Fiscal 2004 Draft Budget Sends Ambiguous Signals

By Tani Sadafumi

JAPAN'S government has compiled a draft budget for fiscal 2004, the period from April 2004 to March 2005. Just marginally larger than its predecessor, this general budget is an austere one. Although the effects on fiscal 2004 will be light, there are indications of future tax increases, including a higher consumption tax rate. Now that the realization is setting in that there no longer exists latitude for pork-barrel budgets as a means of influence peddling, pressure to spend has been abating and tax increases have ceased to be taboo as a topic of discussion. Even so, there still exist expenditure items whose reductions are insufficient, and practically speaking, an end to the worst structural fiscal deficit among the developed nations is nowhere in sight. While the basic fiscal policy stance of Prime Minister Koizumi Jun-ichiro appears to lean towards "small government," the signals coming from the draft budget are ambiguous nonetheless, due to compromise with political forces that demand "big-government" treatment for certain expenditure items.

The framework of the draft budget comprises a general budget of ¥82,110.9 billion, which is 0.4% more than in fiscal 2003. Out of this, general expenditures account for ¥47,632 billion (up 0.1%), national debt services for ¥17,568.5 billion (up 4.6%), tax allocations to local governments for ¥16,493.5 billion (down 5.2%), and other expenditures for ¥416.9 billion (unchanged). Income comprises ¥41,747 billion in tax revenue (down 0.1%), ¥3,773.9 billion in income other than tax (up 6.1%), and ¥36,590 billion in proceeds from bond issuance (up 0.4%).

One factor that has come to weigh on the expenditure side of the budget is the cost of redemption and interest of previous bond issues. Although tax allocations to local governments have been strongly reduced, the Japanese government bond (JGB) cost eating away at the treasury keeps the weighting of general expenditures, the backbone of fiscal policy, at just 58% of the general budget. A look at general expenditure items reveals an increase to ¥19,797 billion (up 4.2%) in social security expenditures to cover medical and pension outlays for Japan's aging population, besides an increase in expenditures for the promotion of science and technology. Apart from these few exceptions, expenditures have been kept at levels uniformly below those of fiscal 2003 for public works and education as well as defense, official development assistance (ODA) and other areas.

On the income side, tax revenues fell for the fourth consecutive year, and at 50.8%, account for barely half of the general budget, marking the lowest level ever. By contrast, the proportion of new bond issuance (indicating a reliance on debt financing) reached 44.6% of all income, which is the same weighting as in fiscal 2003 and is the highest on record. The following is an attempt to illustrate the draft budget using the example of a family budget, notwithstanding the differences that exist between these two types of "treasuries" and at the risk of using a somewhat rough-and-tumble method.

Household income, in this example, comprises the income of the husband (tax revenue) and that derived from part-time work by the wife (non-tax revenue) in the amounts of ¥4.17 million and ¥380,000, respectively, for a total of ¥4.55 million. Support payments to parents and children attending universities (tax allocations to local governments) consume ¥1.65 million. Medical expenses and amounts to be saved for retirement (social security) require ¥1.98 million. Additional expenses are residential maintenance (public works expenditures) of ¥780,000, the cost of security systems (defense expenditures) of ¥490,000, education and entertainment expenses (education-related spending) of ¥480,000, and local membership fees (ODA) of ¥80,000, for total annual expenditures (general expenditures plus tax allocations to local governments) of ¥6.45 million.

The balance at this point is a deficit of ¥1.9 million. The additional cost of ¥1.76 million comes from repayment of loans (debt service on issued bonds) for housing and education. Since there is no other way of balancing the budget, a new bank loan is taken out (bond issuance) in the amount of ¥3.66 million in order to create an impression of consistency.

Having the primary fiscal balance (basic balance) turn black by the early 2010s is a declared goal of the government. The primary balance is the net income and expenditures excluding bond issuance proceeds and outgoes. Measured by the draft budget for fiscal 2004, there will be a small improvement in the deficit to ¥19 trillion from ¥19.6 trillion in fiscal 2003. Restating this observation in terms of the above family budget, the deficit of ¥1.9 million, which is the difference between ¥4.55 million in income and ¥6.45 million in expenditures, corresponds to the primary balance with its shortfall reduced by ¥60,000.

Takenaka Heizo, Minister of State for Economic and Fiscal Policy, when he took up this point, boasted that the buds of reform had now also become visible in the fiscal realm, and lauded this notion as an important step on the way to a positive primary balance. Indeed, efforts being made at thriftiness are evident. However, taking out new loans of twice the redemption amount is, in and of itself, abnormal. When comparing fiscal deficits on an annual basis expressed as a percentage of GDP, Japan's stands at 7.4%, higher than the 6.6% of the United States even after surging expenditures there due to the war in Iraq. Commenting on the

Table 1 General Account Budget (FY2004 Budget) (billion yen)

	FY2003 (Initial)	FY2004 (Initial)	FY2003 ▼ FY2004
(Revenue)			
Tax Revenues	41,786.0	41,747.0	-39.0
Non-tax Revenues	3,558.1	3,773.9	215.8
Government Bond Issues	36,445.0	36,590.0	145.0
Construction bonds	6,420.0	6,500.0	80.0
Special deficit-financing bonds	30,025.0	30,090.0	65.0
[TOTAL]	81,789.1	82,110.9	321.8
(Expenditure)			
National Debt Service	16,798.1	17,568.5	770.4
Local Allocation Tax Grants	17,398.8	16,493.5	-905.3
General Expenditures	47,592.2	47,632.0	39.8
Others	–	416.9	416.9
[TOTAL]	81,789.1	82,110.9	321.8

Source: Ministry of Finance

Table 2 Outline of General Expenditures by Major Expenditure Programs (FY2004 Budget) (billion yen)

	FY2004 Budget		
		FY2003 ▶ FY2004	% change
Social Security	19,797.0	806.3	4.2
Education and Science	6,133.0	-338.2	-5.2
(Science only)	1,284.1	54.3	4.4
Government Employee Pensions and Others	1,132.1	-70.8	-5.9
National Defense	4,903.0	-50.0	-1.0
Public Works	7,815.9	-281.2	-3.5
Economic Assistance	768.6	-47.5	-5.8
ODA (reference only)	816.9	-40.9	-4.8
Small and Medium-Sized Businesses	173.8	0.9	0.5
Energy	506.5	-50.2	-9.0
Food Supply	674.9	-12.6	-1.8
Transfer to the Industrial Investment Special Account	98.8	-64.8	-39.6
Miscellaneous	5,278.4	147.9	2.9
Reserve Funds	350.0	0.0	0.0
[TOTAL]	47,632.0	39.8	0.1

Source: Ministry of Finance

prospects for the primary balance to turn black, the assessment of Finance Minister Tanigaki Sadakazu, saying "I believe we may have got a handle on the problem," sounds overstated.

The cumulative total of central and local governments' debt so far stands at ¥719 trillion, which is in excess of 140% of GDP. This figure ranges between 50-70% for most developed nations, with a reading of 110% even in the case of Italy, a country noted for its chronic fiscal deficits. This comparison makes the state of disarray in Japan's public finances abundantly clear.

Despite the magnitude of the problem, however, there has been little sense of crisis, as bond issues continue to be taken up by the markets. Bond issuance in fiscal 2004 will come to ¥162.34 trillion, totaling the previously mentioned new issues, issues for refinancing, and issues for the fiscal investment and loan programs. Out of this, after offsetting amounts that are to be underwritten by public sources such as postal savings, a balance of ¥114.62 trillion according to projections is to be placed in the market, an increase of ¥1,890.4 billion from fiscal 2003. Despite these outsized issue volumes, their absorption by the market up until now has presented no major problems. The principal reason for this is that financial institutions have been actively increasing their JGB purchase volumes amid slack demand for commercial loans. Prospects remain remote that corporate demand for funds might surge in fiscal 2004 on the back of a sharp economic recovery. Furthermore, new JGB issue volumes turned out to be short of market projections. Given this, there is probably little concern that the markets for JGB issues might fail to fully clear and prevent the government from realizing its fund-raising objectives.

Having said this, long-term yields actually surged (i.e., bond prices tumbled) to close to 1.7% p.a. by September 2003 after having posted a historically unprecedented low of 0.43% p.a. (i.e., bond prices rose) three months earlier. Although the development had no immediate practical implications, amid continuing large issue volumes and redemptions, market sentiment has been growing wary on whether JGB issues will always clear.

To deal with this situation, the Ministry of Finance (MOF) has been taking countermeasures such as issuing floating rate JGBs for purchase by retail investors, and expanding issue volumes of the highly popular 20-year bonds, to ensure that issues will be taken up by the markets as planned. Moreover, the Bank of Japan is clearly committed to a long-term continuation of its monetary policy of quantitative easing and remains anxious to prevent long-term interest rates from rising. Even so, however, if a lasting solution to the problem is the goal, restoring fiscal health is the only way.

Reform issues considered in the budgeting process concern pensions, transfer of tax authority from central to local governments and highway management. Although none appears in the 2004 draft budget as a conspicuous number, as factors they will strongly govern future fiscal policy. In connection with the transfer of authority to local governments, for example, Koizumi announced a policy decision to implement a ¥1 trillion cut in subsidies from the central to regional governments under the 2004 draft budget. Attention shifted subsequently to the question of what national tax revenues would be transferred to regional governments in return. The result is a resolution to establish an income transfer tax amounting to ¥424.9 billion in the initial year. Since this arrangement calls for distribution of the funds by the central government, this measure falls notably short of the original goal of a transfer of authority. Further review of regulations will be necessary, suggesting that resolution of this issue has been postponed.

For highway management, the question of priority between debt repayment and new road construction following the privatization of the Japan Highway Public Corporation has become a point of contention. Contrary to a freeze on construction work demanded by the Promotion Committee for the Privatization of the Four Highway-Related Public Cooperations, a road-construction interest group within the Liberal Democratic Party (LDP) has been calling for the completion of sections on which construction work has yet to be initiated. A final proposal drafted by the Ministry of Land, Infrastructure and Transport has in substance incorporated the wishes of the road-construction lobby. Thus, despite hopes for efficient management upon privatization, the possibility remains that tax revenue may be poured into the building of unprofitable roads, and their maintenance and repair.

Pension reform has attracted the strongest interest. Japan's pension system is not of the savings-type, i.e., accumulation of reserves starting at a young age to be drawn down upon retirement. Rather it relies on payments to be made by the working population to support the retired. In light of a falling birth rate and aging population, the burden on younger generations would become extremely heavy if current benefit levels were to be maintained. Mounting distrust of the pension system among young Japanese makes striking the right balance between benefits and burden a crucial issue. The current levels for pension benefits and pension contributions are 59% and 13.58%, respectively, of working income (payable in equal shares by employers and employees).

The Ministry of Health, Labor and Welfare advanced a proposal that envisages raising pension premiums in stages to 20% of working income by fiscal 2009. The chairman of the Japan Business Federation (*Nippon Keidanren*), Okuda Hiroshi, and other voices from the business world are demanding a ceiling of 16% at the most, citing concern over a loss of corporate vitality as the reason. Political negotiations at one point appeared poised to settle at 18%, which was ultimately increased to 18.30% in order to accommodate a motion by New Komeito, which claims that this percentage would allow pensions to remain above 50% of working income.

This view is premised on an optimistic projection, however, requiring the total fertility rate (TFR) to recover from the current 1.32 (the average number of live births per female during her lifetime) to 1.39. If the TFR continues at its current level, even without a decline, or if nonpayment of pension contributions spreads among the young, the foundation of the pension system will collapse. There is also concern about the effects on the economy from the annually increasing burdens on both households and corporations. Cutting already-effective pension entitlements was conceivable as an idea, but politically the concept proved unpopular and no thorough discussion ensued. Based on improbable assumptions as it is, the discussion surrounding pension system reform appears pointless, and the strong impression remains that the numbers were filled in only to obfuscate the issue.

The common element that these regulatory reform points share is perhaps that priority was given to political expediency. For example, the previous election of the House of Representatives increased the number of New Komeito's seats and strengthened its influence in the ruling coalition. Thus, the LDP, with the forthcoming elections for the House of Councilors this summer, will require the continued support of New Komeito, and was readily prepared to accommodate the latter's views on the pension issue. Among other reform issues, fees for medical treatment, the income source of the medical profession, were to be reduced by 1% according to a demand by the MOF, which cited a fall in the prices of goods as the reason. The Japan Medical Association is a powerful support base for the LDP, however. Devising a policy line and deciding to leave medical treatment fees unchanged required only a reminder from Aoki Mikio, Secretary-General for the LDP in the House of Councilors: "What about the election for the House of Councilors?"

Koizumi has declared that for the duration of his term as president of the LDP until 2006 there will be no consumption tax increase. Stated the other way round, a consensus is taking shape to increase the consumption tax rate by 2007 and beyond from the current 5%. It goes without saying that measures are being rushed into place towards fiscal restructuring. The question to be answered is whether to prioritize cutting expenditures even if that means a frontal assault on living standards, or whether tax increases should be sanctioned. In other words, the public is being presented with the choice between big government and small government, which will require a deepening of the discussion, as the draft budget for fiscal 2004 is telling us. JS

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