FY 2006 Budget Proposal Meets Koizumi's Inaugural Commitment

New JGB Issues Fall to ¥29 Trillion Level

By Aoki Masaru

THE government's FY 2006 general account budget proposal, passed at an extraordinary cabinet meeting on Dec. 24, 2005, allocated a total of ¥79,686 billion, 3% below the previous year. It is the first time in eight years, since FY 1998, that the general account fell below the ¥80 trillion level. In line with the government's plan to cut spending with no "sacred areas," general spending declined for the second year in a row to ¥46,366 billion, a drop of 1.9% from the previous year. On the revenue side, tax revenue increased 4.3% to ¥45,878 billion, owing to the economic recovery.

As a result, new government bond (JGB) issuance to bridge the budget gap was capped at ¥29,973 billion, below the ¥30 trillion level for the first time in five years. With this, Prime Minister Koizumi Junichiro has achieved the pledge of reducing new JGB issuance to below ¥30 trillion that he made in April 2001 in his inaugural address. While the FY 2002 budget proposal met his pledge, the government revised it in consideration of the economic climate, and the new JGB issuance exceeded the target. Thereafter, the amount of new JGBs had continued to remain above the ¥30 trillion level.

In January 2003, at a budget committee meeting of the House of Representatives, in response to a question on the breach of his pledge, Koizumi said, "It is not a major problem that I fail to fulfill my promise to this extent," thus creating a controversy. The FY 2006 budget proposal, the last compilation for Koizumi whose term is due to expire in September 2006, was presented at the regular Diet session in January 2006. The proposal is expected to pass by the end of March 2006, as the ruling parties have a two-thirds majority in the House of Representatives.

Compared with the FY 2005 draft budget, the general account fell by ¥2,496.9 billion, while new JGB issuance dropped ¥4,417 billion, both marking the largest cut-down in history. The primary balance, which shows the balance of fiscal spending supported by revenues (excluding inflows from new JGBs), was ¥11,211.4 billion, a reduction of ¥4,736.4 billion, an improvement for the third straight year.

This indicates that the government is taking the first step toward its target of a positive primary balance by the beginning of the 2010s as well as a reduction of new JGB issuance. Accompanying the improvement in the fiscal balance, the proportion of JGBs to total revenues (the bond dependency ratio) declined to 37.6%, the first time in four years it has dropped to the 30% level.

On the expenditure side, general expenditures were below the ¥47-trillion level for the first time in eight years. Major reductions include a 4.4% cut in public works expenditures to ¥7,201.5 billion, the fifth consecutive year of decline. This figure represents more than ¥2 trillion in cuts from the initial budget amount of ¥9,433.5-billion of FY 2001, the year before the Koizumi administration's inauguration and is the lowest amount in 18 years, since FY 1988.

With this budget proposal, the government had achieved its initial target of keeping down public works spending to the level before the burst of the bubble economy. New issues of construction bonds were ¥5,484 billion, the lowest level in 15 years. In addition, the budget for official development assistance (ODA), which is often criticized for its inefficient operations, has now been cut for seven years in a row, and the defense budget has been shrunk by 0.9%, the fourth successive year of decline.

On the other hand, the social security budget, including medical and pension expenses, increased by 0.9% to reach a record of ¥20,573.9 billion, and its ratio of the total general expenditure rose to 44.3% with a 1.2% increase. While the government moderated the increase in benefit expenses through measures such as regulatory reform of the medical system, it is not enough to offset the natural growth in outlays due to the increase in Japan's aging population.

Local allocation tax grants to offset revenue shortfalls declined 9.5% to ¥14,558.4 billion. Debt servicing costs (applying for JGB redemptions and interest payments) increased 1.7% to ¥18,761.6 billion, for the fourth straight year of growth. The long-term interest rate for interest payments on JGBs remained at 2.0%, the same as the previous year. However, because of the cumulative increase in the JGB balance, the debt servicing costs in the budget proposal continued to increase.

On the revenue side, tax revenues are estimated at ¥45,878 billion. A year-on-year increase of around ¥3,800 billion, mainly in corporate tax, is expected due to the economic recovery. However, ¥1,893 billion will be granted to local governments in the form of local transfer taxes, stemming from the so-called "trinity of fiscal reforms." Therefore, revenues of the central government will not grow even if the economic recovery actually takes place.

While new JGB issuance was reduced to less than ¥30 trillion, the year-end outstanding JGB balance will be ¥542 trillion, marking a new high. This balance amounts to 12 years of general account tax revenues, or ¥4.24 million per capita. For a household of four, for example, the national debt amounts to

Table 1 Toward a Sustainable Fiscal Structure – Maintaining and Strengthening the Commitment to Fiscal Restructuring

	FY 2005 (Unit: billion yen)	FY 2006 (Unit: billion yen)	
Tax Revenues	44,007.0 (+ 2,260.0)	45,878.0 (+ 1,871.0)	The ratio of tax revenues to total revenues: 57.6% (FY 2005: 53.5%) Effect of additional transfer of tax resources : -1,893.0
Government Bond Issues	34,390.0 (-2,200.0)	29,973.0 (-4,417.0)	Government bond issues are below the 30-trillion yen level for the first time in five years. The largest reduction in history. Bond dependency ratio: 37.6% (FY 2005: 41.8%)
Local Allocation Tax Grants	16,088.9 (-404.6)	14,558.4 (-1,530.5)	Local allocation tax grants, etc. from the General Account are restrained through the rationalization of local government expenditures.
General Expenditures	47,282.9 (-349.1)	46,366.0 (-916.9)	The amount of General Expenditures is down from the previous year for the second year in a row.
General Account Total Expenditures	82,182.9 (+720)	79,686.0 (-2,496.9)	General Account Expenditures are down from the previous year for the first time in the past four years
General Account Primary Balance	-15,947.8 (+3,073.7)	-11,211.4 (+4,736.4)	Improvement over three consecutive years. (FY 2006: +4.7 trillion yen, FY 2005 : +3.1 trillion yen)

Source: Ministry of Finance

¥16.96 million.

JGB interest payments alone account for as much as ¥8,600 billion (¥7,800 billion in FY 2005). According to an estimate by the Ministry of Finance (MOF), if long-term interest rates rise by 1%, the government's interest burden would increase by ¥1.5 trillion in the course of the year.

Also, accumulative long-term debt (i.e., bonds issued by both the national and local governments) is expected to grow to ¥775 trillion by the end of FY 2006. This corresponds to approximately 150% of nominal gross domestic product (GDP), which means that Japan owes debt equivalent to 1.5 times its own total economic size.

Aside from the general account, special accounts have been established for managing revenues and expenditures for specific purposes. While total expenditures of the 31 special accounts amounted to ¥225 trillion, due to the complex system of revenue and expense, they are hardly monitored by the Diet and are often criticized as troughs for wasteful tax expenditure.

In the policies of administrative reform, which were decided at the extraordinary cabinet meeting on Dec. 24, 2005, the government issued a directive to cut down the 31 special accounts – including five related to public works, such as road, river and port improvements – to one-half to one-third of the current levels. The administration plans to propose relevant bills to the Diet with a target date of around 2007.

The FY 2006 Fiscal Investment and Loan Program (FILP), which aims to supply funds to governmental corporations and local governments, was also passed in the meeting, as proposed by the MOF. The total amount of FILP, which is often referred to as "the second budget," was ¥15,004.6 billion, a year-on-year decline of 12.5% and the sixth straight year of a double-digit decline. Indeed, in response to criticism of its ballooning budget, FILP is now 40% lower than the ¥40,533.7-billion peak it reached in FY 1996.

The FY 2006 budget proposal put a brake on deteriorating fiscal conditions, "reflecting the results of the Koizumi administration's structural reform," according to Finance Minister Tanigaki Sadakazu. However, social security expenditures will continue to rise as a result of the rapid aging of the population, and with the continuing cuts in public works spending, the margin for further reductions as the conventional means of decreasing government spending has come close to its limit.

The government's Council on Economic and Fiscal Policy, with a view toward fiscal restructuring, will clarify the choices and process for overall fiscal spending and revenue reform in its Basic Policies, which will be formed around June 2006. Koizumi has clearly denied that the consumption tax will be increased during FY 2007 and Liberal Democratic Party leaders, including Policy Research Council chairman Nakagawa Hidenao, are placing a priority on spending cuts and taking a cautious stance toward an early increase in the consumption tax.

On the other hand, Tanigaki, one of the potential candidates for the post of prime minister, has shown a willingness to present a consumption tax increase bill as early as the regular Diet session this year; and Minister of State for Economic and Fiscal Policy Yosano Kaoru is on the same page as the finance minister. The forthcoming Basic Policies will be the key to future tax increases and will also be the basis of discussions on the government's tax and fiscal policies. JS

Aoki Masaru is a deputy editor in the Economic Division of Jiji Press Co., Ltd. His work focuses on economic policy.