FY 2005 Budget Mired in Crisis

By Izumi Masaki

THE Japanese government's draft budget proposal for FY 2005 has taken its final form. General account expenditure increased 0.1% over the initial figure for FY 2004, to ¥82.1829 trillion. General spending contracted 0.7% to ¥47.2829 trillion after an interval of three years, as steadily higher social-security spending was offset by an approximate ¥1.3 trillion cut in subsidies due to the triple reform of the local government tax and fiscal systems. The reduction underscores the fact that the budget has been drafted as an austerity program. The integration of a policy to halve the fixed-rate tax cuts will pave the way for the pending tax revenue increases, and signifies a step forward on the road to fiscal rehabilitation from both the expenditure and revenue sides.

Tax revenue posted its first increase in four years, rising ¥2.26 trillion to ¥44.007 trillion, an expansion of 5.4% compared with the initial budget for FY 2004. This growth was due to the economic recovery leading to a natural increase in tax revenue, coupled with a reduction in tax breaks. It was used to trim new JGB issuance, which fell ¥2.2 trillion to ¥34.39 trillion, marking a 6.0% reduction, the first decline in four years. As a result, dependence on JGBs was reduced to 41.8% from a historical peak of 44.6% in FY 2004.

Issuance of construction bonds fell ¥320 billion to ¥6.18 trillion, reflecting a drop in the number of public works projects. Deficit-financing bonds fell by a substantial ¥1.88 trillion, or 6.2%, to ¥28.21 trillion.

In general account spending, social security outlays rose 2.9% to ¥20.3808 trillion, exceeding ¥20 trillion for the first time. The increase reflects a continued expansion of social-security costs due to the aging population in Japan. All other areas saw budget cuts as public works spending fell 3.6% to ¥7.5310 trillion, spending for education and science shrank 6.7% to ¥5.7234 trillion, and defense spending slipped 1% to ¥4.8564 trillion. The budget for agriculture, forestry and fisheries, including public works spending, contracted 2.8% to ¥2.9672 trillion, falling below the ¥3 trillion level for the first time in 28 years.

UNDER the slogan of "expenditure reforms with no sacred cows," the budget for FY 2005 constitutes the fourth consecutive austerity program since the inauguration of the Koizumi cabinet. Even so, its details have been drawing scathing assessments from those involved. Large-scale public works projects, including the construction of three new *Shinkansen* (bullet train) lines and a second runway at Kansai International Airport, were approved despite their doubtful profitability. Similarly, in the course of negotiations to restore cuts in budget requests, subsidies for private schools received approval for an increase, under pressure from the education lobby of the Liberal Democratic Party.

Last year-end, at a joint conference of the Fiscal System Council (an advisory council of the Minister of Finance), members applauded curbs on general spending and new bond issuance as publicly pledged by Minister of Finance Tanigaki Sadakazu, but criticized the approval of the large-scale construction projects. Ishi Hiromitsu, who also serves as Chairman of the government's Tax Commission, voiced his concern, saying: "I appreciate the overall outline, but public works projects like these strike me as problematic. These projects could become precedents that hinder the fiscal rehabilitation process." Other council members expressed similar criticisms.

To be sure, there are signs of corroborating efforts at efficiency gains in the execution of budgets and in focused budget allocations. Defense spending has been cut by 1% for two consecutive years. The application of the two systems of "model enterprise" and "policy sets" was expanded, with the former having verifiable goals assigned to specific projects, followed by accountability on goal attainment, and the latter using integrated budgeting for projects that straddle multiple ministries. The budget for airports in metropolitan areas rose 2.2% compared with the initial budget for FY 2004, while allocations for regional airports were cut by a substantial 9.6%. In road maintenance, higher outlays concentrated on beltways around the three metropolitan areas, with a 13.9% increase. A budget-execution survey of 53 projects including special account budgets is said to have yielded around ¥27.5 billion in cost reductions.

However, this can hardly be seen as paving the way for fiscal rehabilitation to resolve the problem of the worst public debt of any leading industrial nation. Cuts in social-security spending, which has an annual growth rate of ¥1 trillion due to the falling birthrate and the aging population and is considered the foremost structural problem besetting public finances, are insufficient and do not go deep enough, given the category's 40% share of general spending. With no system reform in sight to review benefit levels for pensions, medical and nursing care, the fear is that Japan's economy would stall if personal consumption falls out of concern over the increasing public burden. In light of this, it appears inconceivable to ask the public to shoulder a greater burden of tax-break reductions or recession without indicating any direction for the future at all. With the discussion on raising the consumption tax to secure financial resources for the social security program set to intensify, the government should respond flexibly regarding the fiscal and tax systems, taking economic trends into account, and calling for a yet tougher stance in advancing structural reform "with no sacred cows."

Table 1 Towards a Sustainable Fiscal Structure – Expenditure Reforms to be Pursued and Strengthened

	FY2004 (billion yen)	FY2005 (unit: billion yen)	
Tax Revenues	**41,747.0** (-39.0)	**44,007.0** (2,260.0)	Effect of additional transfer of tax resources: -691.0 The increase in tax revenues due to the reduction in across-the-board tax credits (20%):185.0
Government Bond Issues	**36,590.0** (+145.0)	**34,390.0** (-2,200.0)	Government bond issues to be reduced from the previous year, for the first time in four years. Bond dependency ratio: 41.8% (44.6% for FY 2004)
Local Allocation Tax Grants	**16,493.5** (-905.3)	**16,088.9** (-404.6)	Local allocation tax from General Account to be restrained through rationalization of local government expenditures.
General Expenditures	**47,632.0** (+39.8)	**47,282.9** (+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 three years through reforms between the central and local governments and a review of all the expenditure items.
General Account Total Expenditures	**82,110.9** (+321.8)	**82,182.9** (+72.0)	
General Account Primary Balance	**-19,021.4** (+625.5)	**-15,947.8** (+3,073.7)	Improvement in two consecutive years (FY2004: 0.6 trillion yen)

Source: Ministry of Finance

LET'S analyze the FY 2005 budget from the perspectives of the primary balance and JGB issuance. Getting the primary balance back into the black by the early 2010s is a proclaimed medium-term milestone in the government's fiscal rehabilitation program. Given that under the budget for FY 2005, the deficit in the primary balance is ¥15.9478 trillion – ¥3.0737 trillion less than in FY 2004, this means a step ahead toward the attainment of the government's goal.

The primary balance, however, has been in deficit for 13 consecutive years. And the improvement of more than 70% in FY 2005 is attributable to an increase in tax revenue from the anticipated economic recovery. Considering the growth potential of Japan's economy, room for a natural rise in tax revenue is obviously limited. At the same time, drastic reform efforts revolving around social security benefits have yet to begin. The distance to be covered to meet the government's objectives remains highly uncertain.

In a joint conference of the Fiscal System Council last year-end, the chairman of the Keizai Doyukai (Japan Association of Corporate Executives), Kitashiro Kakutaro, said: "the Ministry of Finance will have to voice its opinion concerning a route for the government's objectives to be achieved." Other members' additional call for a comprehensive review of the social security and fiscal and tax systems also appeared to reflect their dissatisfaction with the current situation.

Planned JGB issuance in FY 2005 comprises ¥119.7615 trillion for placement in the market through auctions compared with ¥115 trillion in FY 2004, with actual net issuance of issues brought forward to reach ¥118.6 trillion compared with ¥118 trillion in FY 2004, both marking new historical peaks. Total issuance is set to grow to a maximum of ¥169.5051 trillion (compared with ¥162 trillion in FY 2004) for a 14th consecutive year of growth. Issuance of refunding bonds will expand by around ¥19 trillion, eclipsing the cut in new JGB issuance. The Bank of Japan's holdings of JGBs with cash redemption deferred amount to around ¥23 trillion, including a portion of approximately ¥6.4 trillion that will be subject to an unprecedented extension of deferred redemption.

In total, outstanding JGBs at the end of FY 2005 will reach around ¥538 trillion, surpassing the nation's GDP for the first time. Outstanding long-term obligations, including those of municipalities, will climb to 1.5 times the GDP, and the combined total debt obligations of the central and local governments will balloon to over ¥1,000 trillion, more than twice the value of the GDP. To ensure smooth market placement of JGBs in large volumes, efforts are underway to diversify ownership by increasing the issuance of retail JGBs, popular with individual investors, and to increase the issuance of JGBs with long maturities, including 15- and 20-year bonds, in preparation for a peak in JGB redemptions in FY 2008.

Additionally, debt-servicing costs for outstanding JGBs will increase 5.0% to ¥18.4422 trillion. This is due to a higher outstanding balance, and comes despite an assumption that the interest rate on the benchmark 10-year JGB will remain at 2.0%, the same as in FY 2004.

As a percentage of the total general budget, debt-servicing costs will surpass 10% for the first time in three years, deepening fiscal inflexibility. If long-term interest rates were to rise by 1%, this could lift the annual debt-service burden by over ¥3 trillion, and even assuming greater tax revenue from an economic recovery, the entire gains would likely be erased by escalating debt-service costs from higher long-term interest rates.

As the Minister of Finance observed, "obstacles to fiscal rehabilitation remain high," and although the primary balance has somewhat improved, with public finances in a critical condition, the risk of fiscal failure is relentlessly on the rise. JS

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