To Raise or to Cut Taxes: That Is the Question

By Akio Wada

The general-account budget of Japan's central government for fiscal 1984 (April 1984–March 1985) totals ¥50,627.2 billion (about $210.95 billion at the rate of ¥240 to the US$), accounting for 17.1% of the estimated ¥296-trillion GNP for the year. Throughout the 1960s this proportion held steady at about 10%, but the trend toward "big government" strengthened during the period of rapid economic expansion. Nonetheless, the weight of the public sector in the national economy is still much smaller than in most other developed nations, particularly those in Western Europe.

Social security is the biggest category in the 1984 budget, amounting to ¥9,321.1 billion ($38.8 billion), or 18.4% of the total. The second biggest item is national debt service—interest and principal payments on outstanding government bonds —totaling ¥9,155.1 billion ($38.1 billion), or 18.1%. Next come local allocation tax grants to local governments (¥8,886.4 billion—$37.0 billion, 17.5%), followed by general public works (¥6,520.0 billion—$27.2 billion, 12.9%) and national defense (¥2,934.6 billion—$12.2 billion, 5.8%). Defense spending accounts for 0.99% of GNP.

On the revenue side, tax and stamp receipts are projected at ¥34,596.0 billion ($144.2 billion), or 68.3% of total expenditures. Revenues from bond issues are forecast at ¥12,680.0 billion ($52.8 billion, 25.0%). Non-tax revenues, including monopoly profits, are estimated at ¥3,351.2 billion ($13.96 billion, 6.6%).

One distinguishing characteristic is that direct taxation, primarily income and corporate taxes, carry far greater weight than indirect, such as liquor and commodity taxes. The ratio of direct to indirect taxation currently stands at about 7 to 3. This structure is similar to that in the United States but contrasts sharply with major West European nations. In Europe, value-added tax accounts for 40%–60% of the total.

In Japan the Cabinet has the authority to compile the budget, although the actual work is conducted by the Ministry of Finance (MOF). It is customary for ministries and government agencies to submit their budget requests for the following fiscal year to MOF by the end of August each year. MOF examines these requests and prepares its budget estimates. Normally a draft government budget is completed and approved by the Cabinet by the end of the year.

The budget plan is presented to the Diet the following January. If the parliamentary debate goes smoothly, the budget becomes law before April 1, when the new fiscal year begins. Usually the draft budget is passed by the legislature without major revision, in a pattern that has taken root over the nearly 40 years of uninterrupted rule by the Liberal Democratic Party (LDP).

The deepening fiscal crisis

The Japanese government has incurred large budget deficits since the oil price shock of 1973–74. Bond dependence, or bond flotations as a percentage of total general-account expenditure, exceeded 20% in fiscal 1975 and stayed at the 30% level for four years from fiscal 1977. The ratio subsequently declined, but still hovers at around 25%. The deceleration of economic growth slowed the rise in tax revenues, while social security payments, public works and other expenditures continued to expand. As a result, a large gap developed between revenues and expenditures.

Tax and stamp receipts will cover only 68.3% of total expenditures budgeted for fiscal 1984, compared with some 80% in the United States and major West European nations. MOF likens this situation to the plight of a family that spends ¥500,000 ($2,083) a month using borrowed money, while earning only ¥350,000 ($1,458).

The debt load, or total outstanding government bonds, is forecast to reach ¥122 trillion ($508.3 billion) by the end of March 1985. Of this amount, ¥68 trillion ($283.3 billion) is in the form of so-called "construction bonds," floated to raise funds for public works projects. The remaining ¥54 trillion ($225 billion) is in deficit-covering bonds issued to make up for such shortfalls in current expenditures as personnel expenses. Interest payments on outstanding bonds are projected at ¥8.9 trillion ($37.1 billion) for fiscal 1984, or 17.5% of the budget. The government must borrow in order to keep up debt payments.

The growing debt service limits the government's fiscal freedom, making it difficult for it to play an active fiscal role through expanding public investment. Public works spending was frozen for four years from fiscal 1980, and in fiscal 1984 was actually reduced by 2% from the year before. Spending capacity is limited in other important areas as well, including social security, education, and science and technology. The deepening fiscal crisis contrasts with the strong overall performance of the Japanese economy compared with other industrialized nations.

Challenges ahead

The greatest fiscal challenge facing Japan today is to reduce bond issues and bring the budget closer to balance each fiscal year. Over the past few years, the government has given top priority to administrative and fiscal reform, and has taken specific measures to this end.

The current medium-term fiscal reconstruction program is aimed at reducing

Prime Minister Yasuhiro Nakasone at a Budget Committee meeting. The greatest fiscal challenge facing Japan today is to reduce bond issues and bring the budget closer to balance.

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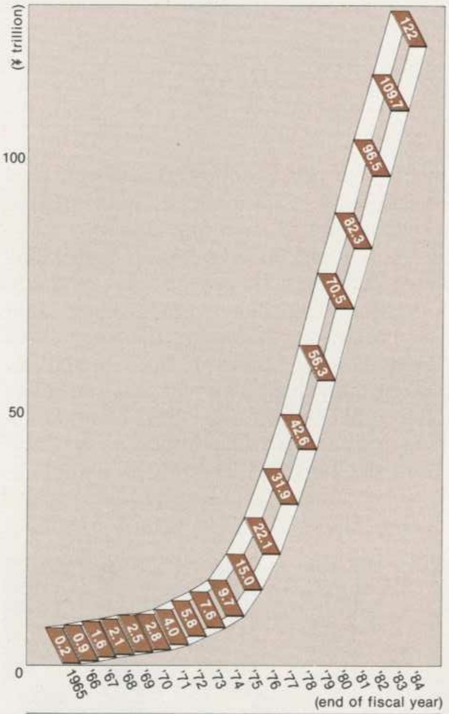
deficit-covering bond issues to zero by fiscal 1990. In the 1984 budget, the government is scheduled to issue ¥12,680 billion ($52.8 billion) worth of bonds. This breaks down to ¥6,225 billion ($25.9 billion) in construction bonds and ¥6,455 billion ($26.9 billion) in deficit-covering bonds. The latter can be reduced to zero in fiscal 1990 only if they are slashed by more than ¥1 trillion ($4.16 billion) annually for the next six years.

So far, the government has tried to achieve this objective by spending cuts, without resorting to major tax increases. For example, total general expenditures for fiscal 1984 are up only 0.5% over the previous year. This is the lowest rate of increase in 29 years. The emphasis on budget reductions reflects not only strong popular resistance to higher taxes but also a consensus that public spending, which increased rapidly during the high-growth period, should be trimmed in favor of "smaller government."

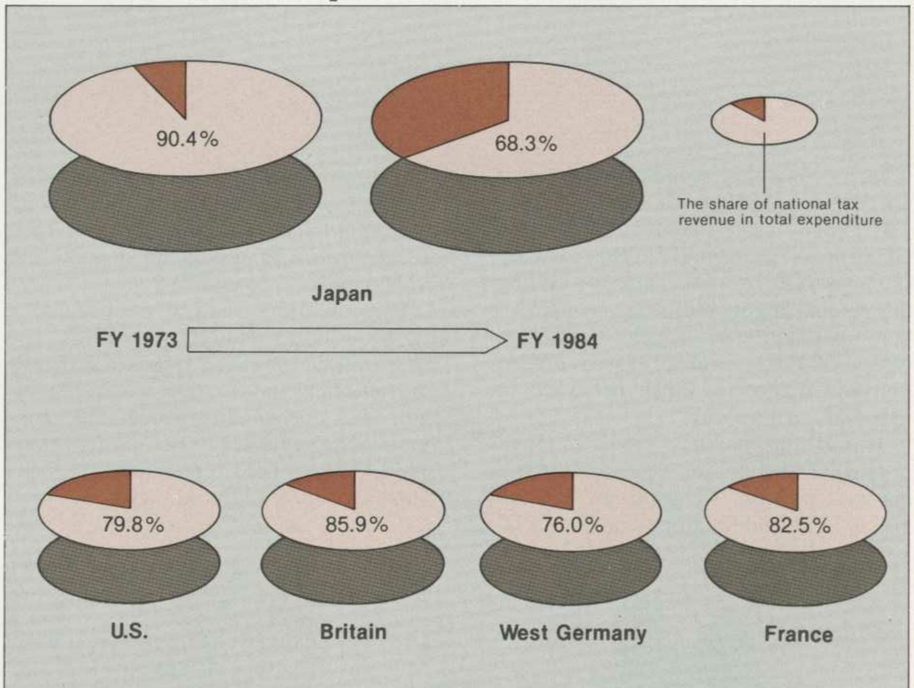
There is also a growing awareness within the government and the LDP of the limits to spending cuts. MOF believes that large-scale tax increases are unavoidable if the fiscal house is to be put in order, and argues that Japan will eventually be forced to introduce a large indirect tax similar to the European value-added tax. Meanwhile, an influential LDP Dietman has advocated large income tax cuts in the belief that higher economic growth through increased consumer spending will bring more revenue to the government, facilitating its efforts toward fiscal rehabilitation. Which of the two approaches—tax increases or tax cuts—is preferable? This question remains a matter of national concern. ●

Fig. 1 Government Bonds Outstanding since 1965



Note: The figure for 1984 is an estimate.
Source: *The Budget in Brief 1984*, Budget Bureau, Ministry of Finance

Fig. 2 International Comparison of National Tax Revenue/Total Expenditure Ratios



Note: Japan: settled (FY 1973), budget (FY 1984), the other countries: actual (CY 1982)

Fig. 3 Budget System