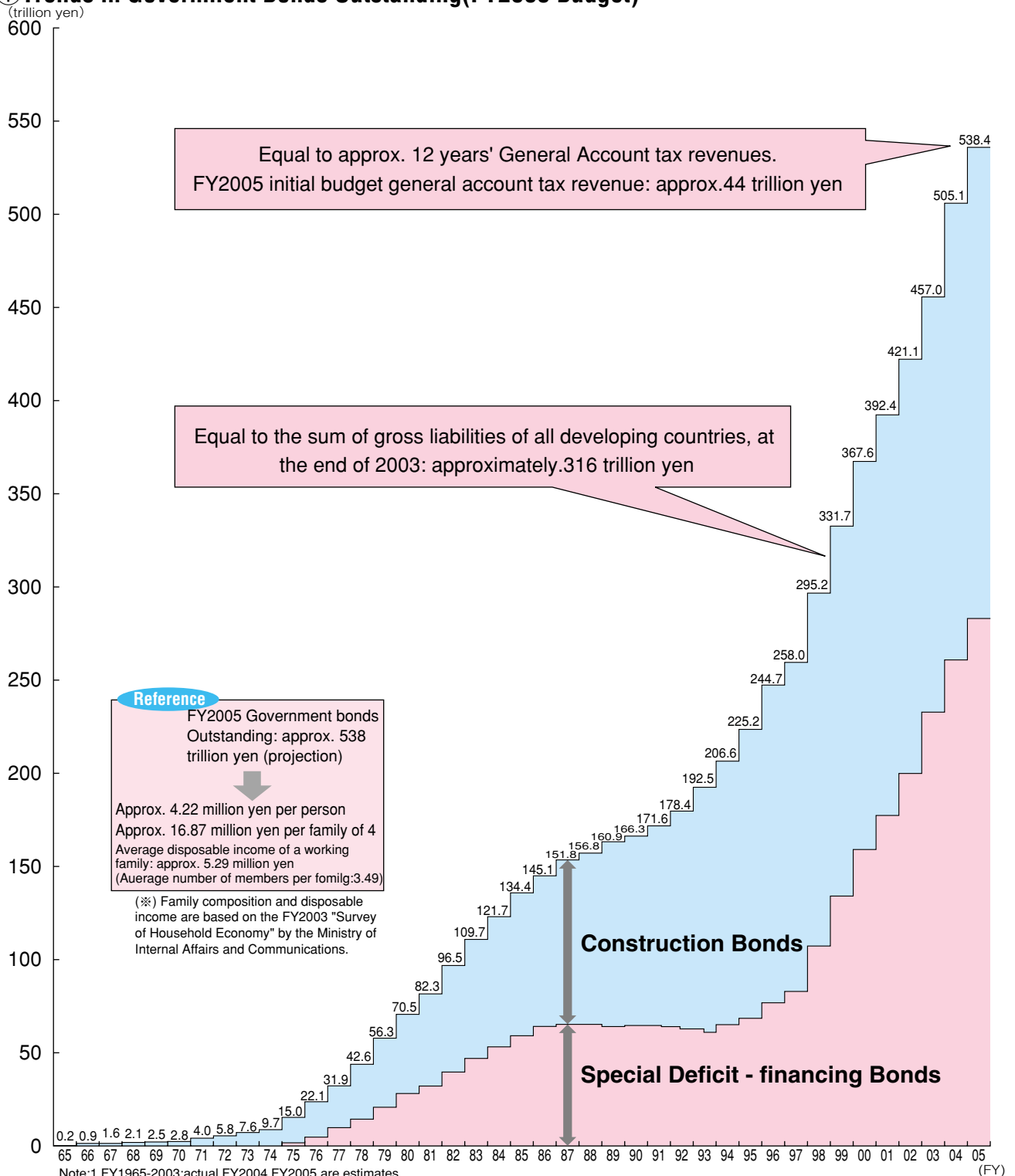


Note: FY1983-FY2003: settlement, FY2004: revised, FY2005: budget

3. Accumulated Government Bonds Outstanding

Government bonds outstanding have continued to climb due to continuous bond issues post years. Government bonds outstanding at the end of FY2005 are expected to reach approximately 538 trillion yen, placing a heavy burden on future generations.

① Trends in Government Bonds Outstanding(FY2005 Budget)



The debt outstanding of 538 trillion yen stacked in 10,000 yen bills ·····



○ If the debt outstanding were stacked in 10,000 yen bills, the height would be 5,380km, which is 1,400 times higher than Mt. Fuji (3,776m) and 600 times higher than Mt. Everest (8,848m).

○ If the stack of 10,000 yen bills were laid down, they would stretch about 1.5 times the distance between Nemuro and Amami Oshima (3,548km).

② Long Term Debt Outstanding

The amount of long term debt outstanding (the sum of national government long-term debts, including outstanding bonds and outstanding borrowing, and local government long-term debt outstanding) is expected to reach approximately 774 trillion yen at the end of FY2005.

(unit: trillion yen)

	FY1995 <settlement>	FY2000 <settlement>	FY2003 <settlement>	FY2004 <Revised>	FY2005 <Budget>
National Government	297	491	525	570 (546)	602 (572)
General Bonds	225	368	457	505 (481)	538 (508)
Local Governments	125	181	198	203	205
Duplication	-12	-26	-32	-33	-34
Total	410	646	692	740 (716)	774 (744)
% of GDP	82.0%	125.9%	138.0%	146.5% (141.8%)	151.2% (145.4%)

Note.1 GDP for FY2004: estimates. FY2005: forecast.

2 The debt outstanding in the Fiscal Loan Fund Special Account at the end of FY2005 is estimated to be approximately 144 trillion yen.

3 Figures in parentheses for FY2004 and FY2005 exclude front-loading issuance of refunding bonds.

4. International Comparison of Fiscal Conditions

In terms of the ratio of general government fiscal deficits to GDP, Japan is at the worst level among developed countries while it is a result of flat-out efforts aimed at economic recovery.

○ General Government Financial Balances (International Comparison)

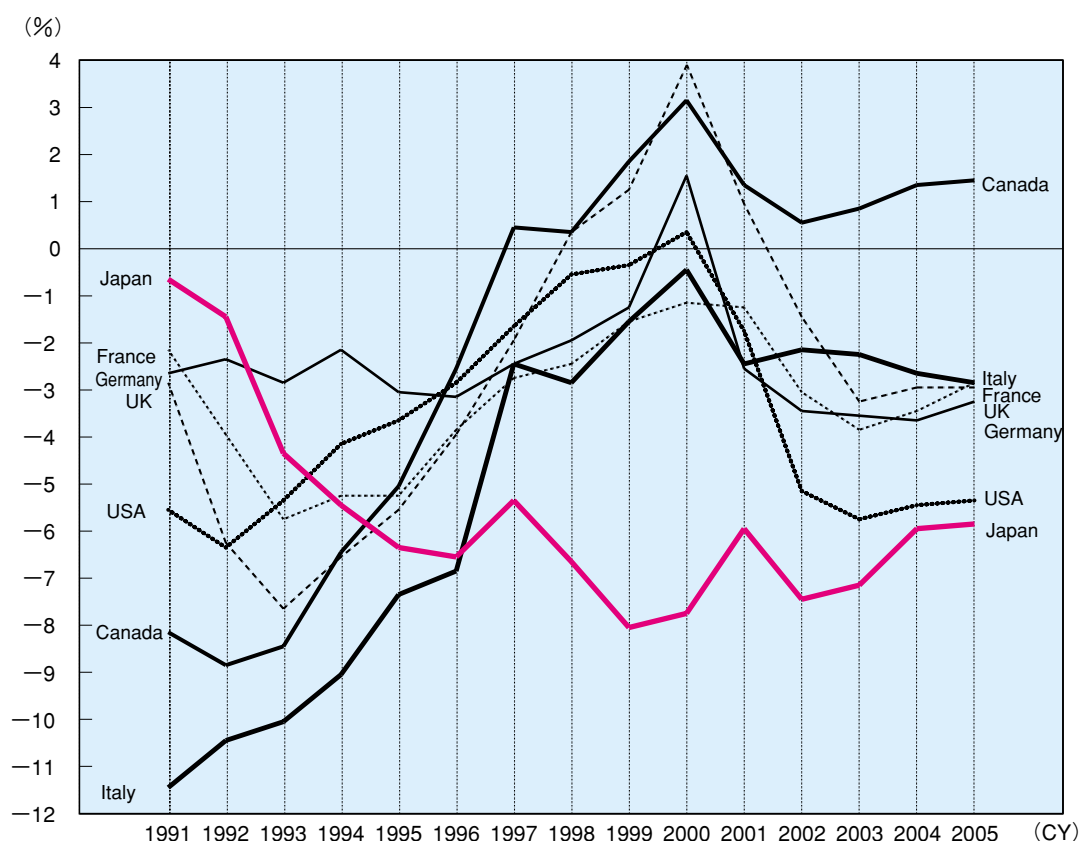
(As a percentage of GDP)

(CY)	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Japan	-0.9	-1.7	-4.6	-5.7	-6.6	-6.8	-5.6	-6.9	-8.3	-8.0	-6.2	-7.7	-7.4	-6.2	-6.1
United States	-5.8	-6.6	-5.6	-4.4	-3.9	-3.1	-1.9	-0.8	-0.6	0.1	-2.0	-5.4	-6.0	-5.7	-5.6
United Kingdom	-3.1	-6.5	-7.9	-6.8	-5.8	-4.2	-2.2	0.1	1.0	3.8	0.7	-1.7	-3.5	-3.2	-3.2
Germany	-2.9	-2.6	-3.1	-2.4	-3.3	-3.4	-2.7	-2.2	-1.5	1.3	-2.8	-3.7	-3.8	-3.9	-3.5
France	-2.4	-4.2	-6.0	-5.5	-5.5	-4.1	-3.0	-2.7	-1.8	-1.4	-1.5	-3.3	-4.1	-3.7	-3.1
Italy	-11.7	-10.7	-10.3	-9.3	-7.6	-7.1	-2.7	-3.1	-1.8	-0.7	-2.7	-2.4	-2.5	-2.9	-3.1
Canada	-8.4	-9.1	-8.7	-6.7	-5.3	-2.8	0.2	0.1	1.6	2.9	1.1	0.3	0.6	1.1	1.2

Note. Figures show general government financial balances on an SNA basis. For Japan and the USA, where pension systems are based on a Modified Funded System, the figures exclude social security funds, which are regarded as future liabilities in real terms. If these were included, the figures for Japan and the USA would be as follows.

(CY)	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Japan	1.8	0.8	-2.4	-3.8	-4.7	-5.1	-3.8	-5.5	-7.2	-7.5	-6.1	-7.9	-7.7	-6.5	-6.4
United States	-4.9	-5.8	-4.9	-3.6	-3.1	-2.2	-0.8	0.4	0.9	1.6	-0.4	-3.8	-4.6	-4.4	-4.1

*Source: OECD Economic Outlook 76 (December 2004). Figures are calculated on an SNA basis.



*Japan and the USA: General government financial balance excluding social security.

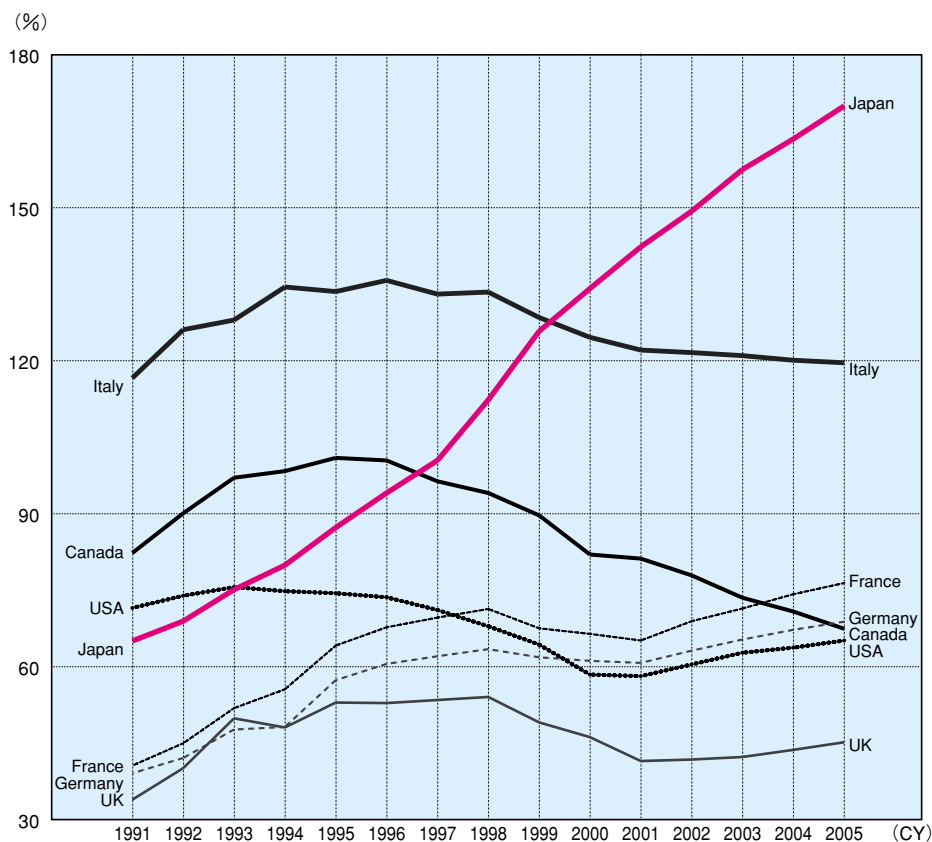
In terms of the ratio of general government gross debt to GDP, some developed countries are managing to level off or reduce by steady efforts towards fiscal consolidation. However, Japan's gross debt has been rapidly aggravated to reach the worst level among developed countries.

○ General Government Gross Debt(International Comparison)

(As a percentage of GDP)

(CY)	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Japan	64.8	68.7	74.9	79.7	87.1	93.9	100.3	112.2	125.7	134.1	142.3	149.3	157.5	163.5	170.0
United States	71.3	73.7	75.4	74.6	74.2	73.4	70.9	67.7	64.1	58.2	57.9	60.2	62.5	63.5	64.9
United Kingdom	33.6	39.8	49.6	47.8	52.7	52.6	53.2	53.8	48.8	45.9	41.2	41.5	42.0	43.4	44.9
Germany	38.8	41.8	47.4	47.9	57.1	60.3	61.8	63.2	61.6	60.9	60.5	62.9	65.1	67.0	68.6
France	40.3	44.7	51.6	55.3	63.9	67.5	69.4	71.1	67.3	66.2	64.9	68.7	71.2	74.0	76.2
Italy	116.5	126.0	127.9	134.4	133.5	135.7	133.0	133.4	128.4	124.5	122.0	121.5	120.9	120.0	119.5
Canada	82.1	89.9	96.9	98.2	100.8	100.3	96.2	93.9	89.5	81.8	81.0	77.7	73.3	70.6	67.2

Source: OECD Economic Outlook 76(December 2004).
Note: Figures are calculated on an SNA basis.



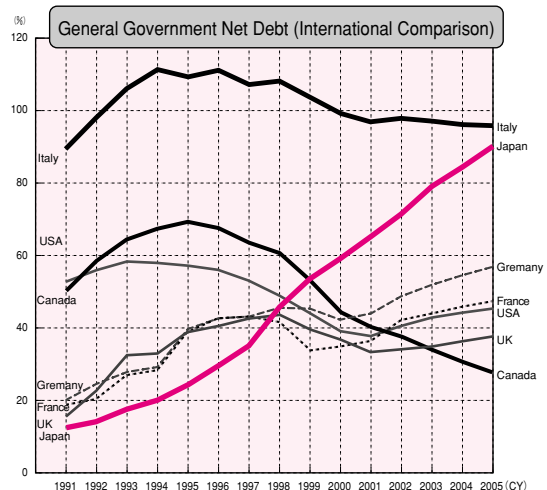
(Reference) Net debt

"Net debt" is another indicator for government's debt outstanding.

It is calculated by subtracting a government's financial assets from its gross debt outstanding.

It should be noted that more than half of the government's financial assets are for future pension payments, etc., and that these, by nature, cannot be used to pay back the fiscal deficit.

Japan's ratio of net debt to GDP is forecast to be 90.1% in 2005. This is among the worst of G7 countries, underscores the severe fiscal situation.

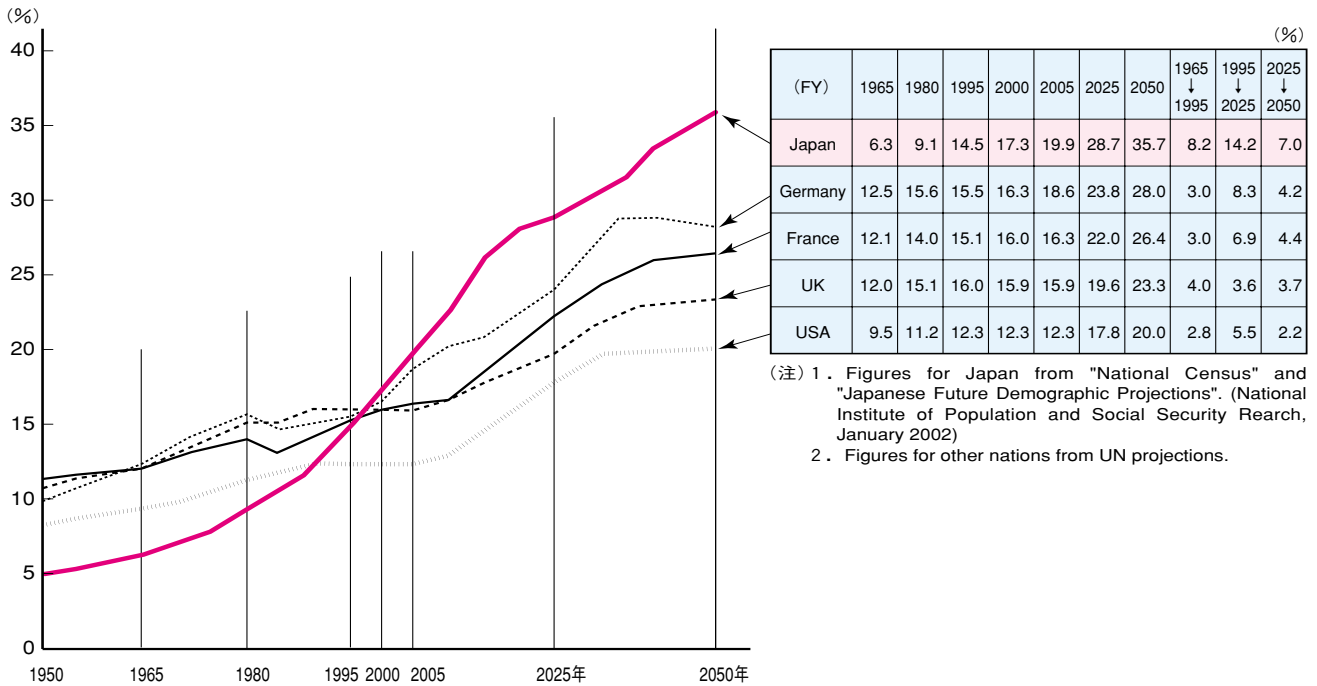


*Source: OECD Economic Outlook 76 (December 2004). Figures are calculated on an SNA basis.

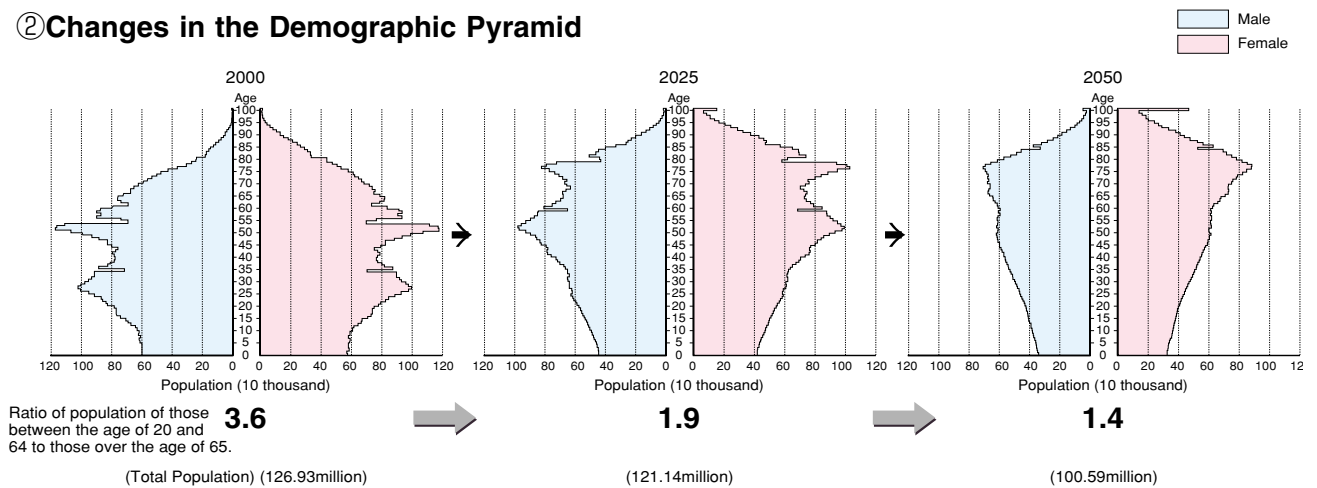
5. Aging Society

In Japan, aging society is progressing faster than in any other developed countries, and so will be in coming years.

① Ratio of elders over 65 to the Total Population

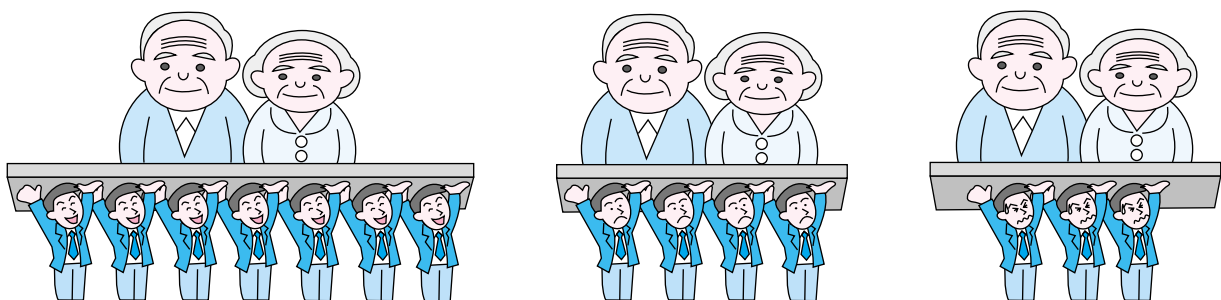


② Changes in the Demographic Pyramid



Note. 1 Total population will peak out at 127.44 million in 2006.

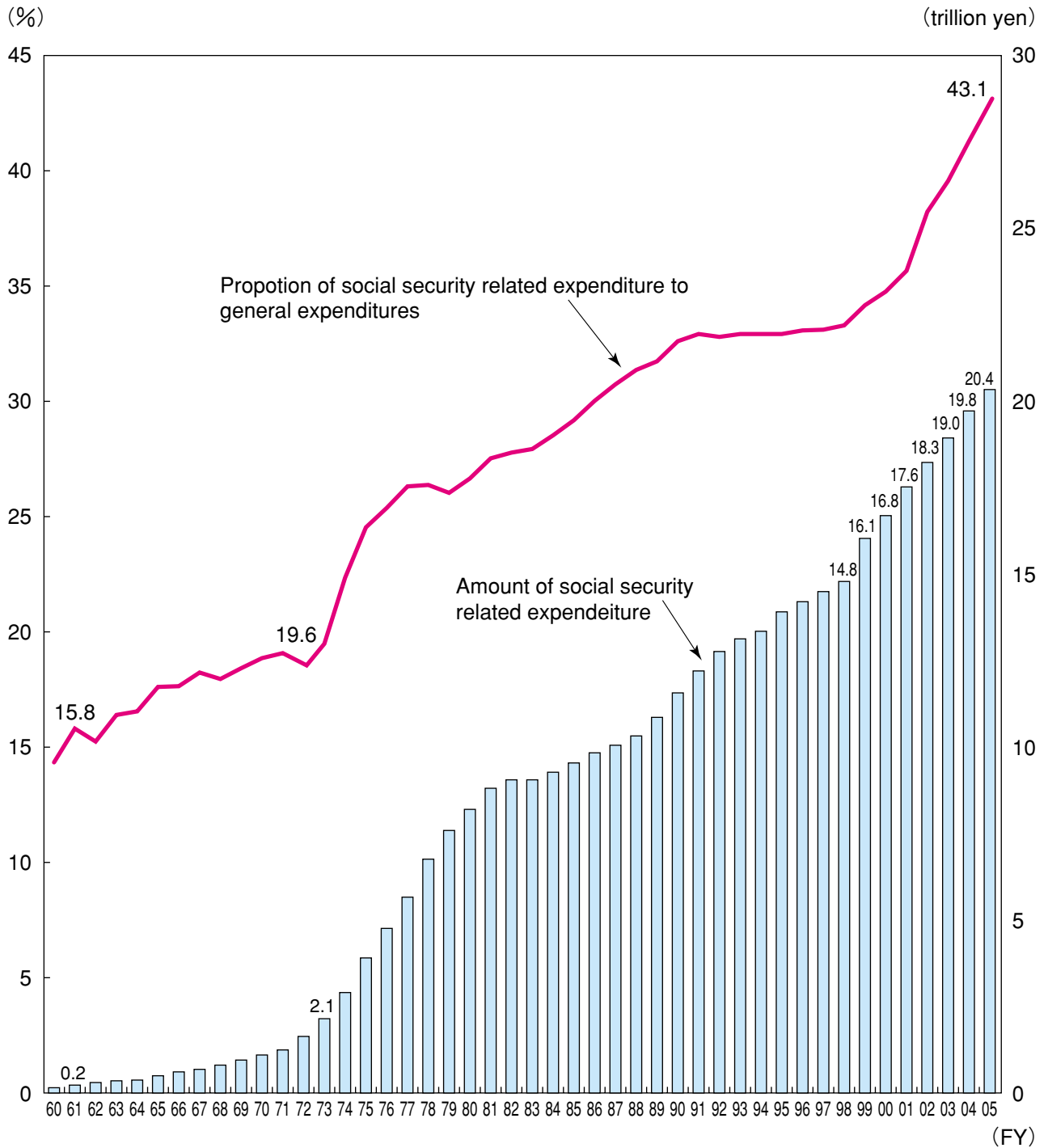
2 Figures from "Japanese Future Demographic Projections". (National Institute of Population and Social Security Research, January 2002)



6. Increase in Social Security Related Expenditure

In Japan, social security related expenditure is increasing year on year with aging society, and will continue to do so more rapidly in future. This is expected to place increasing constraints on the fiscal situation.

○ Trends in Social Security Related Expenditure



Note. Initial budget basis

7. The National Burden Ratio

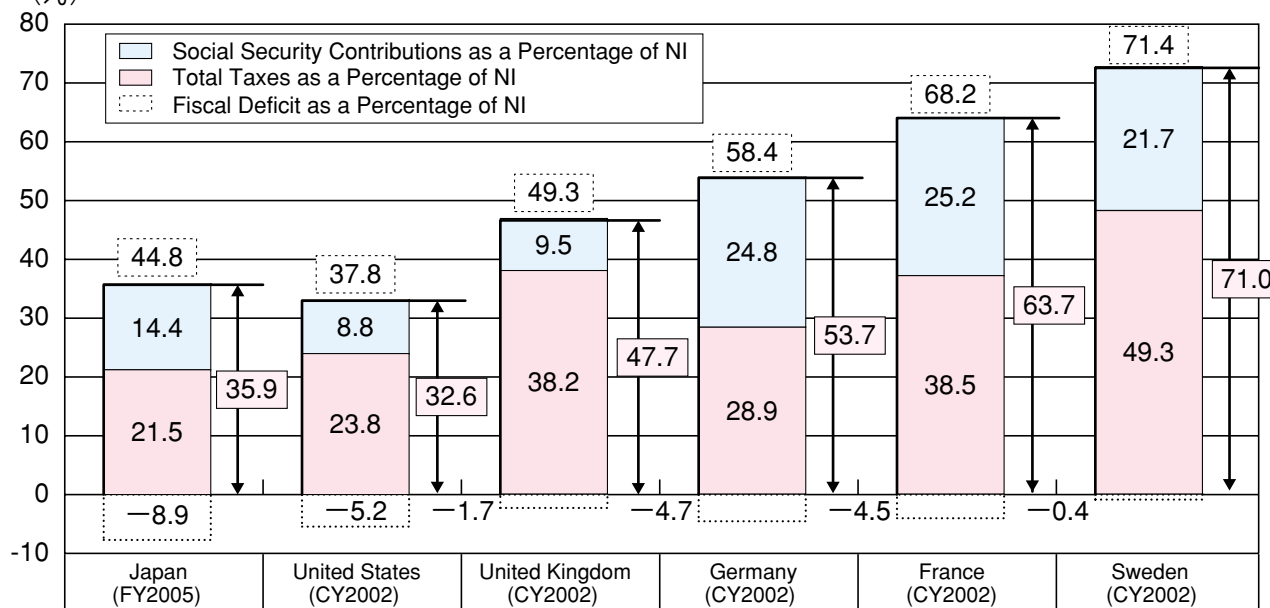
The "national burden ratio" is defined as the sum of total taxes and social security contributions as a percentage of national income (NI). The current national burden ratio of Japan is at a low level compared to other developed countries. This is because the current generation is not bearing enough tax expenses relative to the benefits it is receiving, and is passing the burden on to the next generation in the form of fiscal deficits. In the future, our country's national burden ratio is projected to rise even more, with the increase in the aging society.

① International Comparison of National Burden Ratio to National Income (NI)

[National Burden Ratio=Total taxes as a percentage of NI+social security contribution as a percentage of NI]

[Potential National Burden Ratio=National Burden Ratio+fiscal deficit as a percentage of NI]

(%)



Note1. Japan: FY2005 budget. United States, United Kingdom, Germany, France and Sweden: CY2002 actual.

2. Fiscal deficit as a percentage of NI for Japan and United States excludes social security funds. Others are based on general government figures.

② Trends in Total Taxes, Social Security Contributions and Fiscal Deficit as a percentage of NI

Fiscal Year	Ratio of Tax Burden to NI	Ratio of National Tax Burden to NI		Ratio of Social Security Contributions to NI	National Burden Ratio	Fiscal Deficit as a Percentage of NI	Potential National Burden Ratio
1970	18.9	12.7	5.4	24.3	0.5	24.9	
75	18.3	11.7	7.5	25.7	7.5	33.3	
80	22.2	14.2	9.1	31.3	8.2	39.5	
85	24.0	15.0	10.4	34.4	4.9	39.3	
1990	27.6	18.0	10.6	38.2	—	—	
95	23.7	14.7	12.5	36.2	9.1	45.3	
96	23.4	14.3	12.5	35.8	8.5	44.3	
97	23.5	14.2	12.8	36.3	7.5	43.8	
98	23.0	13.5	13.2	36.2	(*)17.1	(*)53.3	
					10.2	46.4	
99	22.6	13.2	13.3	35.9	11.8	47.7	
2000	23.3	13.9	13.3	36.7	9.5	46.2	
01	23.3	13.6	14.1	37.3	9.0	46.3	
02	21.9	12.7	14.3	36.2	10.9	47.1	
03	21.2	12.3	14.1	35.3	(*)10.5	(*)45.8	
04	21.4	12.5	14.2	35.7	10.2	45.5	
05	21.5	12.5	14.4	35.9	9.5	45.2	
					8.9	44.8	
70→85	5.1	2.3	5.0	10.1	4.4	14.4	
70→05	2.6	0.2	9.0	11.6	8.4	19.9	

Note1. FY1970-2002:Actual. FY2003,2004: Estimates.

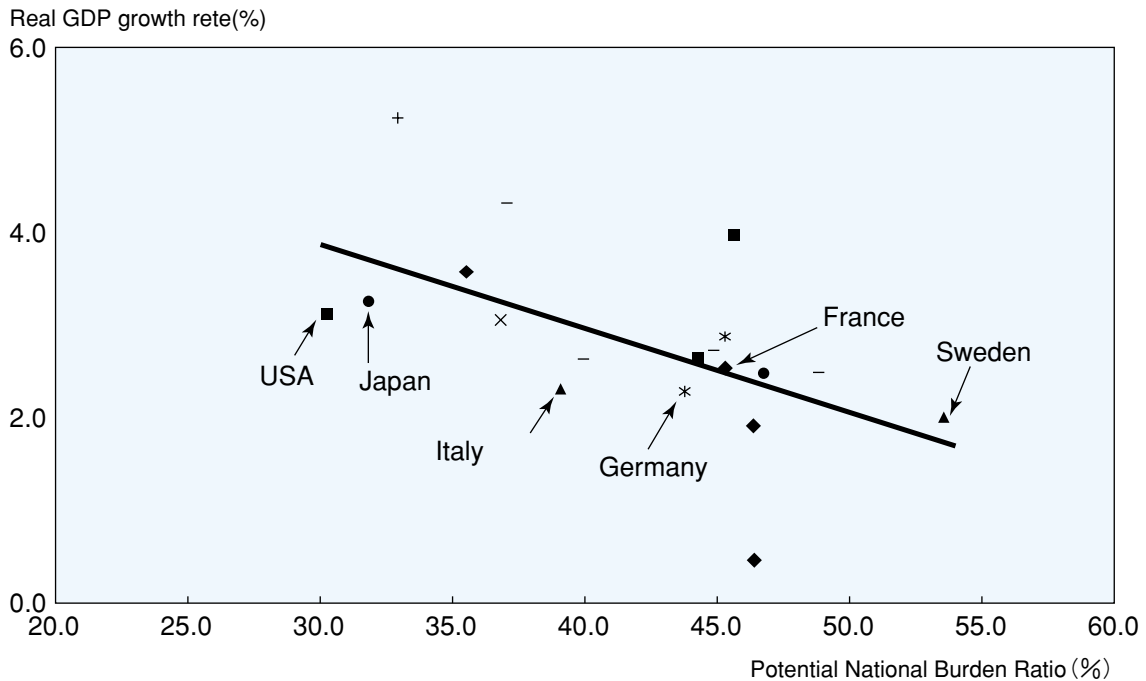
2. Figwres of(*)includes transfers from Japan National Railway Settlement Corporation and National Forest service deficit.

8. National Fiscal Administration and the National Economy

Social security related expenditure will continue to increase with population aging. This will lead to various issues including negative impacts on the economy due to a rise in the potential national burden ratio, further expansion of inequality among generations, and decreased flexibility in fiscal policy resulting from large fiscal deficits.

① Correlation between Potential National Burden Ratio and Economic Growth in OECD Member Countries

The potential national burden may hamper the country's economic growth.



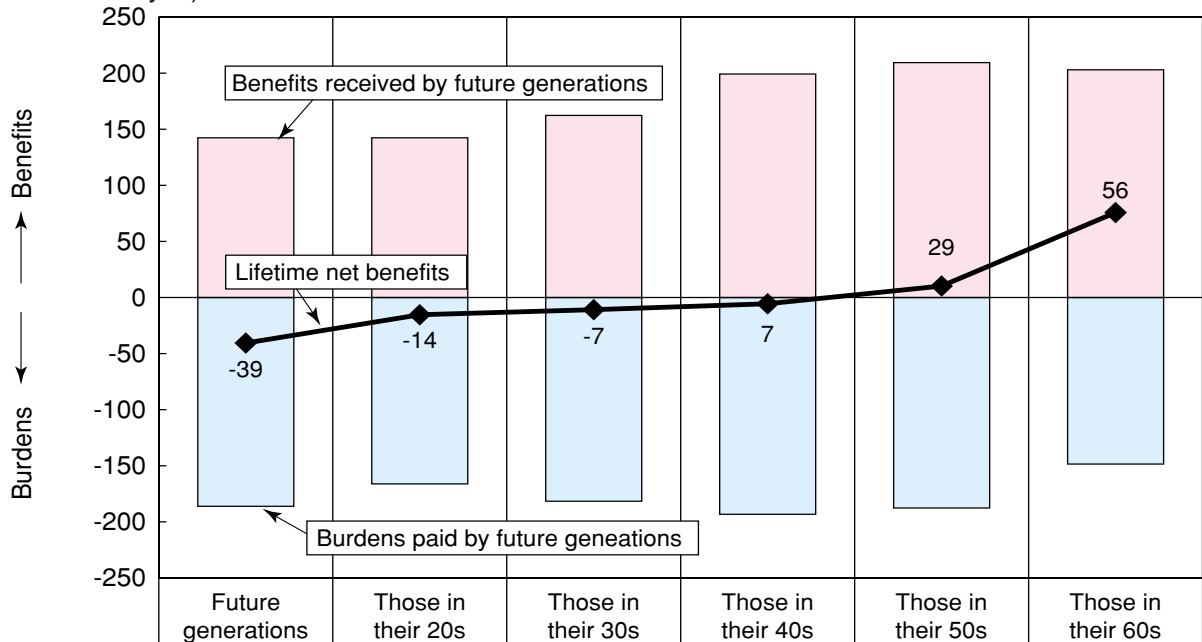
Note.1 OECD "National Accounts" basis
2 Average from 1971 to 2001

(Source) Cabinet Office (2003)

② Lifetime Benefits and Burdens by Generation

Under the current policy and system, younger generations will face excessive net burdens.

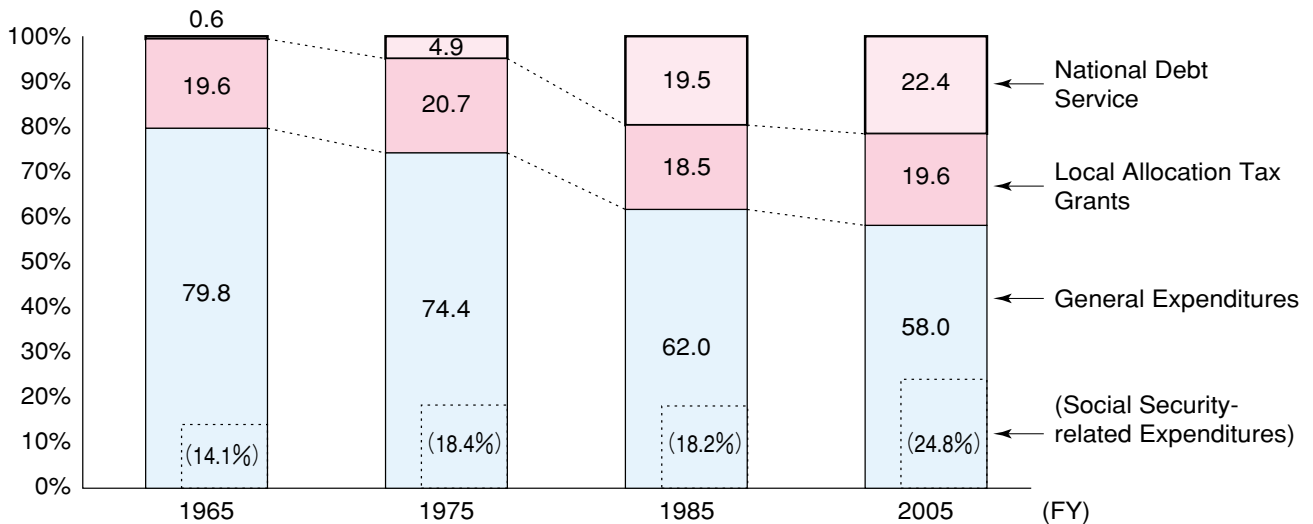
(in millions of yen)



(Source) Cabinet Office (2003)

③ Increasing rigidity of fiscal administration

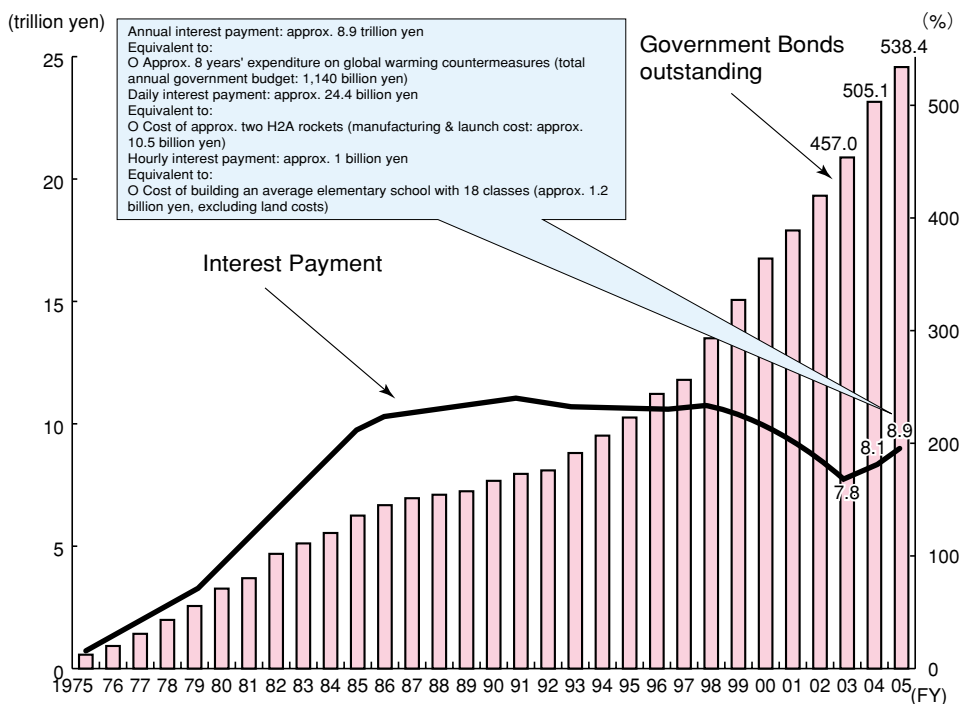
Due to the increase in debt outstanding, the ratio of national debt service within General Account expenditure has risen. Consequently, the ratio of general expenditure, which are for various policies, have decreased, thus weakening fiscal capacity to respond to society's needs.



Note. 1 The above figures are based on initial budgets.
 2 Local Allocation Tax Grants for FY2005 include Special Local Grants.

(Reference) Trends in Interest Payments

While government bonds outstanding are increasing dramatically, interest payments have been kept low thanks to the recent low interest rates. However, these payments could increase vastly depending on future trends in interest rates.



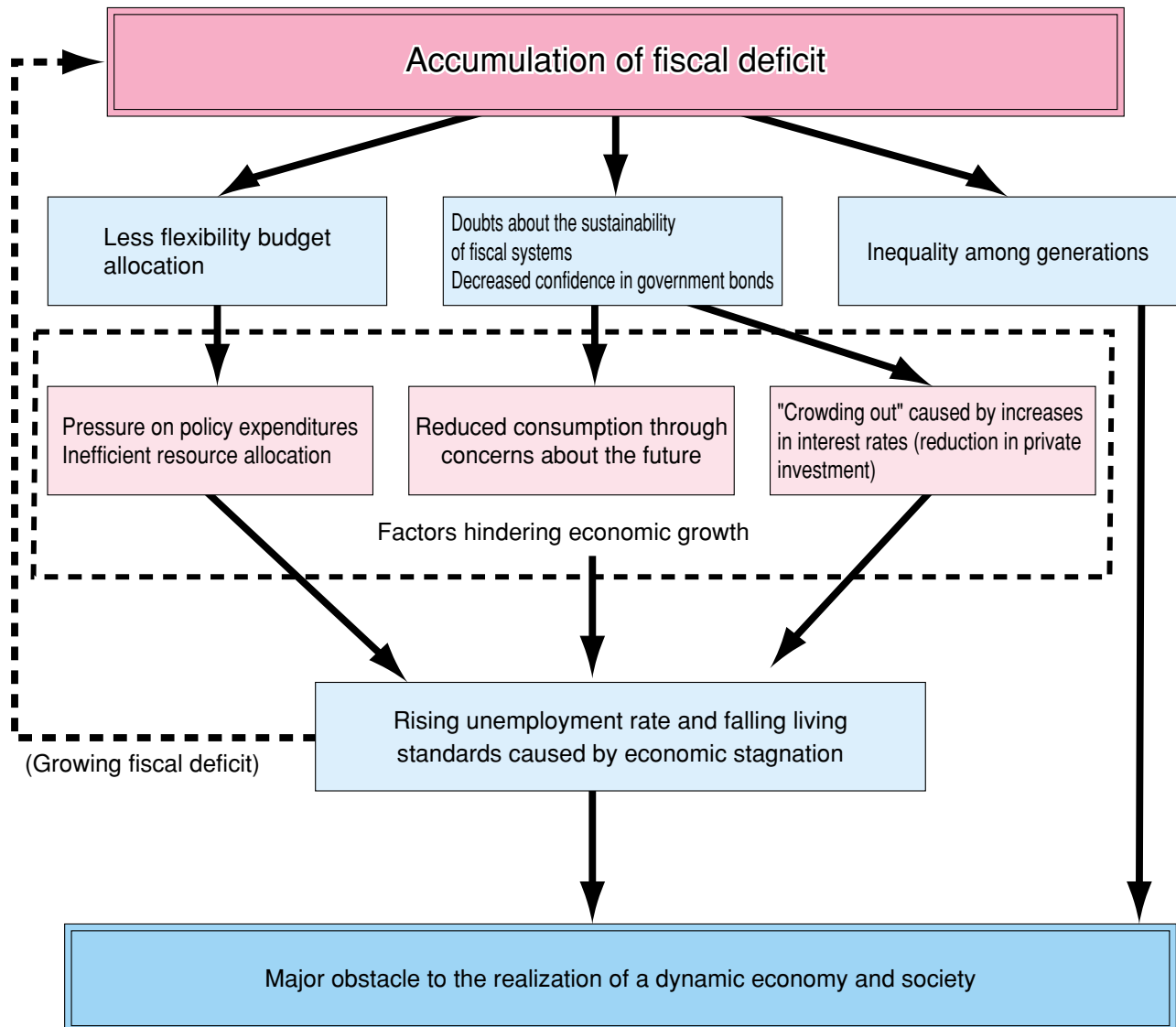
Estimated Impacts of 1% Increase in Interest Rates on National Debt Service

FY 2006	FY2007	FY2008
1.5 trillion yen	2.9 trillion yen	4.4 trillion yen

Note. Estimated increase in national debt service in case of 1% rise in interest rates after FY2006 in "Projected Effects of the FY2005 Budget".

Problems with Fiscal Deficits

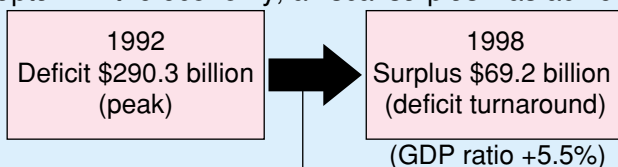
It has become a common understanding that accumulated fiscal deficits will cause mid-and-long term impediments to economic growth. In Japan, with the progressive aging society in future, fiscal deficits will be an obstacle to the realization of a dynamic economy and society.



Source: Fiscal System Council.

(Reference) Economy and Fiscal Administration (example: USA in the 1990's)

- In 1990's America, the fiscal deficit expanded and the economy was in recession.
- Considerable efforts were made to revive the fiscal administration by curbing expenditure and increasing tax revenues, etc., with a view to stimulating the economy. Together with an upturn in the economy, a fiscal surplus was achieved in FY1998.



- Contribution rate behind improved fiscal balance
 - Expenditure reduced by about 60% (including about 30% defense cuts)
 - Revenues increased by about 40%

- Efforts to reduce the fiscal deficit in this period had the effect of lowering long-term interest rates, which promoted equipment investment in the private sector and contributed to stable economic expansion.

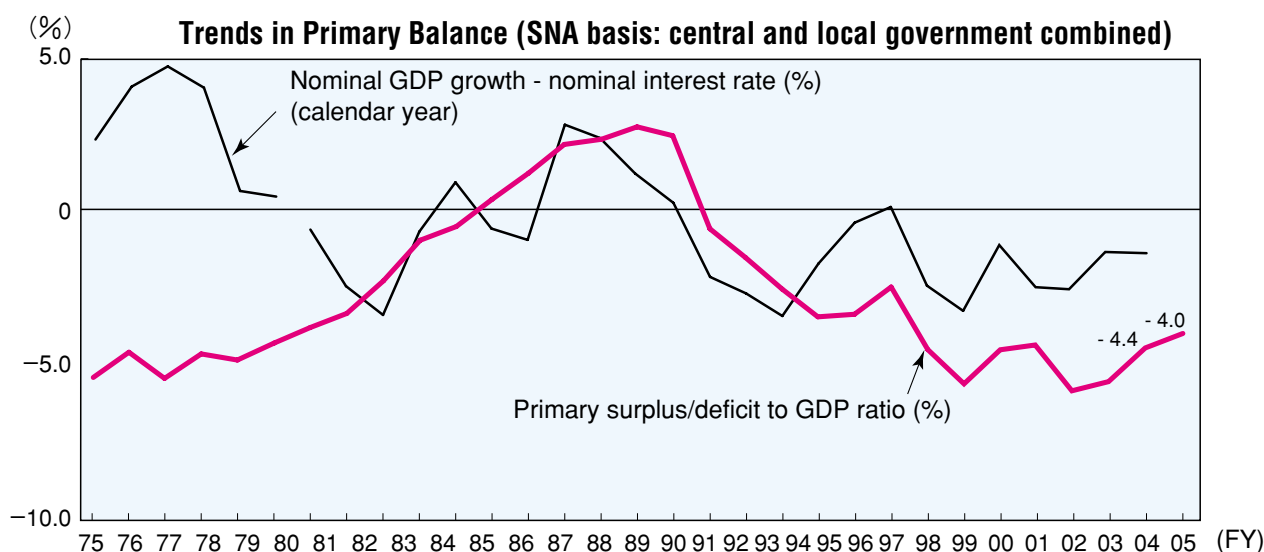
II Future Issues for Fiscal Administration

Overview 1. Future Principles for Fiscal Management

The government is promoting fiscal structural reforms from both aspects of expenditures and revenues and is aiming to achieve surplus in the primary balance in the early 2010s

Structural Reform and Medium-Term Economic and Fiscal Perspectives (Cabinet Decision of January 2005)

- Until FY2006, the government will maintain the size of the government (ratio of general government expenditure to GDP) equal to or below its FY2002 level.
- By FY2006, with the continuing efforts of both central and local governments to reduce expenditure, and based on an assessment of necessary public services and expenditure levels, as well as on the status of economic revitalization and fiscal conditions, the government will judge what tax measures are required.
- Beyond FY2007, it will be important to make the same level of effort as before to improve the fiscal balance. The government aims to achieve surplus in the primary balance in the early 2010s through such efforts and the realization of sustainable economic growth led by private-sector demand.
- By FY2006, reform of expenditure and revenue to improve the fiscal balance beyond FY 2007 will be studied.



(Source) National Accounts

Note.1 Primary balance (SNA basis) is budget deficit - net interest payment.

2 Primary balance in FY 2004 and 2005 are by Cabinet Office estimates.

3 Primary balance of general account (national debt service - government bond issues) in FY 2004 (revised) is - 18.3 trillion yen while that in FY 2005 (initial) is - 15.9 trillion yen.

International Comparison of Primary Balance

(As a percentage of GDP)

CY	Japan	USA	UK	Germany	France	Italy	Canada
2004	-5.0	-2.6	-1.6	-1.2	-1.2	1.8	2.4
2005	-4.7	-2.2	-1.7	-0.8	-0.6	1.5	2.3

(Source) OECD Economic Outlook 76 (December 2004)

Note. The Table above shows figures for general government as a whole (central and local governments plus social security funds) on a calendar year basis. The scope and period of compilation differ from those in the graph above (FY2004: -4.4, FY2005: -4.0), which are compiled on a fiscal year basis for central and local governments.

* "General government": see page 44.

Primary Deficit

Revenues	Expenditures
Bond Revenues	Interest payment Debt redemption
Tax Revenues, etc.	Primary Deficit General Expenditures, etc.

Primary balance

||

Budgetary expenditure for a given year is furnished by tax and other revenues for that year without resorting to fresh borrowing.

Primary Balance

Primary balance is the fiscal balance reached after subtracting "expenditures excluding interest payment and debt redemption" from "tax and other revenues excluding borrowings".

In this condition, general expenditures for the year and the tax burden for the same year are balanced.

In recent years, Japan has suffered a huge primary deficit. First of all, the government aims to achieve a primary surplus in the early 2010s to build a sustainable fiscal structure.

Primary Balance

Revenues	Expenditures
Bond Revenues	Debt redemption Interest payment
Tax Revenues, etc.	General Expenditures, etc.

Achievement of primary balance:

↓

$\frac{\text{Outstanding debt}}{\text{GDP}} \dots\dots \text{stable}$

If the increase in interest rate (= growth in debt) outstanding is equal to growth rate in nominal GDP, the ratio of debt outstanding to GDP will remain stable.

The Relationship between Primary Balance and Debt Outstanding

When primary balance is achieved, debt outstanding increases only by the amount equivalent to interest payment (colored portion of the chart). This is because government bond revenues (new borrowings) can only be allotted to debt redemption and interest payment.

In this case, if the nominal GDP growth rate equals the nominal interest rate, debt outstanding increases at the same rate as nominal GDP. As a result, the ratio of debt outstanding to nominal GDP remains stable.

This is why it is so important to achieve primary balance, with a view to mid-and-long term fiscal sustainability.

Overview 2: Expenditure Reforms (FY2005 Budget)

The Government has attempted the following reforms in its compilation of the FY2005, to promote further reforms of expenditure.

Thoroughgoing Reforms of Expenditure

- Trinity reforms (Fiscal decentralization and rationalization of Central and Local Governments)(see p30)
- Defense (see p34)
 - Fundamental review of defense forces under the new national security environment
- Reform of the social security system (see p21 ff.)
 - Reform of long-term care insurance system
 - Introducing prefectural contributions accompanied by a strengthening of prefectural roles and authority in the National Health Insurance system.
- Public works
 - Restraining public works related expenditure, prioritization to areas contributing to expand private demand and employment
- Review of Special Accounts (see p19)

Prioritization of Budget Allocation

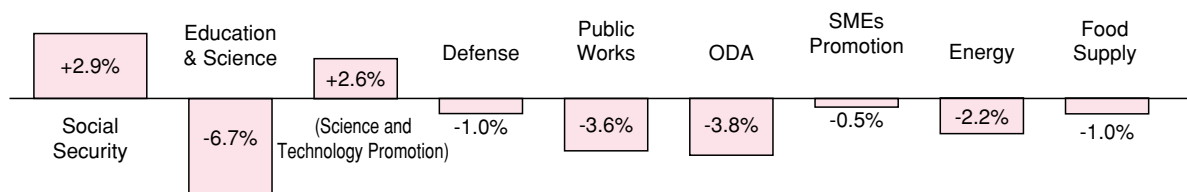
【Budget Concentration in Priority Areas】

- Human resources development
 - University reforms, promotion of employment for youth, promotion of a strategy for creating new industries, and expansion of competitive research grants
- Building a fair and secure aging society and addressing a declining birth rate
 - Measures to tackle the declining birth rate, strategy for health frontiers, and ensuring the safety and security of food
- Building attractive urban areas and local areas with individual characteristics and ideas
 - Towards a "tourism country", support for foundation of small and medium enterprises, and security measures
- Creating an environment-friendly society and economy, and tackling problems of the global environment
 - Building an earth-friendly society
- Prioritization of public works
 - In line with "Basic Principles of Budget Compilation for FY2005", prioritization taking account of level of development, urgency of development, progress in reform of economic structure, role-sharing between public and private sectors, central and local government, and so on.
 - (Growth rates) Community development grants: +45%, Super key ports and harbors: +21%, Loop roads in the three largest urban areas: +14, Disaster prevention parks: +7%

【Inter-Ministerial Coordination】

- Utilizing policy packages (see opposite page)
- Coordination by the Council for Science and Technology Policy (see p33)

〈Year-on-year percentage changes in major expenditure categories〉



Improving Budget Quality and Efficiency

- Strengthening of the management cycle (see opposite page)
 - Budget execution survey, reflection of settlement and report of settlement by GAO, and policy evaluation
- Thorough review of expenditures and revenues
 - Improving expenditure efficiency, diversifying revenues, and reviewing the budgetary system
- Model projects (see opposite page)
- Reducing the number of civil servants (see p36)

Policy Packages: Three Perspectives

The aim of policy packages is to combine the Budget with regulatory reform designed to make maximum use of latent private sector potential, and to attain policy targets through collaboration between ministries and agencies. In FY2005, 18 policy packages are to be promoted from the following three perspectives.

① Strengthening collaboration and eliminating duplication between government agencies

"Promotion and support of ventures into new sectors by construction concerns" (¥930 million)
To support ventures into new sectors by medium/small and core construction concerns, "One-Stop Service Centers" (which offer advice and assistance to help solve management problems, etc.) are to be set up in each prefecture through collaboration between five related ministries, including the Ministry of Land, Infrastructure and Transport.

② Combining the Budget with regulatory reforms, system reforms, etc.

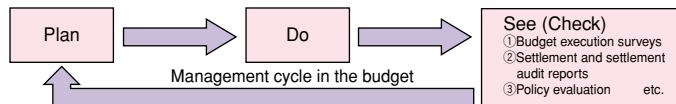
"Next-generation childcare support to reverse the tide of declining birthrates" (¥383.2 billion)
The Ministry of Education, Culture, Sports, Science and Technology and the Ministry of Health, Labour and Welfare will jointly implement a trial project for general facilities that offer combined pre-school nursery and education.

③ Harnessing the latent potential of the private sector

"Promotion of contents business" (¥4.7 billion)
An environment in which private sector concerns can create diverse contents will be developed by correcting the trading environment, etc.

Strengthening the Management Cycle in the Budget

○ Efforts are being made to improve the quality of the Budget by reinforcing the "See" function.



① Budget execution surveys

◆ Since FY2002, the Ministry of Finance has conducted "Budget execution surveys" to accurately ascertain the state of budget execution and reflect this in future budget compilation (enhancement of the "See" function), with the help of Local Finance Bureaus.

◆ Specifically, staff in charge of budget appraisal in the Budget Bureau visit the sites of projects relevant to their respective budgetary areas, and conduct surveys from the perspectives of ① whether the effects of the project are actually being achieved, ② the progress of the project, ③ whether the costs of the project are commensurate with its effects.

◆ In FY2004, 53 projects were surveyed, and the survey results have been appropriately reflected in the FY2005 budget (reflection in Budget: approx. 27.5 billion yen).

(Example) Eco-friendly regional development promotion projects: Removed from the budget, as a considerable number of projects have already been implemented, while efforts by local authorities are also progressing (reflection in Budget: approx. 100 million yen).

② Settlement and settlement audit reports

◆ Appropriate steps are taken in response to settlement audit reports as well as comments, resolutions and others in the National Diet.

(Example) Pension insurance contributions not to be invested in pension and welfare facility development.

③ Policy evaluation

◆ Performance targets, methods of follow-up evaluation, and other aspects of priority tasks are clarified, and these are applied to budget compilation.

(Example of performance targets: Promotion of transplant measures (public information activities to promote donor registration, etc.): registration of approx. 300,000 bone marrow bank donors, etc.)

Thorough Review of Expenditures and Revenues

I. Improving expenditure efficiency

○ Reducing costs

Utilizing discount airline tickets, reducing official vehicles and introducing fuel-efficient cars, minimizing administrative costs as part of the review of Special Accounts

○ Review of administrative operations More efficient prison operation (-¥800 million)

○ Streamlining

Rationalizing the national tax computer system and reducing its maintenance costs (-¥200 million)

Reviewing allocations of government offices and transferring offices from commercial rented buildings to government office buildings (-¥50 million)

II. Diversifying revenues

○ Promoting the disposal of national property Encouraging the purchase of rented property(+¥5.2 billion)

○ Improving the system of fees Electric service charges in line with electricity congestion(+¥6.7 billion)

○ Effective use of advertising media Advertisements in government publications will be considered

III. Review of the budgetary system

○ Review of optional contracts: Reviewing disclosure standards(¥16 million→¥1.6 million)

○ Market test : Model projects for job-placement offices and collection of pension contributions

Model Projects (44 Projects)

Quantitative outcome target

Rigorous follow-up evaluation

More flexible budget implementation aimed at increased efficiency

Vertical flexibility: Facilitation of multi-year projects by contract authorization, etc.
Horizontal flexibility: Relaxation of input controls

Effects of increased efficiency reflected in budgets

[Example] 10% increase in the number of Japanese staff delegated to the UN and affiliated organizations in the next 5 years (Target) (from 610 in 2004 to 670 in 2009)

(Method) Provision of information on career opportunities, approaching executive officers and human resources officers of such organizations, and receiving more recruit missions

(Relaxation) Consolidation of budget expenditures, such as domestic and foreign travel costs/remuneration, into single line items.

Review of Special Accounts

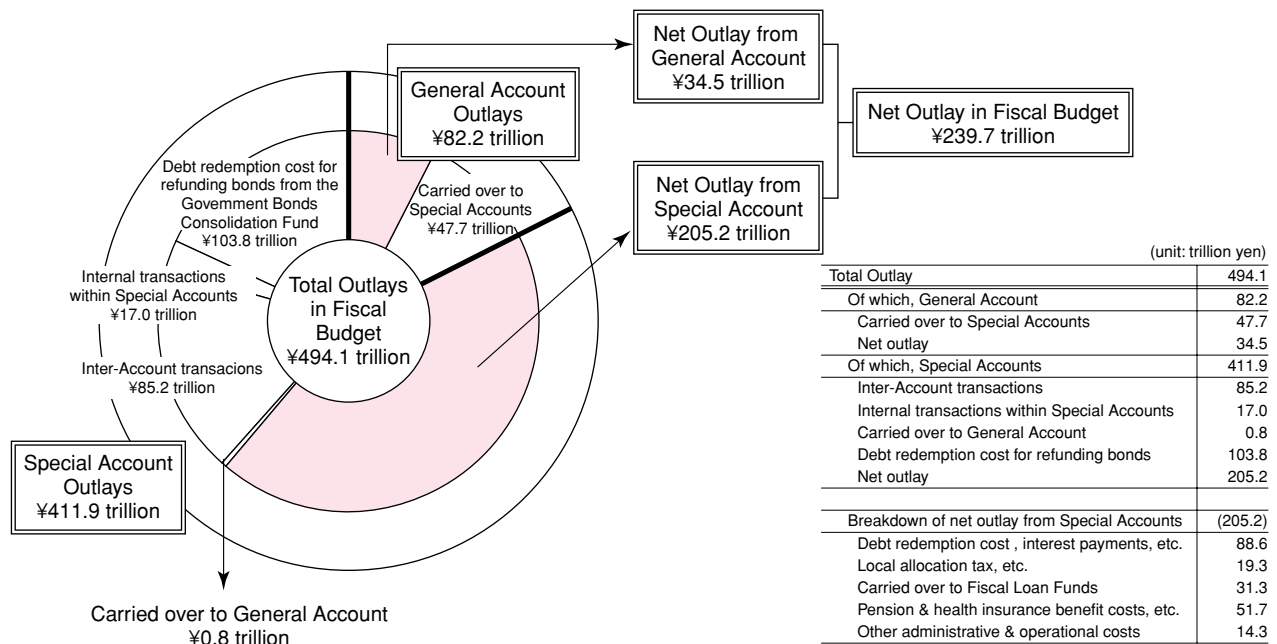
What are Special Accounts?

The national finances consist of a General Account and Special Accounts. The latter may be set up to carry out specific projects, to manage specific funds, and others administered by the government.

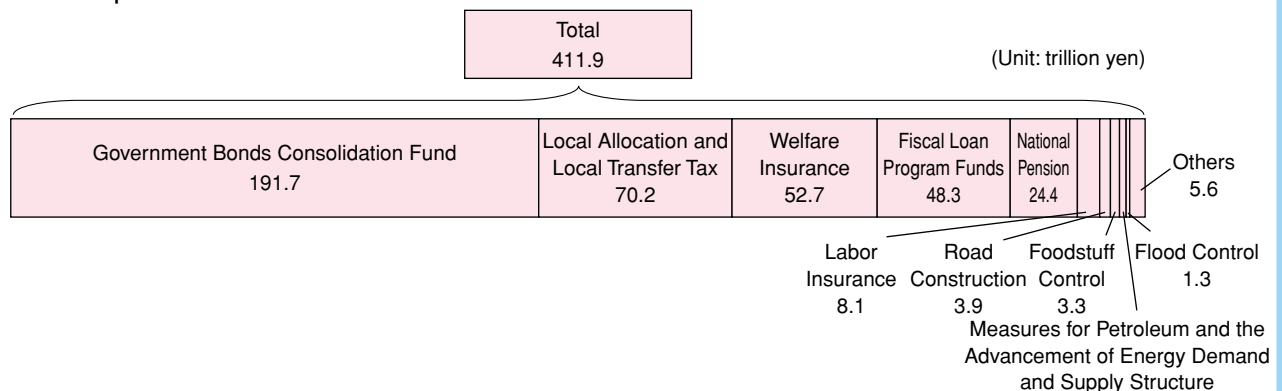
Flow of Funds in Special Accounts (FY2005 budget)

As each Special Account covers a different area of fiscal expenditure, the total outlay reached by simply adding the individual outlays from each Special Account in FY2005 is around 411.9 trillion yen.

Many of these Special Accounts include overlapping or duplicated allocations as inter-account transactions. If these are omitted, the net amount allocated for Special Accounts is around 205.2 trillion yen.



A major part of expenditure from Special Accounts is taken up by the Government Bonds Consolidation Fund, Local Allocation & Local Transfer Tax, and other Special Accounts for the consolidation of funds, Special Accounts for fiscal loans and fund management, and Special Accounts for managing pensions and insurance business, including welfare insurance and national pensions.



Review of Special Accounts

On November 19th, 2004, the Financial System Council made concrete proposals concerning approximately one-third of all Special Accounts (31 in total). Administrative operations would be reviewed, projects prioritized by applying policy evaluations, and ongoing reviews would be continued in these and other ways.

[Examples of Specific Measures in the FY2005 Budget]

- With a view to ultimately scrapping the system of interest-free loans using revenues from NTT share purchases, the system is only to be applied to cases that are already planned, and the amount transferred from the General Account will be reduced. (NTT interest-free loans: ¥71 billion (¥27.7 billion less than in FY2004))

[Industrial Investment Special Account (Social Infrastructure Development Account)]

- Steps will be taken to improve the fiscal balance by reviewing barley policies, etc., thus eliminating losses carried over continuously since FY2001.

(Losses carried over: 0 (¥10.1 billion projected by the end of FY2004))

[Foodstuff Control Special Account]

* See the MOF website for more detailed information.
<http://www.mof.go.jp/singikai/zaiseseido/top.htm>

(Reference 1) Legal justification for the creation of Special Accounts

Article 13 paragraph 2 of the Public Finance Law states that "Limited only to cases where (i) the State carries out a certain program; (ii) the State possesses and manages certain funds; and (iii) the State uses certain revenue to secure special expenditure and thus needs to deal such revenue and expenditure separately from the general revenue and expenditure, a special account shall be established with legislation." As of April 1st, 2005, 31 Special Accounts had been created.

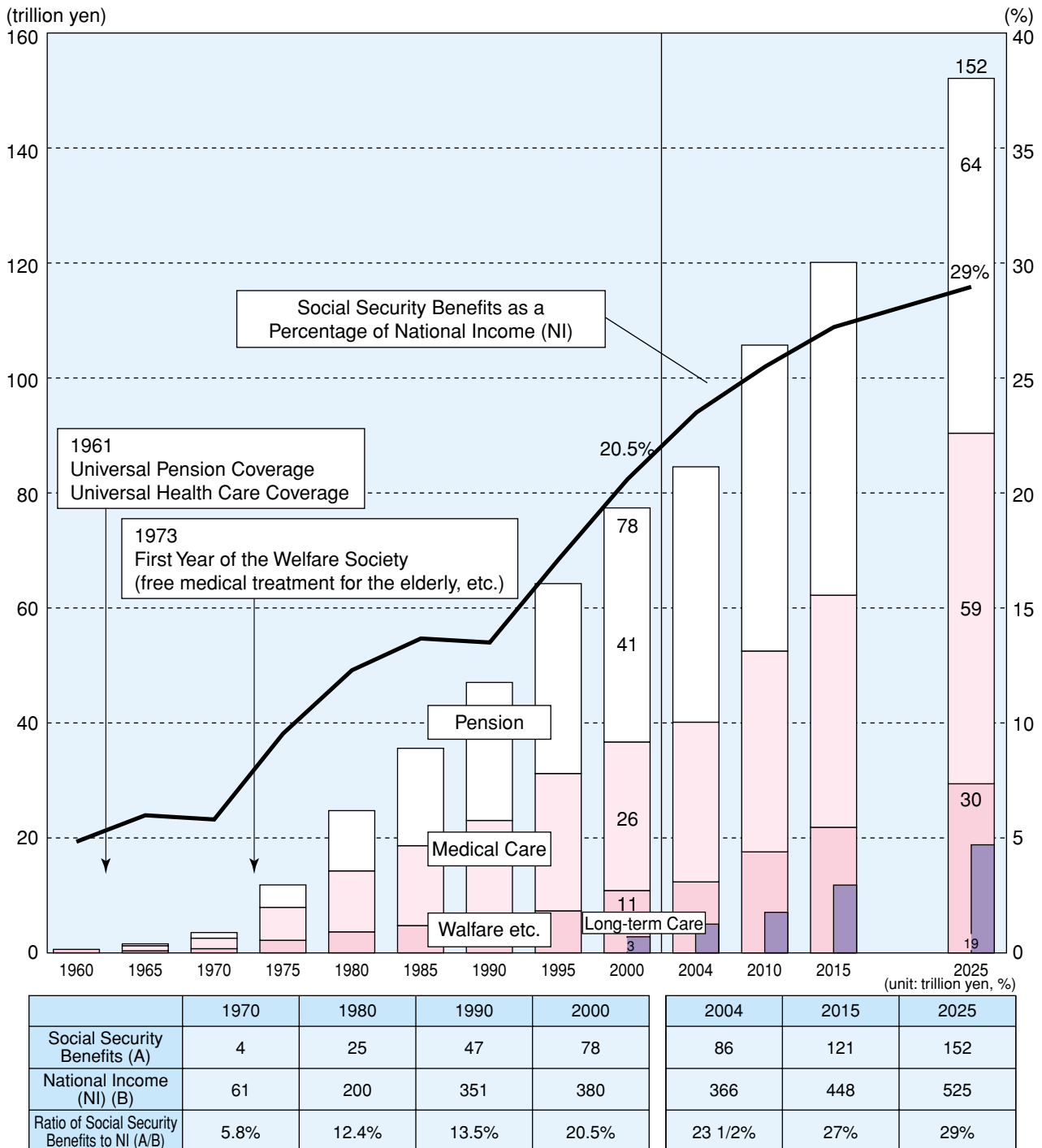
(Reference 2) Types of Special Accounts (SAs) (April 1, 2005)

1. Special Accounts for Enterprise...25 accounts (1) SA for Government Enterprises (1) • National Forest Service (2) SA for Insurance (9) • Earthquake Damage Reinsurance • Welfare Insurance • Seamen's Insurance • National Pensions • Labor Insurance • Agricultural Mutual Aid Reinsurance • Forest Insurance • Fishing Boat Reinsurance • Trade Reinsurance and Fishermen's Mutual Aid (3) SA for Public Works (5) • National Land Improvement • Road Construction and Improvement • Flood Control • Airport Improvement • Harbor Improvement (4) SA for Administrative Business (8) • Registrations • Designated National Properties Consolidation	• National Center for Advanced and Specialized Medical Care • Foodstuff Control • Agricultural Foundation Improvement Measures • Patent Registration • Compensation Reinsurance for Motor Vehicle Damages • Motor Vehicle Inspection and Registration (5) SAs for Loans (2) • Industrial Investment • Urban Development Loan
	2. Special Accounts for the Fund Management...2 accounts • Fiscal Loan Program Funds • Foreign Exchange Funds
	3. Others...4 accounts (1) SAs for the Consolidation of Funds (2) • Local Allocation and Local Transfer Tax • Government Bonds Consolidation Fund (2) Others (2) • Promotion of Power Source Development • Measures for Petroleum and the Advancement of Energy Demand and Supply Structure

Discussion 1: Social Security

In Japan, social security benefits and contributions are forecast to increase in line with the rapid aging of the population. To construct a stable and efficient social security system that can be sustained in the future, benefits and contributions need to be made fairer both between the generations and within each generation, growth in the public cost of benefits needs to be curbed, and structural reforms of the existing social security system need to be made.

① Trends in Social Security Benefits



Note:

1. Social security benefit is the total of expenditures paid under the public social security system.
2. Figures for FY2000 or before are actual. Figures for FY2004 or later were estimated by the Ministry of Health, Labour and Welfare in May 2004.

② Changes in the Social and Economic Situation

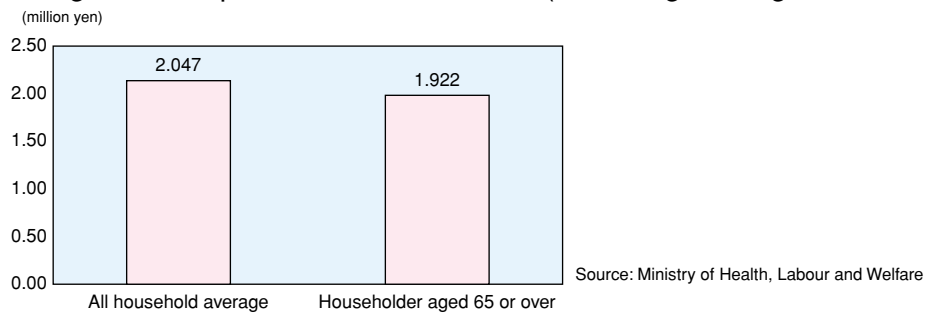
Development of a Rapidly Aging Society

		1960	2000	2050
Dramatically increasing life expectancy	Female	70.19	84.62	89.22
	Male	65.32	77.64	80.95
Declining fertility rate		2.00	1.36	1.39

Economic Situation surrounding the Elderly

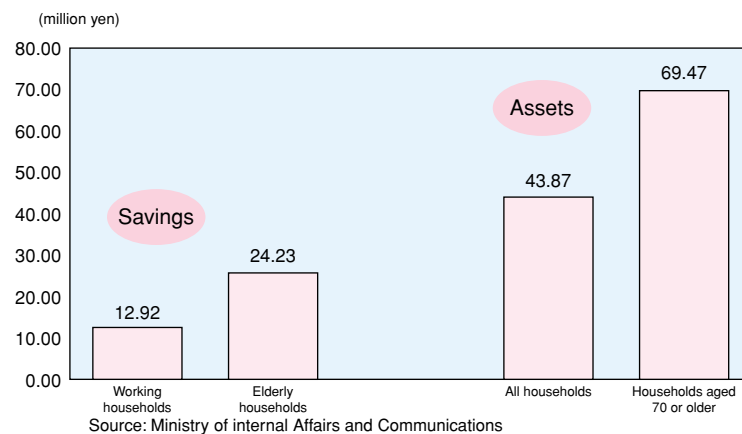
There is hardly any difference in the average incomes of elderly households compared to those of other age groups in income distribution

- Average income per household member (excluding three-generation households)



Elderly households outperform working households in terms savings and assets, owning about twice as much in savings on average.

- Average savings and assets per household



③ Tasks to be tackled in future

Medical Care:

Review of medical care insurance schemes (reorganization and integration of contributors, etc., based on prefectural units), reviews of content and scope of public insurance benefits, and other system reforms (Bill to be presented to the ordinary Diet session in 2006).

Long-term Care:

Review of facility benefits (review of room and board costs, due in October 2005), creation of new preventive benefits, and other system reforms (whole system reform in FY2006).

Pensions:

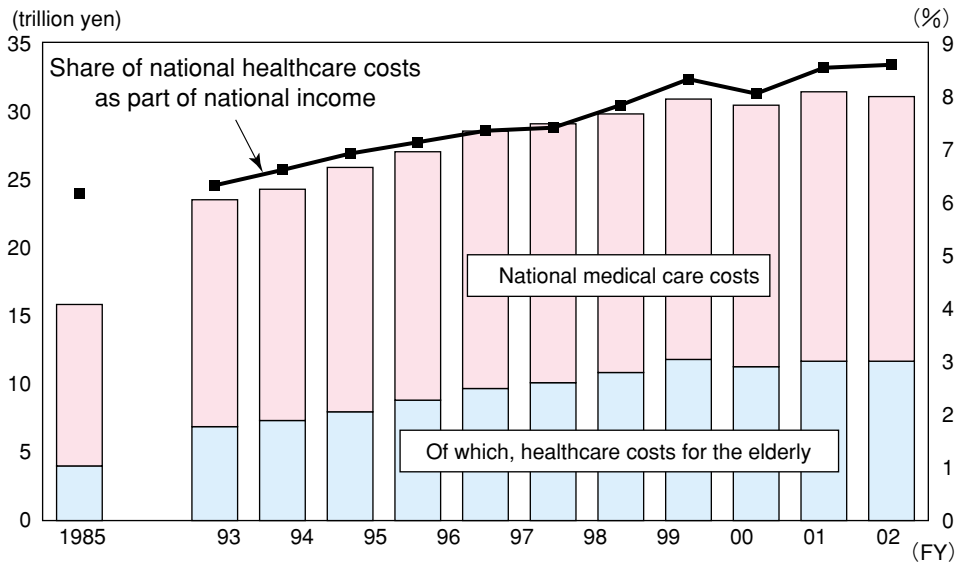
While conducting systematic reviews of social security as a whole, necessary reviews will also be made of the public pensions system to maintain consistency with this. The future directions of the system will also be studied with a view to the ultimate integration of the public pensions system.

Medical care

Reforms of the healthcare system will be essential in order to maintain the universal national insurance system as a sustainable system in the future with population aging. These reforms will need to include curbs on the growth of public healthcare costs, reviews of the content and scope of public insurance, a reorganization and integration of contributors, and greater parity in benefits and contributions between generations.

① Trends in Medical care expenses

Healthcare expenses are growing year by year. Especially medical care expenses for the elderly are growing at a particularly rapid rate, and already account for one-third of the nation's medical care cost.

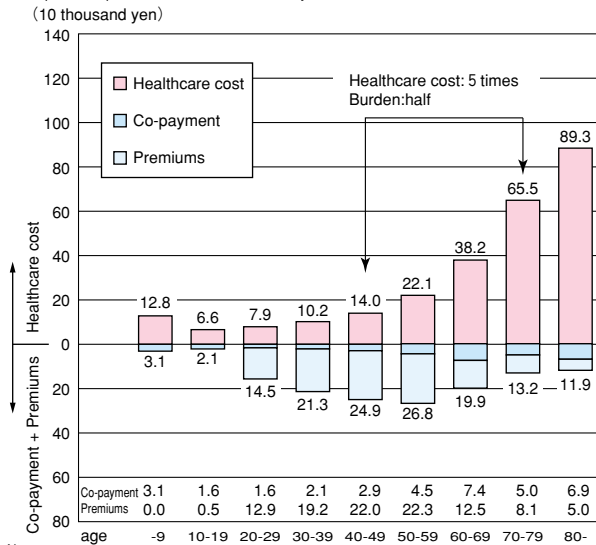


Note: Figures for FY2000 and after reflect partial transfer of healthcare cost to long-term care insurance after initiation of the long-term care insurance system

② Benefits and burdens by generation

There are dramatic disparities in healthcare cost benefits and burdens among Japan's generations.

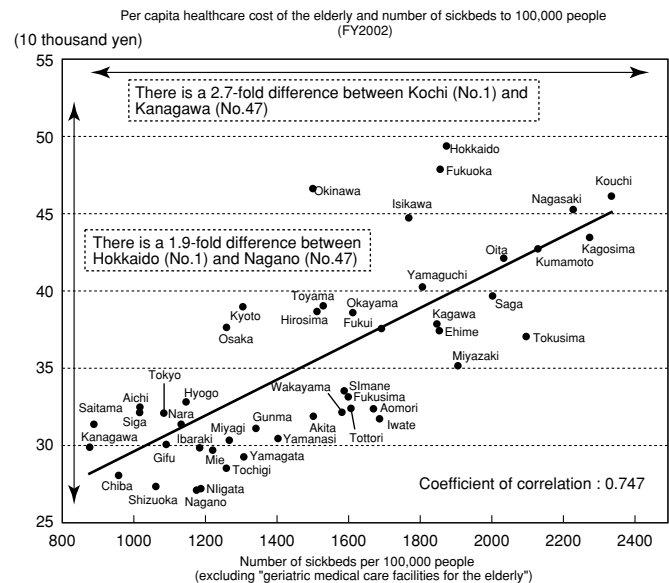
Comparison of per capita healthcare cost personally-borne cost, and insurance premiums (yearly amount) by age group (Estimates based on actual results for FY2000)
Per capita in-hospital healthcare cost for the elderly



Notes:
1. Per capita healthcare cost and co-payment are calculated by dividing the healthcare cost and co-payment for each age group by the number of people paying into the system in that age group.
2. "co-payment" refers to co-payment in the health insurance system.
3. Per capita premiums are calculated by (dividing the premiums of payers in each age group (householders in municipal national health care programs) by the number of people paying into the system in that age group.
4. Some totals may not match due to rounding.

③ Per capita healthcare cost of the elderly by prefecture

The per capita healthcare cost is marked by considerable regional differences. Also, a trend is apparent where per capita cost rises in line with the number of sickbeds in the prefecture.



Note 1: In-hospital healthcare costs include cost of meals during hospitalization
Note 2: The number of sickbeds per 100,000 people was calculated from the total number of hospital sickbeds and sickbeds in clinics on October 1, excluding the number of sickbeds in "geriatric medical care facilities for the elderly" and based on population figures as of October 1 from the Statistics Bureau of the Ministry of Internal Affairs and Communications.

Public Pensions

To maintain a pension system that can offer reassurance for the future, the stability of the system needs to be guaranteed. This can be done by securing a balance between benefits and contributions over the long term, and ensuring that the burden on future generations is not too severe.

○ Outline of FY2004 Pension System Reform

[Automatic adjustment of benefit levels by the "contribution level fixing method" and the "macroeconomic-indexation method"]

- Introduction of "Contribution Level Fixing Method" —a method which automatically adjusts the level of benefits within the revenue after fixing the future contribution level.
- ※ Macroeconomic-indexation method
Reduction of ability to bear social security burdens by the whole society, caused by a declining labor force, will be automatically reflected in the benefit level.

(New recipients)	Per capita wage growth rate	—	Sliding adjustment rate
(Existing recipients)	Inflation	—	Sliding adjustment rate
※Sliding adjustment rate: Takes into account the rate of decrease in public pension contributors and the increase in life expectancy → Average around 0.9% by FY2025			

Employee's Pension

Benefits will be maintained at more than 50% of the average income of working generations (standard case: 50.2% in FY2023).

(Employee's Pension)

Contribution rate will be: 1) raised by 0.354% per year from Oct. 2004 onward (at present: 13.934%).
2) fixed at 18.30% from FY2017 onward.

(National Pension)(in FY2004 values)

Amount of monthly contribution will be: 1) raised by ¥280 per year from Apr. 2005 onward. (at present: ¥13,580)
2) fixed at ¥16,900 from 2017 onward.

[Ratio of State Contributions to Basic Pension Benefits]

- The ratio of state contributions to basic pension benefits will be raised to 50% and applied by FY2009, following a radical reform of the tax system to secure the requisite stable revenue source.

- From FY2004: Allocation of increased revenue due to review of tax on pensions (from FY2005, 1.1% of the basic pension will be added to the existing state contribution ratio of 33.3%)
- FY2005 and FY2006: Having applied requisite tax measures in line with trends in Japan's socio-economy, the state contribution ratio will be raised to an appropriate level (in FY2005, of the increased revenue due to the revision of across-the-board tax credit, 110.1 billion yen will be added to the state contribution amount (the amount borne by the treasury due to the addition of 1.1% to 33.3%))
- After radical reform of the tax system to secure the requisite stable revenue source by FY2007, taking account of trends in reforms of the overall system of social security and other circumstances while maintaining consistency with the government's principles of economic and fiscal management, the ratio will be raised to 50% by FY2009.

Long-term care

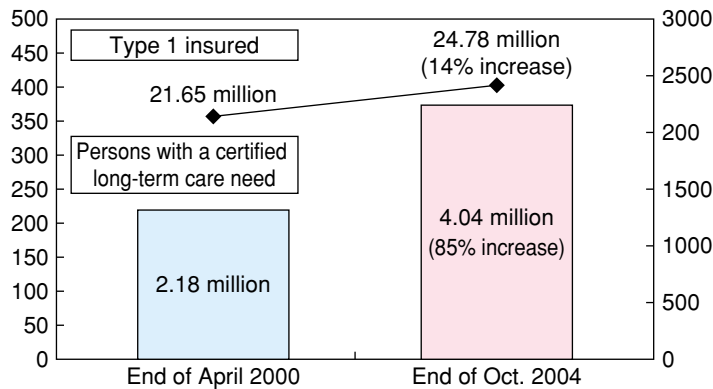
The cost of long-term care insurance benefits is growing by more than 10% every year. Since the insurance contributions and public contributions needed to support this are also growing rapidly, the sustainability of the system now needs to be improved. Accordingly, reforms will include reviews of board and room costs in facilities.

① Trends in numbers insured and numbers in need of long-term care

The number of persons with a certified long-term care need has increased by around 1.9 million since the start of the system 5 years ago. The ratio of persons in need of long-term care to Type 1 insured persons, only about 10% when the system was launched, has now risen to about 16%.

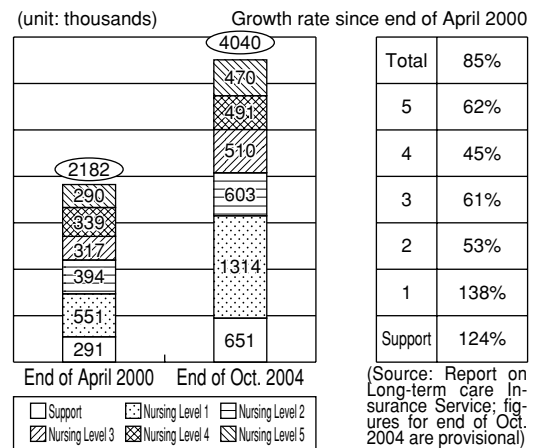
In terms of the type of nursing, the increase is particularly conspicuous among those with moderate needs (Support or Long-term care Level 1).

【Trends in numbers insured and numbers in need of long-term care aged 65 or over】



(Source: Report on Long term care Insurance Service; figures for end of Oct. 2004 are provisional)

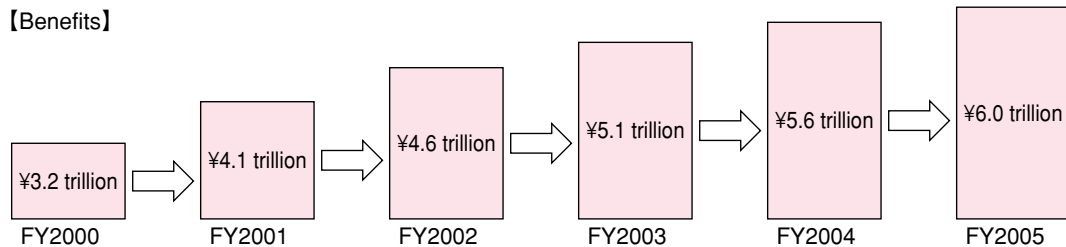
【Trends in numbers in need of long-term care need】



② Trends in long-term care insurance benefits and contributions

The cost of nursing insurance benefits is increasing year on year, and insurance contributions are also increasing in line with this.

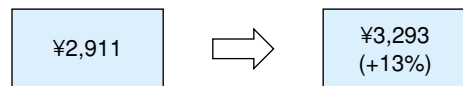
【Benefits】



(Note) FY2000-2003: actual figures; FY2004: revised budget figure; FY2005: initial budget figure.

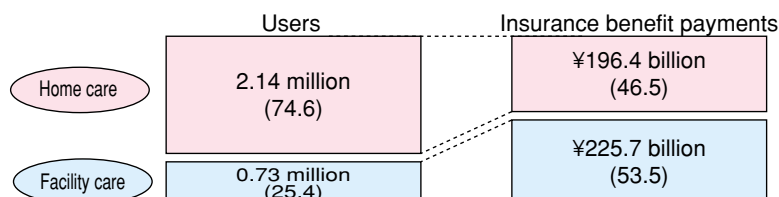
【Type 1 insurance contributions (national average / monthly, weighted average)】

Phase 1 (FY2000-2002) Phase 2 (FY2003-2005)



③ Balance between home and facility care

While the ratio of persons using home to facility care is 3:1, the ratio of insurance benefit payments is virtually 1:1.



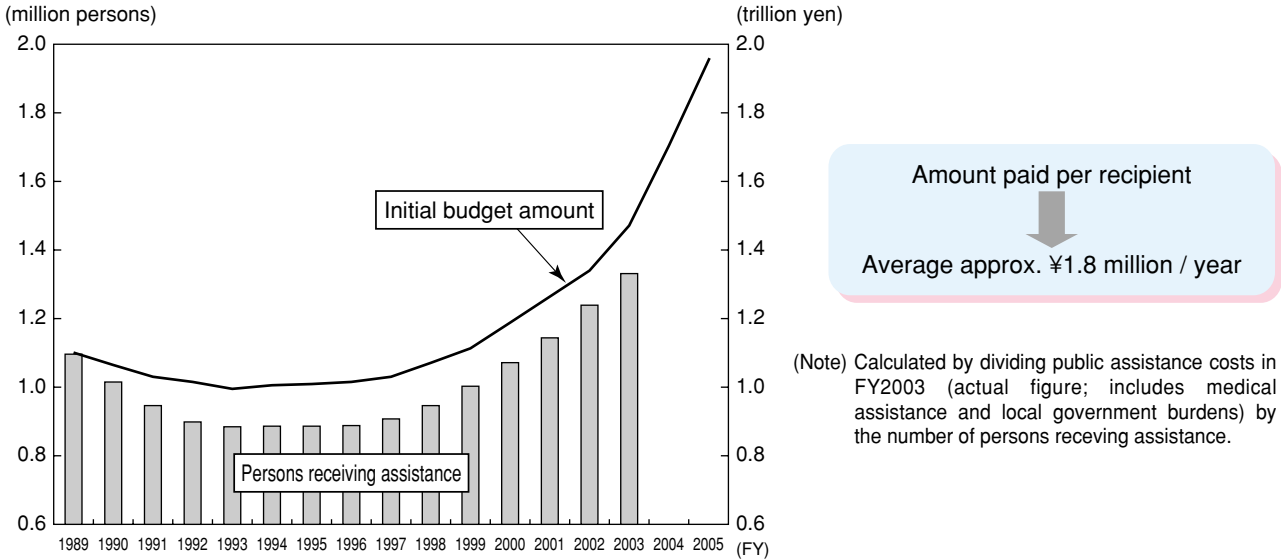
Source: FY2003 Nursing Insurance Service Report (Annual)

Public Assistance

Recipients of public assistance are increasing dramatically. In future, both the system and its execution will need to be reviewed, including a correction of benefit levels, promotion of independence and job placements, etc.

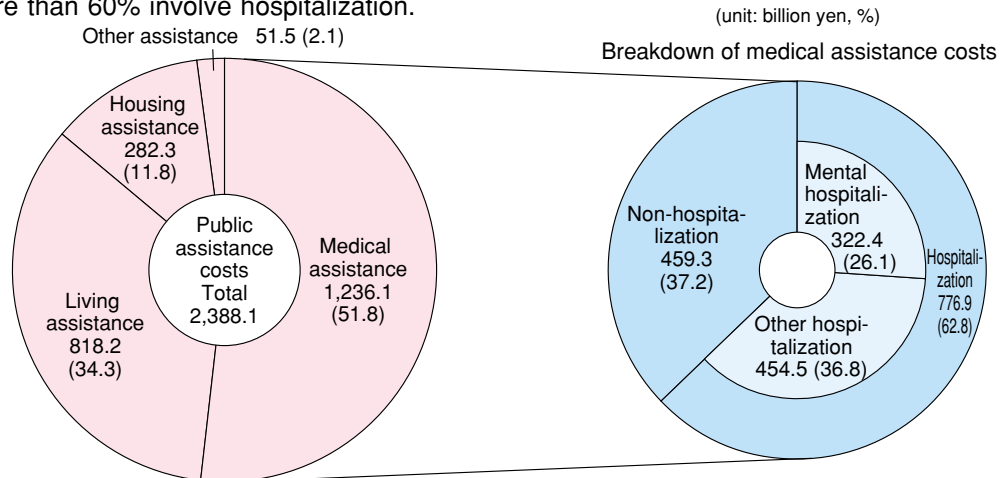
① Trends in persons receiving assistance and state contribution of public assistance

With the rapid increase in persons receiving protection, budget amounts are also growing.



② Breakdown of public assistance costs (FY2003)

About half of all public assistance costs (including local government burdens) consist of medical assistance, while more than 60% involve hospitalization.



Source: Performance Report on Treasury Contributions to Subsistence Protection Costs

③ Trends in protected households by type of household

In FY2003 there were 940,000 protected households, of which about half were elderly households.

	FY1995	FY2003	Growth rate
Total protected households	(100.0%) 600,980	(100.0%) 939,733	56.4%
Elderly households	(42.3%) 254,292	(46.4%) 435,804	71.4%
Single mother households	(8.7%) 52,373	(8.7%) 82,216	57.0%
Sick and disabled households	(42.0%) 252,688	(35.8%) 336,722	33.3%
Other households	(6.9%) 41,627	(9.0%) 84,941	104.1%

Source: Welfare Administration Report example

④ Protection rates by prefecture (FY2003)

A regional disparity can be seen in protection rates.

Prefectures with high protection rates		Prefectures with low protection rates	
①Hokkaido	22.0%	①Toyama	2.1%
②Osaka	21.5%	②Fukui	2.6%
③Kochi	19.1%	③Nagano / Gifu	2.9%

(Note) Prefectural protection rates include designated cities and core cities.

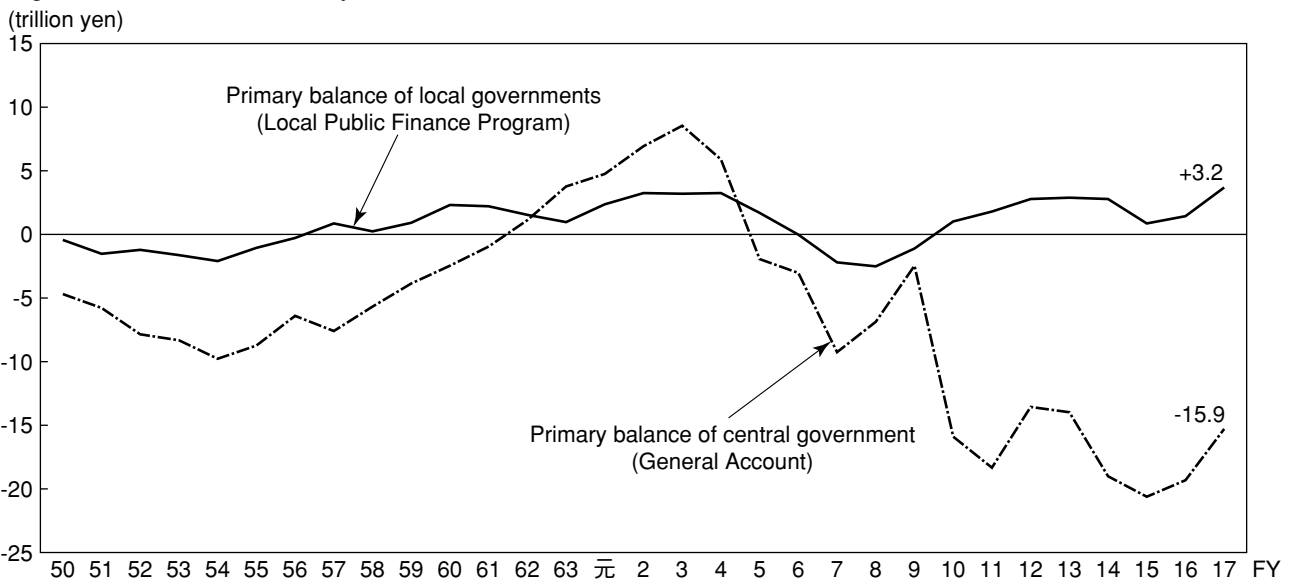
Discussion 2: Central and Local Governments

While central and local governments are equally important in supporting the public economy, they face now in an extremely harsh fiscal situation. Local governments need to tackle rationalization/efficiency of expenditure, as well as take steps to achieve fiscal consolidation. This will be achieved by further promoting the simplification of financial and administrative operations, controlling personal numbers, and correcting wage levels etc.

Meanwhile, when studying fiscal problems that concern central and local governments, it should be borne in mind that the fiscal situation of the central government is far more critical than that of local governments.

① Trends in Primary Balance at Central Government and Local Government Levels

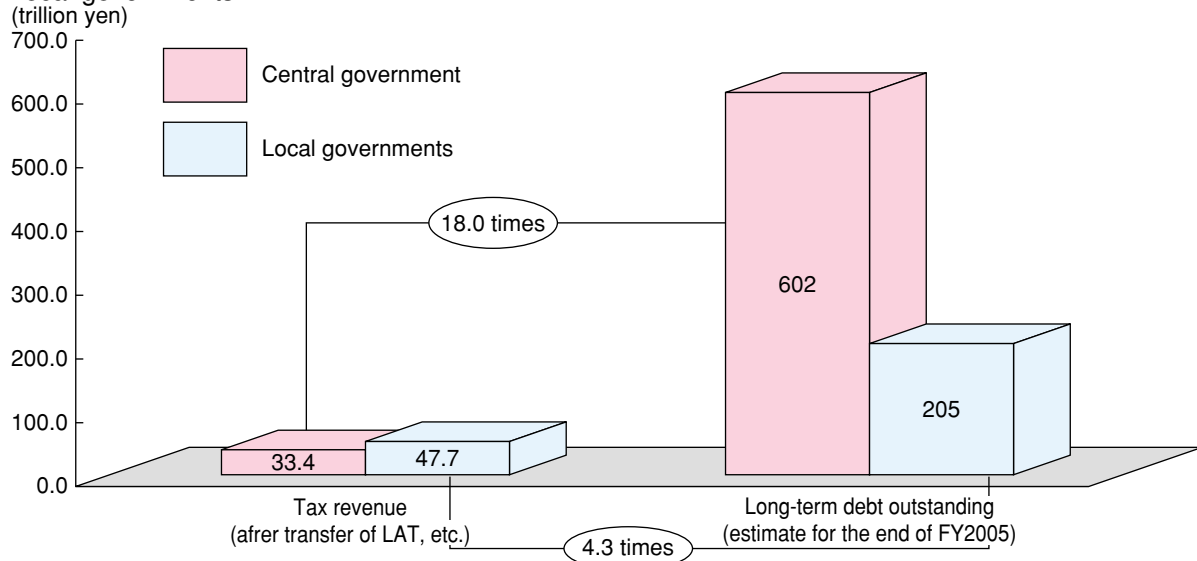
The primary balance of local governments, based on figures in the Local Public Finance Program, tends to stay close to zero while that of the central government, based on figures in the General Account, has seen significant deficits in recent years.



Note 1. The primary balance of the central government consists of "national debt service-government bond issues".
Based on the revised budget until FY 2004. Based on the initial budget for FY2005.
2. The primary balance of local governments consists of "(debt services+cost of repaying corporate debt included in money transfers to public enterprises)-local bond issues"

② Ratio of Tax Revenues and Bonds Outstanding for Central and Local Government

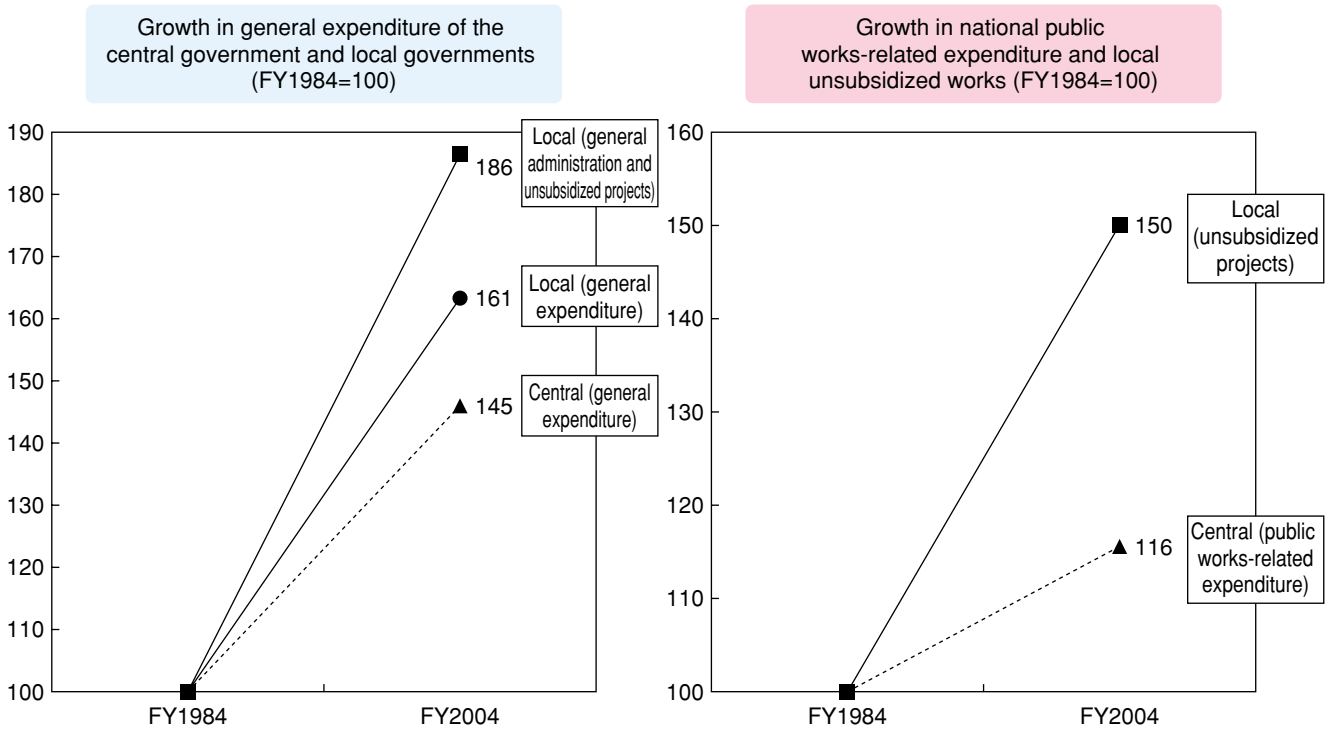
The ratio of tax revenues to bonds outstanding is 1 to 18.0 for central government compared with 1 to 4.3 for local governments.



Note 1: National tax revenue includes special account taxes, while local tax revenue includes tax revenue that is outside the local public finance program.
2: Tax revenue after transfer of LAT, etc., is calculated after transfer of the percentage of LAT that is stipulated by law as well as local transfer tax from the central government to local government.

③ Trends in Expenditure of the Central Government and Local Governments

Until recent years, expenditure by local governments increased at a rate that far outstripped that of the central government. Though now in a decreasing trend, the expenditure is still at a high level. A major cause of this is a low awareness of local burdens since revenue sources are guaranteed by local allocation tax.

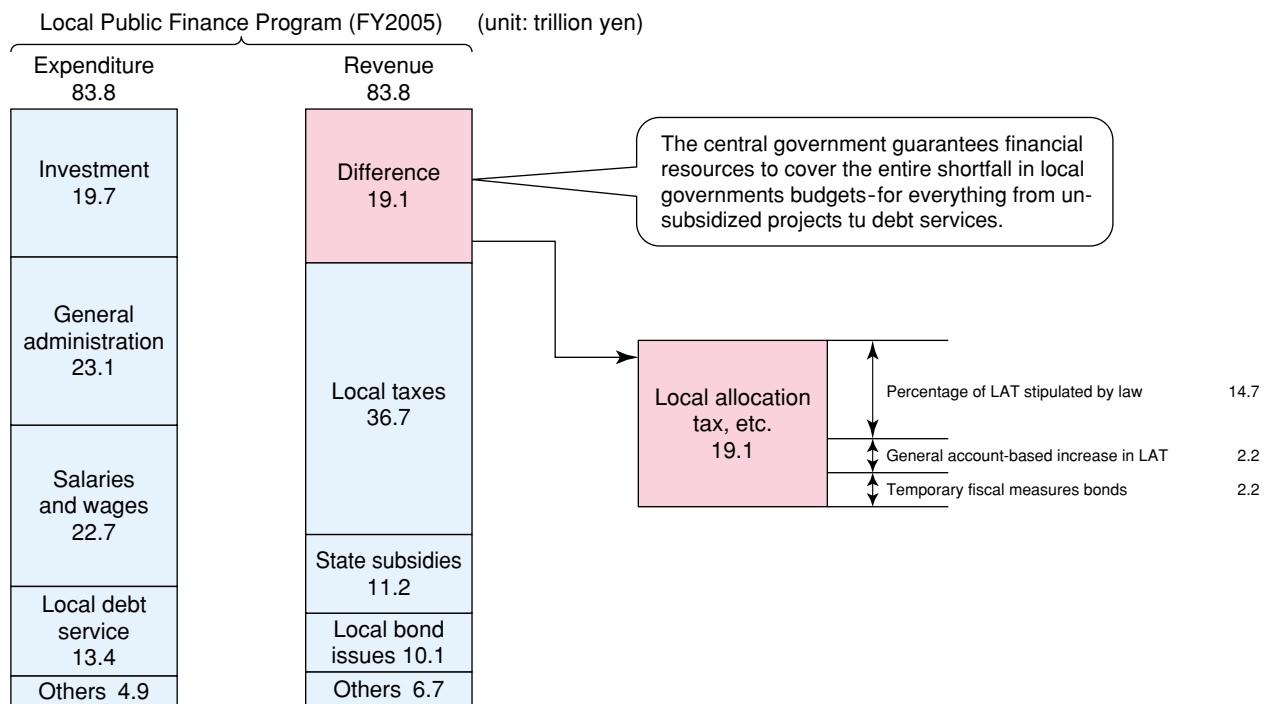


Note 1: Figures for central government are from the general account budget; figures for local governments are from the local public finance program.

Note 2: "General administration and unsubsidized projects" is the total of expenses related to ordinary activity conducted independently by local governments (waste treatment, industrial promotion, etc.) and investment projects (road works, facilities establishment, etc.) It should be noted that general expenditure includes salary-related costs and costs associated with projects that are implemented with state subsidies.

④ Revenue Guarantee Function through Local Allocation Tax

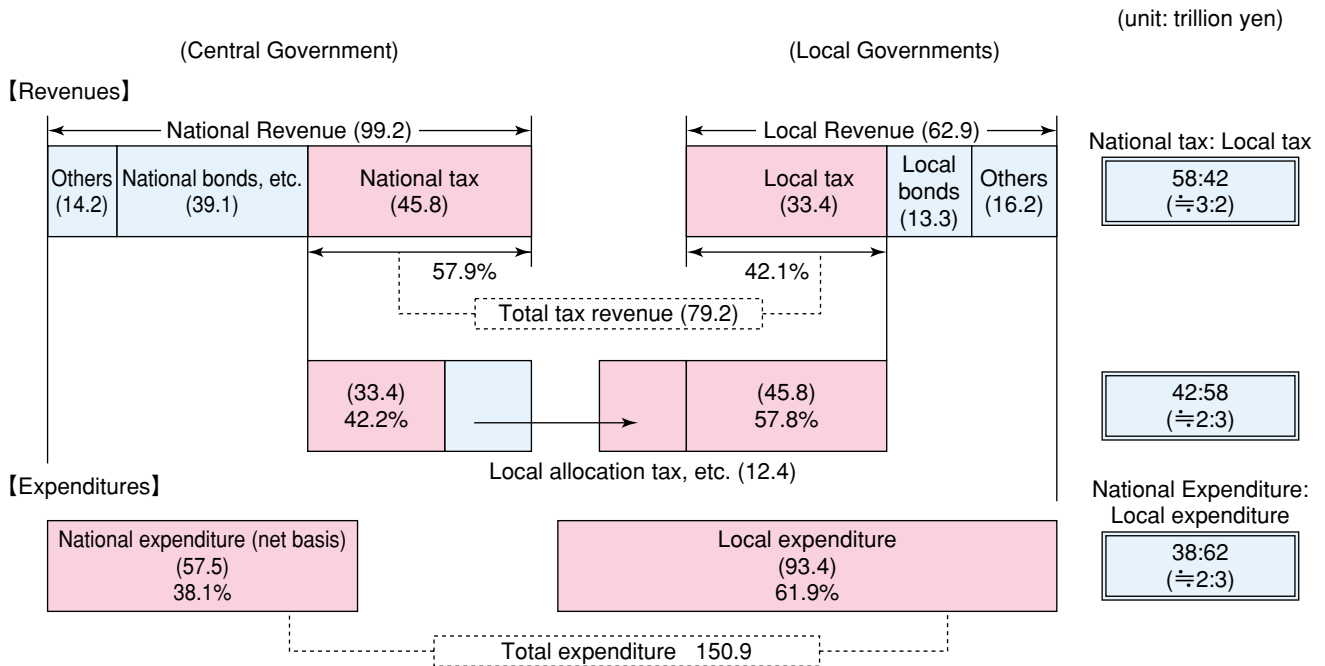
Local Allocation Tax guarantees revenue sources to cover the expenditures of local governments, including unsubsidized projects and local bond repayments through the Local Public Finance Program.



⑤ Schematic Diagram of National and Local Revenues and Expenditures (FY2002 Settlement)

The imbalance in both national and local revenues and expenditures (tax revenue of ¥79.2 trillion against expenditure of ¥150.9 trillion) as a whole has become a matter of concern.

The national tax to local tax ratio (2:3) is almost the same as the expenditures ratio, after adjustment with local allocation tax, etc.

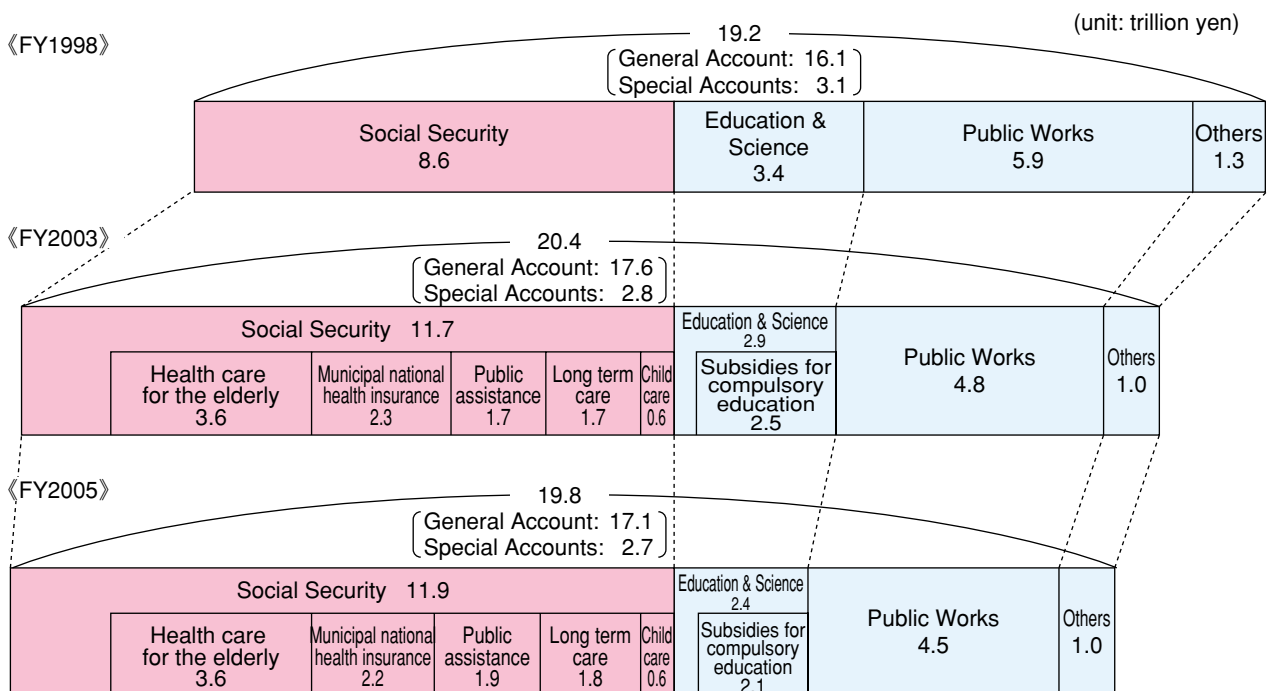


(Note) Figures are on a settled basis and rounded off.

⑥ Situation of Subsidies for Local Governments

In addition to the local allocation tax, the central government's expenditure to local governments includes subsidies to these governments.

Looking at subsidies to local governments, while subsidies are being scaled back or abolished primarily in public works areas, social security-related subsidies have continued to grow (natural growth). As a result, the total amount of these subsidies is increasing compared with, for example, FY1998.

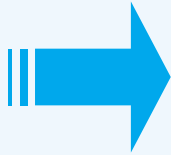


(Reference) State of the "Trinity Reforms" in FY2005

The government and ruling party drew up an overall image of reforms on November 26th, 2004, and incorporated the results in the FY2005 Budget.

1. Reform of Local Government Subsidies

Reforms to the value of 1,768.1 billion yen are to be implemented, with a view to reducing the central government's involvement, expanding the authority and responsibility of local governments, and streamlining administrative operations on both central and local level.

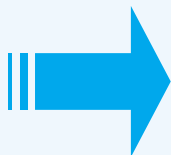


<Main content of reforms>

- Reforms toward tax resource transfers (¥1,123.9 billion)
 - Subsidies for compulsory education: 425.0 billion yen, state contribution to the national health insurance system: ¥544.9 billion
- Transformation Subsidies into grants (¥343.0 billion)
 - Grants for roads: ¥27.0 billion, grants for sanitation: ¥49.0 billion, grants for harbors: ¥5 billion
- Rationalization of subsidies (¥301.1 billion)

2. Tax Resource Transfers, etc.

Among the subsidized projects planned to be abolished transfer of tax revenue sources will take place for projects whose implementation is required by local governments.

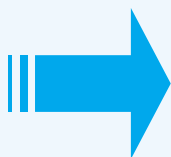


<Main content of reforms>

- In response to de-earmarking of subsidies in FY2003, FY2004 and FY2005, tax resources will be transferred through local income transfer tax as a provisional measure (¥1,115.9 billion, including a new portion of ¥691.0 billion).
 - In response to the review of subsidies for compulsory education costs in FY2004 and FY2005, provisional measures will be taken through exceptional local grant tax (¥629.2 billion, including a new portion of ¥425.0 billion).
- ▶ Total of the above: ¥1,745.1 billion

3. Reforms of Local Allocation Tax

Review of each expenditure items leads to reduction in the total amount of local government expenditures as well as local allocation tax grants from General Account. On the other hand, the total amount distributed to local governments is to be kept on the same scale as in FY2004, taking account of fiscal management by local governments.



<Main content of reforms>

- Reduction in the total amount of Local Allocation Tax
 - General Account basis ¥14.6 trillion (-¥0.8 trillion)
 - Local Public Finance Program basis ¥16.9 trillion (+¥0.0 trillion)
- Review of each expenditure item leads to a reduction in the total amount of local government expenditures.

Total expenditure	¥83.8 trillion (-¥0.9 trillion)
• Salaries	¥22.7 trillion (-¥0.3 trillion)
• Investment	¥12.4 trillion (-¥1.1 trillion)

Discussion 3: Public Investment

Facilities that form the foundation of socio-economic activities, the national way of life, and the protection of national land — such as roads, harbors, housing and sewerage — are referred to as "public investment".

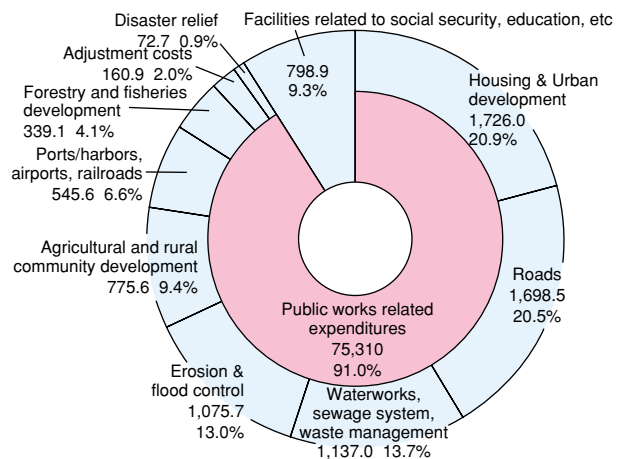
A high level of investment has been consistently maintained and, as a result, the level of public investment in Japan has risen dramatically. When developing social infrastructure in future, we will need to promote further prioritization and efficiency while reducing the scale of investment.

① Trends and Breakdown of Public Investment Related Expenditures

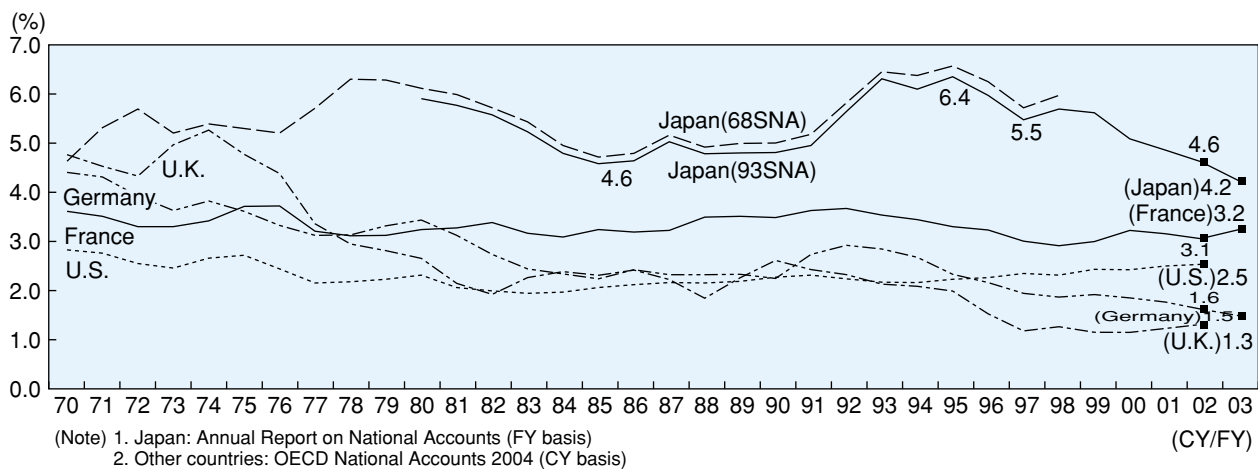
Public Investment Related Expenditures for
FY2005 ¥8,272.0 billion
(Reduction by ¥342.9 billion or 4.0%)

(in billions of yen, %)

	FY2002	FY2003	FY2004	FY2005
Total amount	9,252.5	8,911.7	8,614.9	8,272.0
Growth rate	-10.8	-3.7	-3.3	-4.0



② International Comparison of Gross Fixed Capital Formation as a Percentage of GDP



"Structural Reform and Medium - Term Economic and Fiscal Perspectives" ("Reform and Prospects") (decided by the Cabinet on January 25th, 2002) Directions for Economic and Fiscal Policies Centered on Structural Reform

(Directions for the government)

Throughout the period subject to "Reform and Prospects", steps will be taken to prioritize the government's public works investment and maximize its efficiency, while taking account of prevailing economic trends. The aim will be to return to levels that existed before major additions were made for economic stimulation measures.

(Directions for Public investment)

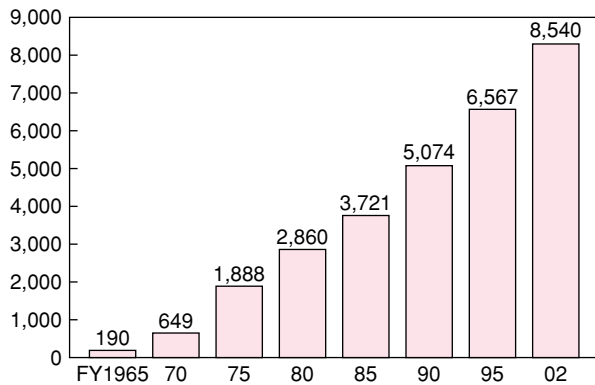
Public works will be selected with a focus on absolute necessity, and the most efficient system of development will be established.

The scale of investments also needs to be revised, considering the current harsh fiscal situation, as well as the fact that the scale of public works investment compared to the national economy is extremely high compared to that in other countries.

③ International Comparison of Infrastructure

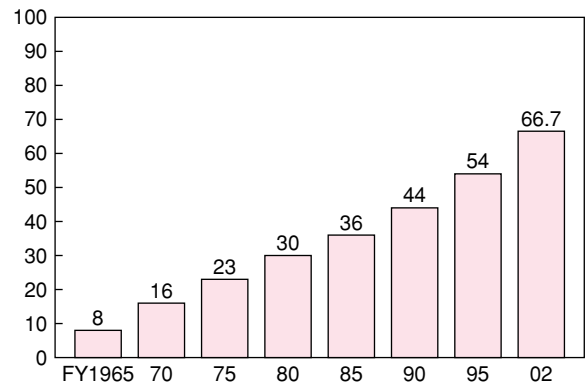
The level of public investment in Japan is growing rapidly, a level that matches any other country.

○ Total length of highways developed (km)



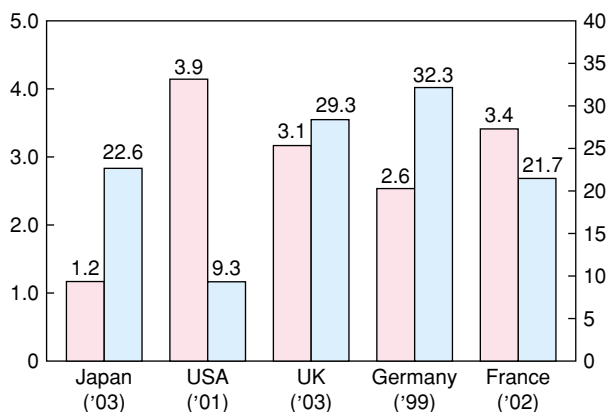
Note. As well as national route expressways, the above includes ordinary national route highways, the Honshu-Shikoku Road Bridge, and ordinary national route highways running parallel to national route expressways.

○ Population diffusion ratio of sewerage (%)



Note. "Population diffusion rate of sewerage" refers to the percentage of the population for which wastewater is treated via sewerage lines (from among all wastewater treatment facilities).

○ Length of expressway per 10,000 vehicles (km/10,000 vehicles) (left-hand bar) Length of expressway per unit of national land area (km/1,000 km²) (right-hand bar)

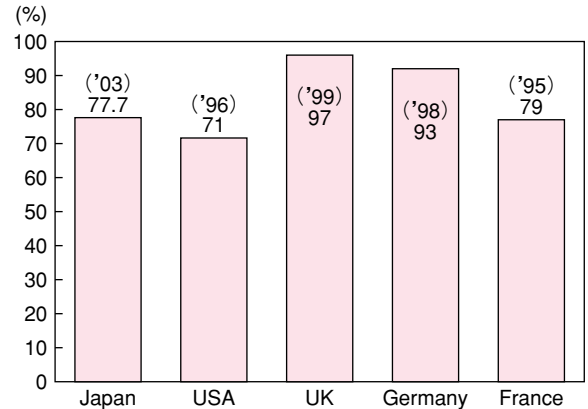


Note.1. For Japan, the length of expressways includes national route expressways, ordinary national route highways, the Honshu-Shikoku Road Bridge, and ordinary national route highways running parallel to national route expressways.

2. For the UK, the length of expressways includes motorways and dual carriageways (trunk roads).

Sources: IRF "World Road Statistics 2004"; Ministry of Land, Infrastructure and Transport data; and the Ministry of Internal Affairs and Communications (Statistics Bureau), "World Statistics 2004"

○ Rate of development of sewage treatment facilities (%)



Note. The rate of development in Japan is shown as the proportion of the population served by sewage treatment facilities (sewerage, rural drainage facilities, etc; joint treatment and purifying tanks; community plants) against the total population. For other countries, the rate is shown as the proportion of the population connected to public sewerage and served by public sewerage treatment.

Increased Efficiency of Public Works

① Cost shrinkage: "Structural Reforms of Public Works Costs" are being promoted (aiming at 15% reduction in total costs over 5 years from FY2003).

② Project Evaluation

When adopting new projects, their appropriateness is carefully examined using cost-benefit analysis (benefits divided by costs). Even after a project has been adopted, projects may be discontinued if, as a result of re-evaluation, their level of necessity is deemed to have diminished.

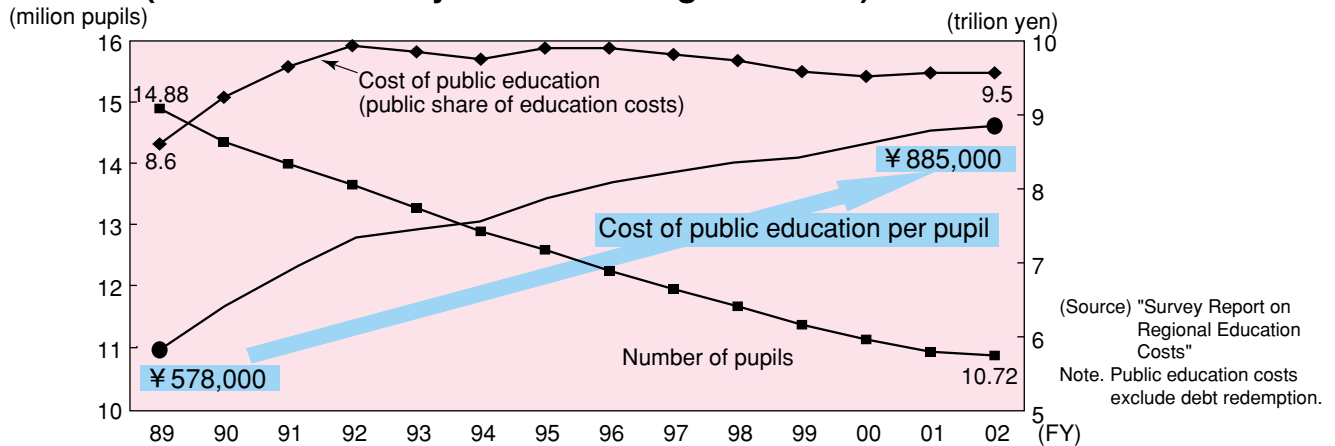
Re-evaluation is appropriately carried out for dam construction and other individual projects. In FY2005, three projects are to be discontinued (including the Kiso River Flow Improvement Project and the Wide-Area Fishing Port Development Project, with residual project costs of approx. 1.8 billion yen), because it was judged that the necessity of continuing these projects has diminished.

Discussion 4: Other Sectors

(1) Education

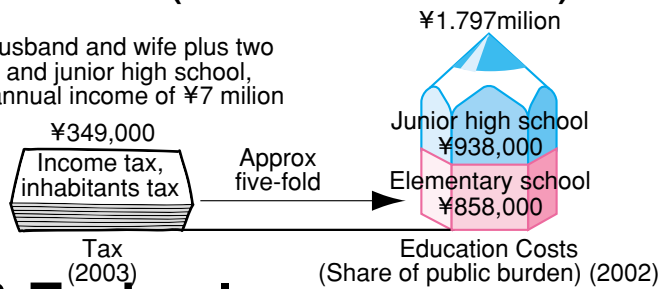
Tasks of pressing urgency are to rationalize the budget in response to declining numbers of school pupils, place greater stress on burdens borne by recipients, review ways of sharing roles and cost burdens between central and local governments, and other efforts, as well as focusing priorities and maximizing efficiency.

① Sharp Decrease in Pupil Numbers and Increase in Public Share of Education Costs (Public Elementary and Junior High Schools)



② Taxes and Education Costs (Share of Public Burden)

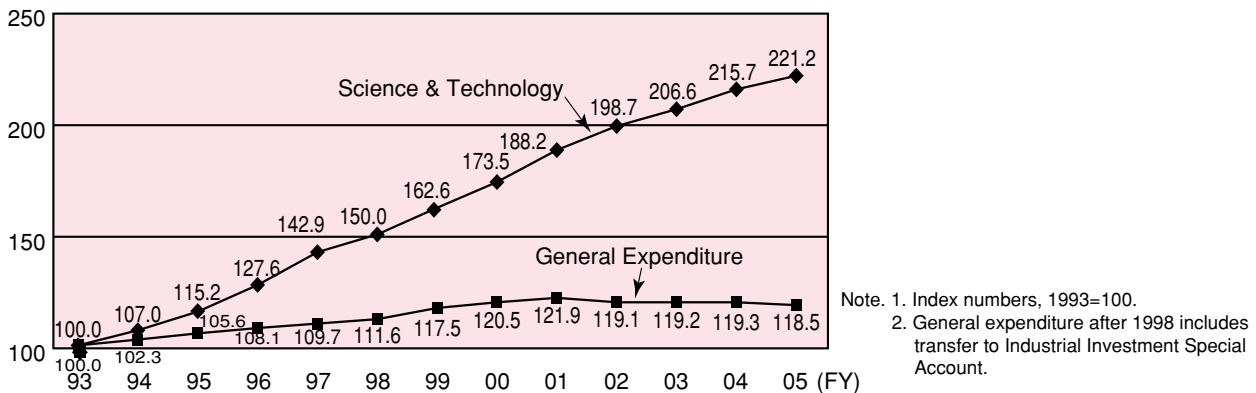
Salaried household (husband and wife plus two children in elementary and junior high school, respectively) with an annual income of ¥7 million



(2) Science & Technology

Given a volume expansion, budgetary allocations will be prioritized in high-ranking projects based on the "priority rankings" devised by the Council for Science and Technology Policy. Meanwhile, low-ranking projects will be progressively reduced. In future, steps will need to be taken to enhance interim and follow-up evaluation.

● Comparison of Science and Technology Expenditures with General Expenditures



- Projects are given varying degrees of attention based on the "Priority Rankings (SABC)" formulated by the Council for Science and Technology Policy. (Growth rate from FY2004 to the FY2005 Budget) S: +13%, A: +7%, B: -5%, C: -15%
- Competitive funding to support fundamental research (total amount: ¥467.2 billion), "Future Creation Projects" for economic stimulation (total amount: ¥126.5 billion), and construction of a successor to the Antarctic observation ship "Shirase" (¥3.5 billion) will be tackled.

(3) National Defense

Japan now faces a new security environment in which the possibility of full-scale military incursion has been replaced by new threats and imaginary scenarios such as terrorism and ballistic missiles. Given this situation, steps must be taken to develop a flexible self-defense capability, while prioritizing important issues in line with the new National Defense Program Outline and Mid-Term Defense Program.

● Trends in national defense expenditure

(unit: billion yen)

	FY2001	FY2002	FY2003	FY2004	FY2005
Amount	4,955.3	4,956.0	4,953.0	4,903.0	4,856.4
Year-on-year	+19.5 (+0.4%)	+0.7 (+0.0%)	-3.0 (-0.1%)	-50.0 (-1.0%)	-46.6 (-1.0%)

- The development of the Ballistic Missile Defense (BMD) system (contract basis, ¥119.8 billion) will be balanced by a reduction of existing armaments, while front-line equipment and others will be reduced to 714.1 billion yen on a contract basis (falling by ¥86.9 billion or 10.8% from FY2004).

(4) Official Development Assistance (ODA)

Steps will be taken to maximize the efficiency of Official Development Assistance (ODA) by approaching aid fields in a strategic manner, reducing project costs, and improving transparency while ensuring ODA scale that fully and appropriately meet Japan's international responsibilities.

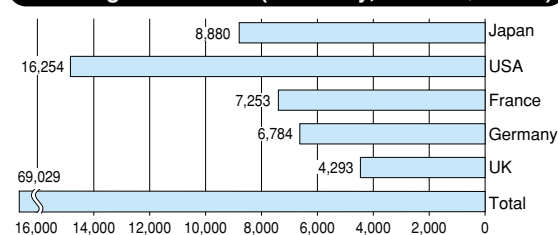
① Trends in the ODA Budget

(unit: billion yen, %)

	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005
amount	1,046.6	1,015.2	910.6	857.8	816.9	786.2
Growth rate	-0.2	-3.0	-10.3	-5.8	-4.8	-3.8

(Reference) ODA extended by leading donors in 2003

Actual figures for ODA (net outlay, unit: US\$million)



Note: Figures for other countries are provisional.
Source: DAC Press Release

② Breakdown of the ODA Budget (FY2005)

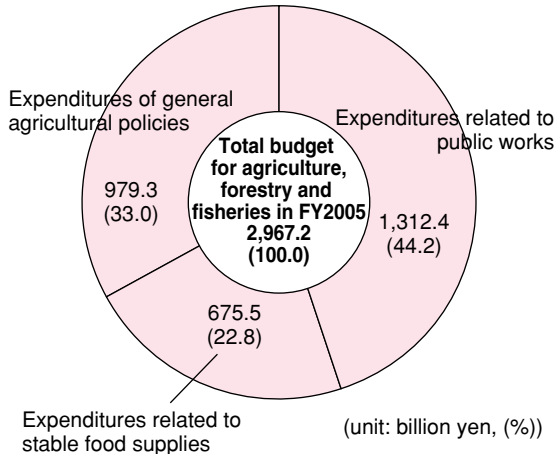
		Budget (billion yen)	Share of ODA (%)	Major examples	
Official Development Assistance (ODA)	Bilateral	Economic development assistance	208.5	26.5	<ul style="list-style-type: none"> • Construction of schools, hospitals, etc. • Relief for natural disaster victims and refugees • Food aid etc. • Dispatch of JOVC volunteers • Acceptance of trainees etc. • Economic & social infrastructure, etc. • Contributions to UNICEF, WHO, etc.
		Grants			
	Technical cooperation	308.7	39.3		
	Loans (non-grant aid)	174.4	22.2		
	Contributions to international organizations	94.5	12.0		
Total ODA		786.2	100.0		

Note. Totals do not add up exactly as figures have been rounded off.

(5) Agriculture, Forestry and Fisheries

In the agriculture, forestry and fisheries sector, attempts must be made to concentrate and prioritize measures towards motivated and capable farm businesses and to further promote structural reform aimed at strengthening competitiveness, while paying attention to food safety and reassurance as well as environmental protection.

● Breakdown of the Budget for Agriculture, Forestry and Fisheries



- Budget for agriculture, forestry and fisheries consists of public works to develop farmland, stable food supply to the public and promotion of forestry, etc.

(Initial budget basis; unit: billion yen)

Category	Fiscal year	1985	1995	2005
Total budget for agriculture, forestry and fisheries		3,300.8	3,290.6	2,967.2
Agriculture		2,646.2	2,499.3	2,261.1
Forestry		350.7	448.2	426.3
Fisheries		304.0	343.1	279.8

Expenditures related to public works:

Cost for development of farmland and water facilities for agriculture

Expenditures for stable food supplies:

Cost of stabilizing the price of agricultural and products and their supply

Expenditures of general agricultural policies:

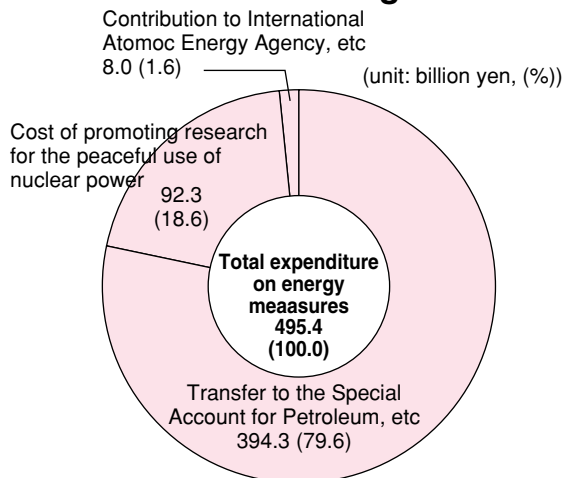
Cost for other policies such as promotion of farming villages and forestry

(6) Energy

Important issues for energy measures are ① guaranteeing a stable supply of energy, ② responding to the problem of global warming, and ③ ensuring efficiency by applying market principles.

In the FY2005 Budget, reviews have been made with a view to eliminating unused or surplus funds in the Energy Special Account.

● Breakdown of the Budget for Energy

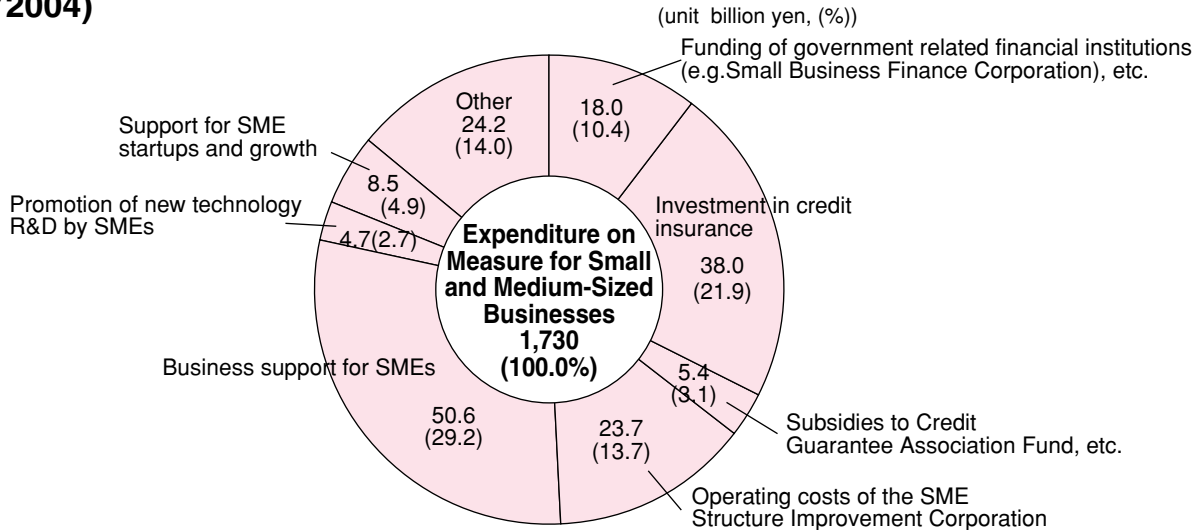


- Most of the spending on energy measures is transferred to the Special Account for Petroleum and Measures for Petroleum and the Advancement of Energy Demand and Supply Structure (Special Account for Petroleum). The Special Account is used to implement measures concerning energy conservation and new energy that include securing stable supplies energy and responding to global warming.

(7) Measures for Small and Medium-Sized Enterprises

Active support will be extended for the self-help efforts of small- and medium-sized businesses that have the motivation and capability to create new businesses, achieve business innovation, etc.

● Breakdown on Expenditures for Small and Medium-Sized Enterprises (FY2004)

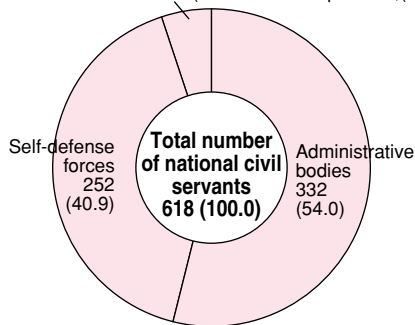


(8) The Number of Civil Servants

While appropriately allocating personnel in truly essential areas such as law and order, a general streamlining of government personnel is being promoted.

① The number of national civil servants at the end of FY2005: 615,000

Diet, court 32 (5.1) (unit: thousand persons, (%))



● Net reduction of national civil servants, excluding self-defense forces, Diet and courts, and national forests

FY2004
-445



FY2005
-624

● Increase in the security areas

FY2004
1,339

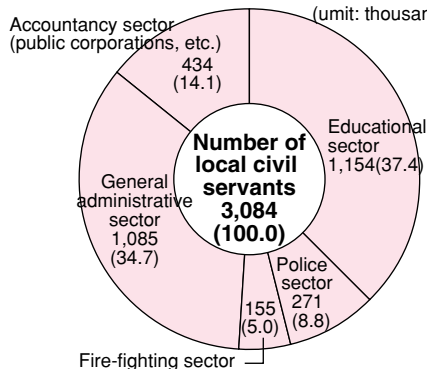


FY2005
1,580

Note: The increase includes: Prison +567, Immigration +174, Prosecution +43, Customs +195

② The number of local civil servants at the beginning of FY2004: 3,084,000

(unit: thousand persons, (%))



● Net reduction of local civil servants

FY2003
-27,000



FY2004
-33,000

Source: Ministry of Internal Affairs and Communications

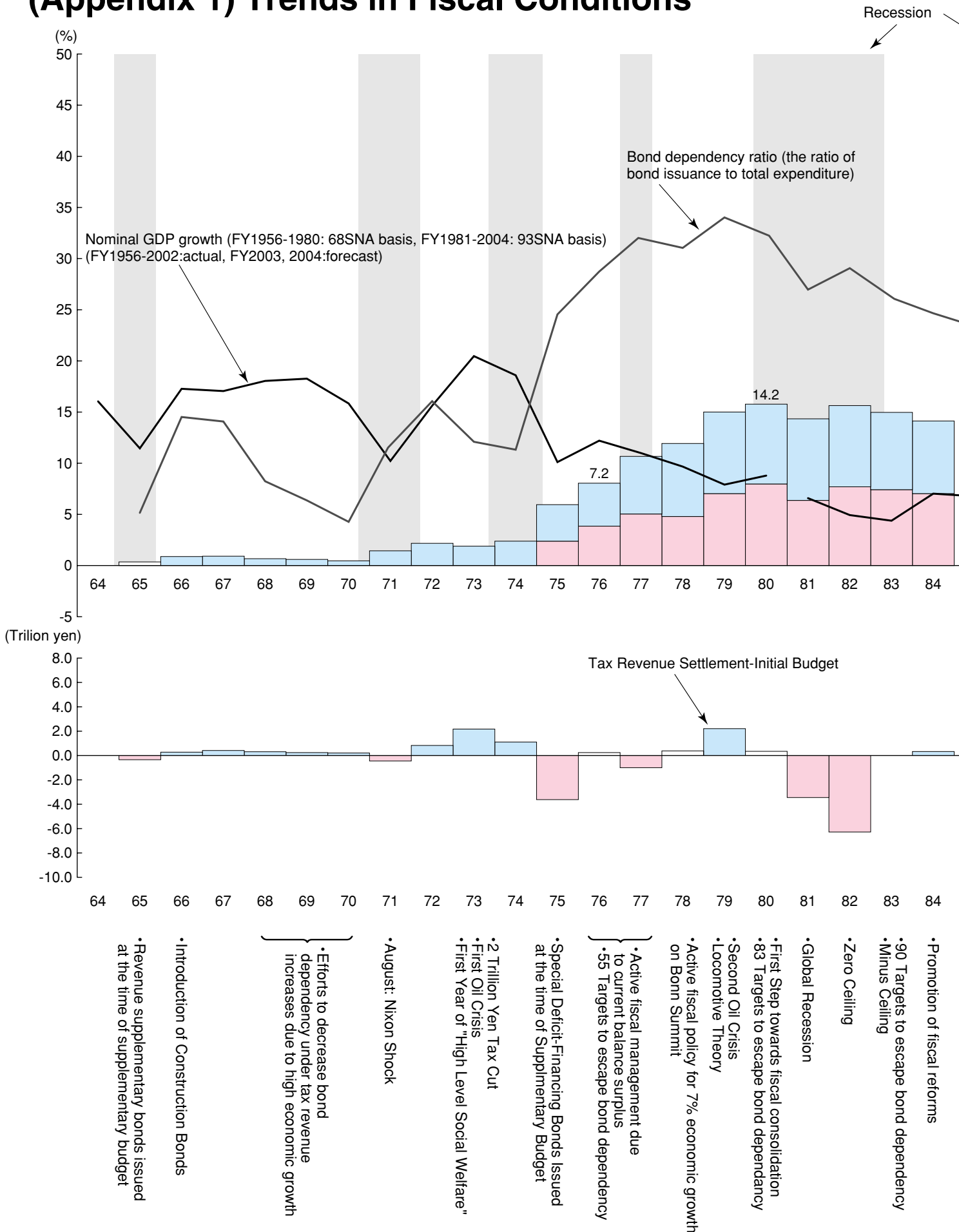
● Increase in local police personnel
Increased by +3,500 following FY2002 (+4,500) and FY2003 (+4,000).

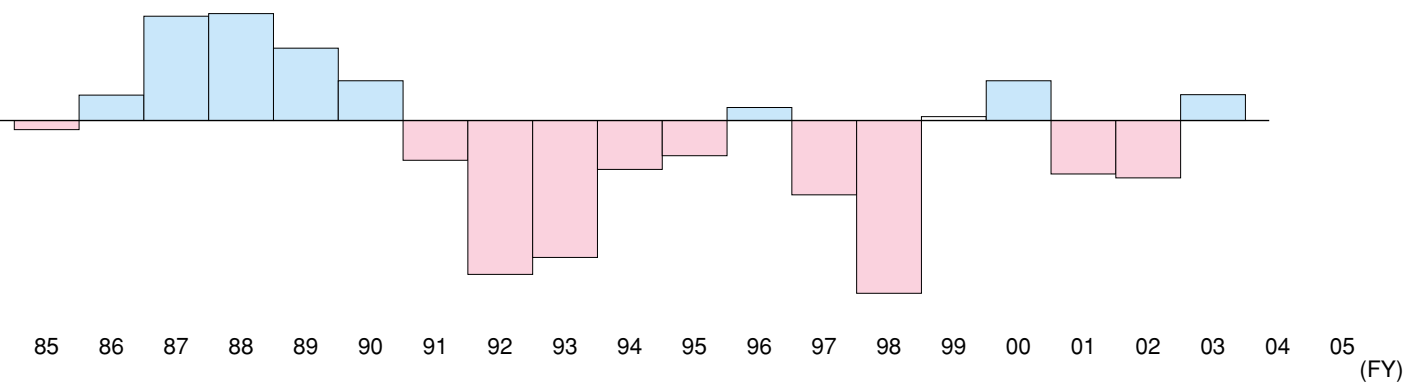
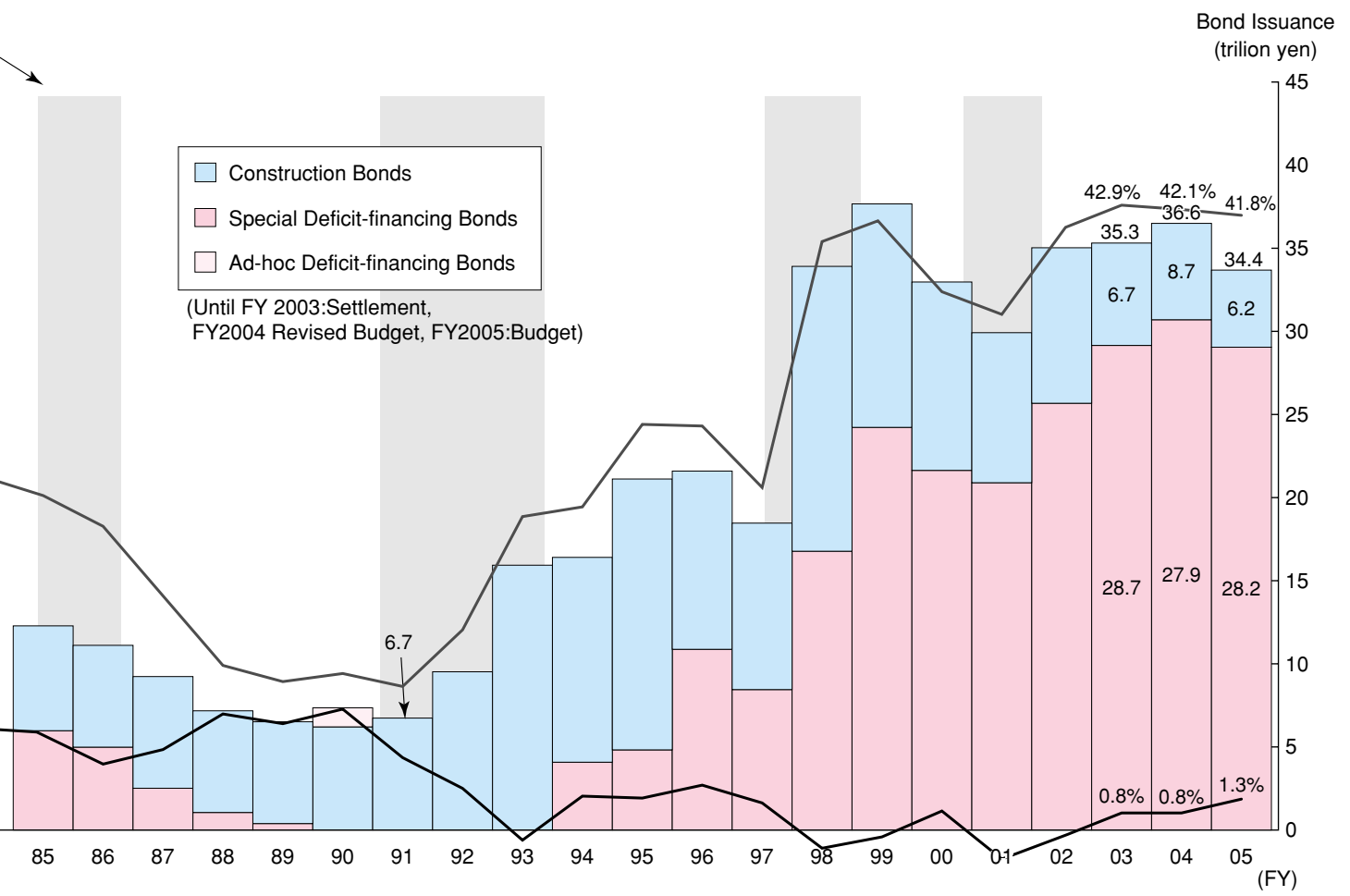
③ The number of civil servants per 1,000 people including administrative staff and defence forces

Country	Japan	United States	United Kingdom	France	Germany
Value	35	81	73	96	58

Source: Ministry of Internal Affairs and Communications.
Note. 1. Administrative staff includes national public employees, local public employees and government enterprise staff.
2. Numbers of civil servants are based on 2001 data in principle.

(Appendix 1) Trends in Fiscal Conditions





- September: Plaza Accord
- Use of NTT stock revenues
- Introduction of consumption tax
- Escape from special deficit-financing bond dependency
- New targets for mid-term fiscal management
- (Escape from deficit accumulation)
- Special deficit-financing bonds issued to offset tax cuts
- Reduction in individual income taxes(6 trillion yen)
- 05 targets to escape bond dependency
- Suspension of the Fiscal Structural Reform Act
- Enactment of the Fiscal Structural Reform Act
- Increase in Consumption tax rate
- Special tax cuts(4 trillion yen)
- Across-the-board tax credit, ect. (over 6 trillion yen)

(Appendix 2) Budget Projections in FY2005 Budget Policy

This projection presents how the FY2005 budget policy affects future outlays and revenues in the General Account budget. Economic assumptions are based on statements in "Structural Reform and Medium-Term Economic and Fiscal Perspectives-FY2004 Revision" (Cabinet decision: January 2005). It should be noted that this projection is not binding on the government's future budget formulation, and the figures presented here may vary according to changes in assumptions.

[Projection Results]

(trillion yen, %)

		FY2004	FY2005	FY2006	FY2007	FY2008
Outlays	National Debt Service	17.6	(5.0) 18.4	(5.2) 19.4	(5.7) 20.5	(3.1) 21.1
	Local Allocation Tax Grants	16.5	(▲2.5) 16.1	(9.6) 17.6	(15.0) 20.3	(1.7) 20.6
	General Expenditures	47.6	(▲0.7) 47.3	(1.5) 48.0	(2.6) 49.3	(1.5) 50.0
	Social Security Related Expenditures	19.8	(2.9) 20.4	(3.9) 21.2	(5.2) 22.3	(5.3) 23.5
	Public Works Related Expenditures	7.8	(▲3.6) 7.5	(▲0.5) 7.5	(1.3) 7.6	(▲3.4) 7.3
	Others	20.0	(▲3.2) 19.4	(▲0.3) 19.3	(0.2) 19.4	(▲0.9) 19.2
	Subsidies for redemption of NTT Interest-Free Loans (B type)	0.4	(▲11.5) 0.4	(2.1) 0.4	(0.0) 0.4	(▲98.0) 0.0
	Total	82.1	(0.1) 82.2	(3.9) 85.4	(5.9) 90.4	(1.5) 91.8

(trillion yen, %)

		FY2004	FY2005	FY2006	FY2007	FY2008
Tax and Non-tax Revenues	Tax Revenue	41.7	(5.4) 44.0	(5.3) 46.3	(2.0) 47.3	(1.6) 48.1
	Non-tax Revenue	3.8	(0.3) 3.8	(▲5.5) 3.6	(▲0.2) 3.6	(▲12.5) 3.1
	Total	45.5	(5.0) 47.8	(4.4) 49.9	(1.9) 50.8	(0.6) 51.2

(trillion yen, %)

	FY2004	FY2005	FY2006	FY2007	FY2008
Difference	36.6	(▲6.0) 34.4	(3.2) 35.5	(11.5) 39.6	(2.6) 40.6

- Notes 1. Figures in parentheses indicate changes in percentage from the previous fiscal year.
 2. Figures for FY2004 are based the initial budget.
 3. On the revision of across-the-board tax credit in the FY2005 tax system amendment, the increased revenue from FY2006 onwards (which is to be studied in the process of compiling budgets from FY2006 onwards) is not reflected in outlays.
 4. "Difference" is a simple subtraction of tax and non-tax revenues from outlays, and may vary depending on the assumptions used in projections, etc.

[Economic Assumptions]

	FY2005 (government economic outlook)	FY2006	FY2007	FY2008
Nominal GDP Growth Rate	1.3%	2.00%	2.00%	2.00%
CPI	0.1%	0.50%	0.50%	0.50%

Note. The economic assumptions are drawn from the statement in "Structural Reform and Medium-Term Economic and Fiscal Perspective - FY2004 Revision" that "It is expected that after FY2006 real GDP growth rate will be around 1.5% or higher, while nominal GDP growth rate will reach around 2% or higher"

[Projection Method]

National Debt Service : Interest rate is assumed to be 2.0% for 10-year JGB. The difference between "Outlays" and "Tax and Non-tax Revenues" is assumed to be fully funded through bond issues.

Local Allocation Tax : Elasticity of the statutory rate portion of LAT against nominal GDP is assumed to be 1.2. Moreover, redemption of borrowing by the Special Account for LAT is assumed to start FY2007, as prescribed by

Grants (LAT) Article 4-2 of the Supplementary Provisions of the LAT Act.

General Expenditures : FY2005 Budget policy is assumed to continue in the coming the coming years, the CPI increase rate is taken into account.

Tax Revenues : Elasticity against a nominal GDP growth rate of 1.1 is assumed (the FY2005 tax reform is taken into account).

Other Revenues : Elasticity against a nominal GDP growth rate of 1.0 is assumed.

Note. The projection reflects the agreement between the government and the ruling party on the "Trinity Reforms" of central and local governments (November 2004). As for "State contribution within compulsory education costs" (provisional), the projection assumes that 850.0 billion in exceptional grants due for tax resources transfer from FY2006 onwards will remain (in the agreement between the government and the ruling party, it was stated that "the Central Education Council would reach a conclusion on the compulsory education system by autumn 2005").

[Reference]

Alternative assumption : Interest rate of 3.0% for 10-year JGB after FY2006

(trillion yen, %)

		FY2004	FY2005	FY2006	FY2007	FY2008
Outlays	National Debt Service	17.6	(5.0)	(13.1)	(11.9)	(9.1)
	Local Allocation Tax Grants	16.5	(▲2.5)	(11.8)	(14.9)	(1.8)
	General Expenditures	47.6	(▲0.7)	(1.5)	(2.6)	(1.5)
	Subsidies for Redemption of NTT Interest-Free Loans (B type)	0.4	(▲11.5)	(2.1)	(0.0)	(▲98.0)
	Total	82.1	(0.1)	(6.1)	(7.4)	(3.1)
Tax and Non-tax Revenues	Tax Revenues	41.7	(5.4)	(5.3)	(2.0)	(1.6)
	Non-tax Revenues	3.8	(0.3)	(▲5.5)	(▲0.2)	(▲12.5)
	Total	45.5	(5.0)	(4.4)	(1.9)	(0.6)
Difference		36.6	(▲6.0)	(8.5)	(14.7)	(5.9)

(Appendix 3) Explanation of Key Words

General Account

This account is used to manage the government's general revenues and expenditure. Funded by tax revenues, it furnishes basic government costs such as expenditure for social security and education. In exceptional cases, Special Accounts may be created when it is necessary to manage revenues or expenditure separately from the General Account.

General Expenditure

This is total expenditure minus national debt service (costs allotted to repaying principal and interest on government bonds) and local allocation tax grants distributed to local governments, etc, funds needed by the government to implement policy.

Government Bonds

Bonds issued by central and local governments to create a revenue source for expenditure. Those issued by the central government are national government bonds, while those issued by local authorities are local government bonds.

Construction Bonds

Government bonds issued to fund public works and other projects. Normally, government expenditure is supposed to be funded from tax and other revenues. However, the Public Finance Law permits public works costs to be funded by government bond issues, since the purpose of these works is to create national property.

Special Deficit-financing Bonds

Bonds issued to fill shortages in expenditure funding in the General Account. Their issue is permitted by special legislation limited to single years, with a view to maintaining fiscal discipline.

Local Public Finance Programs

Estimate of total revenues and expenditure of local authorities, based on standard administrative levels of local governments, amendments to the tax administration system, national budgets, etc.

Local Allocation Tax

The tax resource the central government provides local authorities with a fixed proportion of revenues from the five main taxes (income tax, liquor tax, corporation tax, consumption tax, and tobacco tax). In recent years, special measures have been adopted for the total amount in each fiscal year, to prevent impediments to fiscal management by local governments.

SNA

Short for "System of National Accounts", a system of economic statistics that monitors the overall state of a national economy (such as Gross Domestic Product or GDP). The current standards were adopted by the UN in 1993, and are referred to as "93SNA".

General Government

While bodies that undertake economic activity are classified into several types within SNA, "general government" refers to governments, or bodies with a strong character of government agency. These consist of the central government (the General Account, etc.), local governments (Ordinary Accounts, etc.), and social security funds (Welfare Insurance Special Account, etc.). Public corporations that exist as independently managed bodies are not included.

GDP (Gross Domestic Product)

The total added value produced as a result of economic activity within a country. The increase or decrease in GDP for a given period compared to the previous period indicates the rate of economic growth.

Primary Balance

A fiscal balance reached by subtracting expenditure (excluding interest payments and debt redemption) from tax and other revenues excluding borrowings. If the primary balance is achieved, the benefits and burdens of the present generation are in equilibrium.

Ig (Gross Public Fixed Capital Formation)

A category within SNA, indicating a government's investment activity in constructing facilities and purchasing machinery.

MEMO

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