Analysis of the Draft Budget for Fiscal 2002

By Tani Sadafumi

At the end of December 2001, the Japanese government estimated the national budget for fiscal 2002 (April 2002 to March 2003), which was characterized as a "budget for resolute reform." The general account budget totaled ¥81.23 trillion, 1.7% less than the original budget for fiscal 2001. The budget converted to a "retrenched budget" from the ones in which priority had been given to reviving the economy over the past few years. Prime Minister Koizumi Jun'ichiro redeemed the pledge to keep "new government bond issuance to below ¥30 trillion" that he has maintained since he ran for the presidency of the Liberal Democratic Party (LDP). The government will introduce relevant legislation, with the intention of implementation by the end of March this year.

Balancing national finances and solving the problems posed by non-performing loans have been the main targets of the structural reforms sought by Koizumi. Attention has been given to how much reform the prime minister can institute under the circumstances of widespread economic recession. The budget draft for fiscal 2002 is characterized by at least a 10% reduction in public investment, which has been criticized as being a waste of money, and a reduction in expenditures (including special accounts) on special and authorized corporations by ¥1.13 trillion from the budget for the previous fiscal year. These reductions indicate an attempt at financial restructuring by eliminating wasteful and inefficient spending. Conversely, tax revenues are expected to decrease due to the effects of deflationary recession, and it is a fact that measures which seemed contrary to the spirit of structural reform were taken to secure revenues. The budget draft leaves many issues unsolved though it achieves certain results.

The State Minister in Charge of Economic and Fiscal Policy Takenaka Heizo has long suggested that the outlook for the economy would be negative growth for the first time in history. However, the government's outlook regarding the actual gross domestic product (GDP) growth rate was publicized as being 0%. This is because the Ministry of Finance opposed the outlook assuming negative growth due to apprehension that there would be loud cries for additional financial support. This outlook, therefore, should be considered an "objective to be attained with effort" rather than a genuine outlook. Conversely, such adverse figures as an unemployment rate of 5.6% and a 0.6% decrease in the consumer price index (CPI), suggest that this outlook is "more honest" than the government's conventional outlook, which has been generally perceived as being overly optimistic.

The outstanding feature of the budget draft for fiscal 2002 is the capping of new government bond issues at ¥30 trillion (or a 5.9% increase from the budget for the previous fiscal year). It can be said that this budget was compiled to achieve this "supreme mission." There is no doubt that the government could reduce expenditures despite opposition, because it has limited the revenues earned by government bonds to ¥3 trillion. On the other hand, the government could not help but resurrect a budgetary burden of "invisible debts" after an interval of four years, which is actually a delay in debt payments or advanced reception of income.

Detailed methods of handling invisible debts include: 1) loans from the private sector in the special account for tax allocation to suppress the growth of tax allocations to local governments, 2) appropriating a surplus in the special account for foreign exchange funds in advance, 3) extending the terms for the repayment of some debts and 4) increasing special payments from the Japan Racing Association (JRA). The total effects of decreasing expenditures and increasing revenues by these methods are estimated to be over ¥1.5 trillion.

The reason why the government had to employ these "tricks" is that it largely misjudged the outlook of tax revenues. Due to the economic recession accelerated by the terrorist attacks in the United States on Sept. 11, 2001, the government could only estimate ¥46.8 trillion in tax revenues, or 7.7% (i.e., just under ¥4 trillion) less than the draft for the previous fiscal year. The government, therefore, had to collect money from special accounts for foreign exchange funds and the JRA to increase its estimate of non-tax revenue to ¥4.4 trillion (or 22.4% more than the fiscal 2001 budget).

General expenditures, which are outlays for policy measures, amount to ¥47.55 trillion (down 2.3% from the fiscal 2001 budget) – a decrease after an interval of four years. Tax allocations to local governments are estimated at ¥17 trillion (or 1.1% more than fiscal 2001), but the estimate will expand to ¥18 trillion (or a 7% increase) when excluding the effects of "invisible debts." The expenditures to redeem government bonds issued in the past are estimated at ¥16.7 trillion (down 2.9% from the fiscal 2001 budget), thus reflecting a slightly decreased load than the previous fiscal year partly due to the benefits of low interest rates. However, the primary balance of the fiscal 2002 budget draft, which excludes the repayment of debts (national bond expenditures) and new debts (government bond issues), shows a large deficit of ¥13.4 trillion. The deficit is expanded to ¥15 trillion when "invisible debts" are included. Based on actual conditions, the government's objective of "turning the balance back to black by the beginning of 2010" appears very difficult to achieve.

Regarding detailed general expenditures, Koizumi first clashed with opponents within the LDP over the estimated expenditures for road construction. As a result, estimated road construction expenditures were reduced by 9% from the fiscal 2001 budget and tentatively proposed the elimination of "the construction of unnecessary roads for consigning public works projects to local constructors," although this reduction is less than the 10.7% reduction allowance in public work-related expenditures. Total revenues from the motor vehicle tonnage tax (when converted to a source of general finances) were reduced from the initially targeted ¥300 billion to ¥225 billion due to strong opposition by the Ministry of Land, Infrastructure and Transport, backed up by some LDP members of the Diet. The fundamental reform of the system in which "roads are naturally constructed because we have tax revenues" was thus deferred until at least fiscal 2003.

A revision of the new *Shinkansen* construction project was strongly opposed by LDP supporters of the construction industry in the Diet, and the reduction in expenditures for the project was restricted to 6.7% from the fiscal 2001 budget to avoid adversely affecting implementation of the project. Official Development Assistance (ODA) was reduced by 10.3% from the fiscal 2001 budget, but was allocated with priority given to assistance for war-torn Afghanistan. The Fiscal Investment and Loan Program (the so-called "secondary budget") was estimated at ¥26.79 trillion, or a reduction of 17.7%, thus marking the largest reduction in history.

Due to the declining birthrate and increasing of the "graying" of Japan's society, ¥18.28 trillion was allocated for social security, representing a 3.8% increase from the fiscal 2001 budget. Note that this significant increase was estimated after a reduction of ¥300 billion by lowering medical charges and taking other measures. Also conspicuous was the 13.6% increase in expenditures for unemployment compensation in recognition of the current harsh economic conditions.

Other special measures were taken in seven areas for the budget draft compiled by the Koizumi Cabinet, including expenditures for urban renewal, environmental protection, the promotion of science and technology and information technology, for which special budgets are preferentially allocated. A total of ¥2 trillion was budgeted for these fields to accelerate the creation of new businesses and industries. However, it must be noted that conventional public works may still be included in the projects of these seven fields.

Finance Minister Shiokawa Masajuro said that the government estimated this budget after "making a very strict assessment of increased administrative efficiency and the effectiveness of investments, while attaching importance to the seven fields," and emphasized that, even though the budget was retrenched, it eliminated inefficiency and had strength to support the economy. Takenaka complimented the budget draft by stating, "We basically sought to achieve a decrease of ¥5 trillion (in expenditures for public works) and an increase of ¥2 trillion (in preferential allocations for the seven fields)."

Many economists have somewhat favorable views of the budget draft. For example, Professor Takagi Masaru of Meiji University stated that, "The reduction in expenditures for special corporations should be appraised." Takahashi Susumu, chief economist of Japan Research Institute Ltd., stated that, "The budget draft can be valued highly although complete qualitative improvements have yet to be made." At the same time, they are also skeptical about capping government bond issues at ¥30 trillion with apprehension regarding future economic conditions. Takagi stated that, "It is a downcast budget draft caught in a trap of bond capping at ¥30 trillion. The deflationary pressure due to financial causes will increase and the economic deterioration will continue." Takahashi added, "It is less effective in supporting the economy, and there is no denying the possibility of a systemic crisis in the future. The government should plan to issue additional bonds in case of an emergency."

When considering the fiscal 2002 budget draft from the standpoint of rebuilding the government's finances, it can be said that the budget draft is valued as the first step being taken in the right direction. Financial conditions are worsening, however, due to large outstanding bills. The issue of government bonds was limited to ¥30 trillion, but the percentage of bonds issued to total revenues (i.e., debts in total revenues) increased from 34.3% to 36.9% as a result of the reduction in terms of the general account. The outstanding amount of government bonds, which stood at ¥388 trillion at the end of fiscal 2001, will increase to ¥414 trillion by the end of fiscal 2002 (end of March 2003). The total amount of long-term debt, including the debt of local governments, will increase from ¥668 trillion to ¥693 trillion, or 139.6% of GDP. Among the Group of Seven countries, only Japan and Italy (105.2% in calendar year 2002) exceed 100% in the ratio of long-term debt to GDP. Thus, Japan's debt-ridden financial balance is exceptional in the world.

Under these circumstances, Moody's Investors Service and Standard & Poors have lowered their ratings of Japanese government bonds. This action may adversely affect the absorption of bonds in the market. The amount of new bond issues in fiscal 2002 will reach ¥30 trillion, but the total amount of bond issues in the market, including the refunding bonds, will reach ¥104.8 trillion. Thanks to ultra-low interest rates and a few targets of surplus-fund investment, the market absorption of government bonds has yet to be hindered. However, any further lowering of the government bond rating may prompt risk-sensitive foreign investors to redeem their bond holdings. JJTI

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