# Encouraging News: An intelligent analysis of Japan's fiscal policy and accurate policy formulations

## "A Financial Analysis of Japan's Fiscal Policy: The Nation's Fiscal Position Should be Analyzed from the Viewpoint of Net Debt"

(1) Japan has plenty of room to increase its fiscal spending.

(2) Japan should use fiscal policy as a means to extricate itself from the current dismal economic situation.

(3) Here is my recommendation of the best policy for reducing fiscal debt and expanding the economy.

February 10, 2005

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Any comments, suggestions and criticisms concerning this proposal are very welcome. Please forward them by either email <17kikuchi@mse.biglobe.ne.jp>
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10 Feb, 2005

# Japan's Debt, 730 Trillion Yen Lie

## Investment Tax Credit Rather than Increasing Taxes Reduces Deficits

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Author Profile

*Born 1936 in Tokyo, he left the former Bank of Tokyo in 1995 for his present position. In 1998, he proposed injecting public funds into major banks, an idea which was later enacted into law; and has appeared before the Upper and Lower House Budget Committees three times. He has publicly stated, "Japan's public finance should be viewed in terms of net debt. Its budget deficit will not decrease unless an aggressive fiscal policy is adopted."*

**Japan, Laughingstock of the World**

Every year, I have the opportunity to meet and share ideas with many prominent figures at conferences in New York and Washington, DC. They have no idea that Japan has a financial crisis. I have often heard people say recently: "Thanks to Japan's purchasing a lot of treasury bonds, we've been able to reduce taxes significantly in the United States, and our economy is starting to recover. Why doesn't Japan also reduce taxes to stimulate demand?..." Former Malaysian Prime Minister Mahathir Mohamad also scoffed, "Japan is a good example of what not to do"; and a friend of mine in East Asia gave me this piece of advice, "Although Japan is the world's richest country, why doesn't it use its own money for itself? If it did, tax revenue would probably increase."

And yet, tax revenue has been dropping sharply in Japan since 2001. A policy of tax increases will also be initiated in the fiscal 2005 budget. How did such a contradiction come about?

In this article, I inquire into these causes of this situation and suggest remedies. Why is Japan in such a hurry to increase taxes? Which policies are wrong? What should be done to create an economy where tax revenue increases without increasing taxes?

The main points of this article are:

1. The government is emphasizing only debt in trying to force a tax increase. However, while it had a ¥730 trillion debt as of September 2004, there was ¥480 trillion in financial assets, for a net debt of ¥250 trillion (calculated by subtracting financial assets from total national debt), which is about 50 percent of Gross Domestic Product [GDP] and on par with the United States and European countries.

2. The only nation that maintains financial assets roughly equivalent to GDP is Japan (other major powers are between 15 and 20 percent). Unless Japan's fiscal

problems are grasped in terms of "net debt," any "understanding" will be inaccurate. Other nations commonly view their debt in terms of net debt. The reason people in other countries do not think that Japan has a financial crisis follows from this reasoning.

3. As for Japan, the problem is that the ratio of net debt to GDP (the size of the government debt burden) is rising rapidly. This is because of a negative nominal GDP growth rate and stems from insufficient domestic investment.

4. The lessons learned from the Great Depression of the 1930s teach us that if an austere fiscal policy is adopted during a deflationary spiral, the economy will contract, prices will fall, tax revenue will plunge, and the only thing that will increase is government debt. Since the inauguration of the Koizumi Cabinet, this is exactly what has happened to Japan. Because a course of fiscal austerity has been taken and the lessons of history ignored, budget deficits have escalated only increasing the government's debt burden. To redress this situation is to do as both the United States and Japan did successfully in the 1930s, stimulate private sector demand with an aggressive fiscal policy. In Japan's present situation, fiscal discipline should be applied to the proportion of net debt to nominal GDP, and the reduction of this ratio should be the fiscal objective.

5. Public investment in the United States and Europe includes military spending. Looking at the "ratio of GDP to public investment" which is premised up on this, Japan is much lower than the United States, showing that Japan is deficient in this area. Furthermore, public spending and policies to induce private investment are essential in Japan where savings surpasses investment by a large margin.

6. A policy of curbing domestic demand owing to five consecutive years of fiscal retrenchment(a reduction in investment related expenditures) have spurred the manufacturing industry to shift overseas (mainly to China). This hollowing out of the manufacturing industry is weakening Japan's economic strength, and is a major reason for the decline in tax revenue. To prevent the nation's strength from declining due to further industrial hollowing out, private investment should be stimulated through large-scale investment tax credits, and public investment in the form of budget allocations for disaster prevention and national land conservation should be increased considerably.

7. Japan is the world's richest country holding external credit exceeding 50% of GDP. Nevertheless, we should not use our money for ourselves. We should use our money for ourselves! Let's come up with ideas on how to do so!

In Japan today, increasing taxes is crude thinking. It is absolutely impossible for a country, which does not have increasing tax revenue due to a deflationary spiral, to reduce budget deficits or to shrink its debt unless it adopts a fiscal policy to augment the economy.

**Government Statements Ignore Assets**

Let's take a look at the data released by the Ministry of Finance (December 25, 2004; chart below). Newspaper reports tended to be along the line of "Nation's Debt at ¥730 Trillion" [Yomiuri Shimbun], and "Debt Only Ballons" [Nikkei Shimbun]. Not a word was said about the government's vital assets. Scholars also pounced on only the debt without considering assets in creating their models, which in many cases exaggerated the fiscal crisis. However, this prostitutes scholarly study by using incomplete theories that mislead the public.

If we compare breakdowns of the ¥730 trillion to the nation's assets, we will find, as in Chart 1, that the government has financial assets on an amount of ¥480 trillion. So the nation's debt viewed as "net debt" is at the most ¥250 trillion or 50 percent of GDP, which is equivalent in real terms to that held by the United States and the nations of Europe. Even if debt per capita is ¥5.7 million, there is a ¥3.8 million term deposit, so the actual debt is no more than ¥1.9 million. The majority of the government's short-term debt is in short-term government bonds, which the Ministry of Finance issued to purchase dollars (sell yen), and the dollars purchased are almost invariably being invested in United States Treasury bonds.

In other words, even though there is a debt, there is also a huge amount of financial assets, so the "net debt" is surprisingly small. Despite this, propaganda is intentionally being disseminated about only the debt. Could anything be more deceiving to the public?

**Chart 1 Debt ¥730 trillion and Financial Assets ¥480 trillion**
**(As of September 2004)**

| Debt (Ministry of Finance release) | Financial Assets (Note 1) |
|---|---|
| 1 Government Bonds & Investment-and-Loan Bonds **587**<br>2 Government Short-Term Securities **87**<br>[Subtotal 674] | Financial Assets (Note 2) **480**<br>Social Security Funds **230**<br>Domestic and External Loans & Investments **160**<br>Foreign Currency Reserves **90** |
| 3 Government Guaranteed Debt 58 | Negligible Actual Burden |
| **TOTAL Approx. 730** | **[Net Debt 250]** |

Note 1: According to the Cabinet Office's National Accounts, financial assets at the end of 2002 were ¥434 trillion. The ¥480 trillion figure includes estimated subsequent increase.

Note 2: Foreign currency reserves are actual amount as of the end of September 2004. Figures for "Social Security Funds" and "Domestic and External Loans and Investments" are the actual amounts as of the end of 2002 plus estimated subsequent increase (See Chart 3).

## Chart 2 Ratios of Japan's "Total Debt" and "Net Debt" to GDP

| Item/Year | 1996 | 1998 | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|---|---|
| 1. Nominal GDP (trillion yen) | 515 | 515 | 515 | 502 | 498 | 500 | 502 |
| 2. Total Debt (trillion yen) | 483 | 580 | 660 | 753 | 789 | 830 | 860 |
| 3. Ratio of Total Debt to GDP (%) | 94 | 113 | 129 | 150 | 158 | 166 | 171 |
| 4. Financial Assets (trillion yen) | 368 | 379 | 411 | 423 | 434 | 470 | 480 |
| 5. Net Debt (2 - 4) (trillion yen) | 115 | 201 | 249 | 330 | 355 | 360 | 380 |
| 6. Ratio of Net Debt to GDP (%) | 22 | 39 | 48 | 66 | 71 | 72 | 76 |

(Source: Cabinet Office "National Accounts for Fiscal 2002")

→ Inflated "Total Debt"

(Notes)
1. Figures for 2003 and 2004 are estimates.
2. Since 2001, the Cabinet Office has inflated the calculation of Total Debt by including debt for local government sewage system projects (¥52 trillion in 2001). This is the reason for the extreme increase in debt after 2001.

## Chart 3 Breakdown of Financial Assets

| Year | Total | Items: Social Security Funds | Items: Foreign Currency Reserves, Loans, Investments |
|---|---|---|---|

Source: Cabinet Office "National Accounts" 2003 Edition.

(Notes)
1. Actual figures used through 2002; From 2003, figures are estimates.
2. Foreign Currency Reserves at the end of September 2004 were ¥90 trillion (actual figure).

□98□+11

**Japan's Public Finance Viewed as Net Debt**

If we lay out Japan's fiscal standing based on the government's 2002 data released by the government, the following can be said.

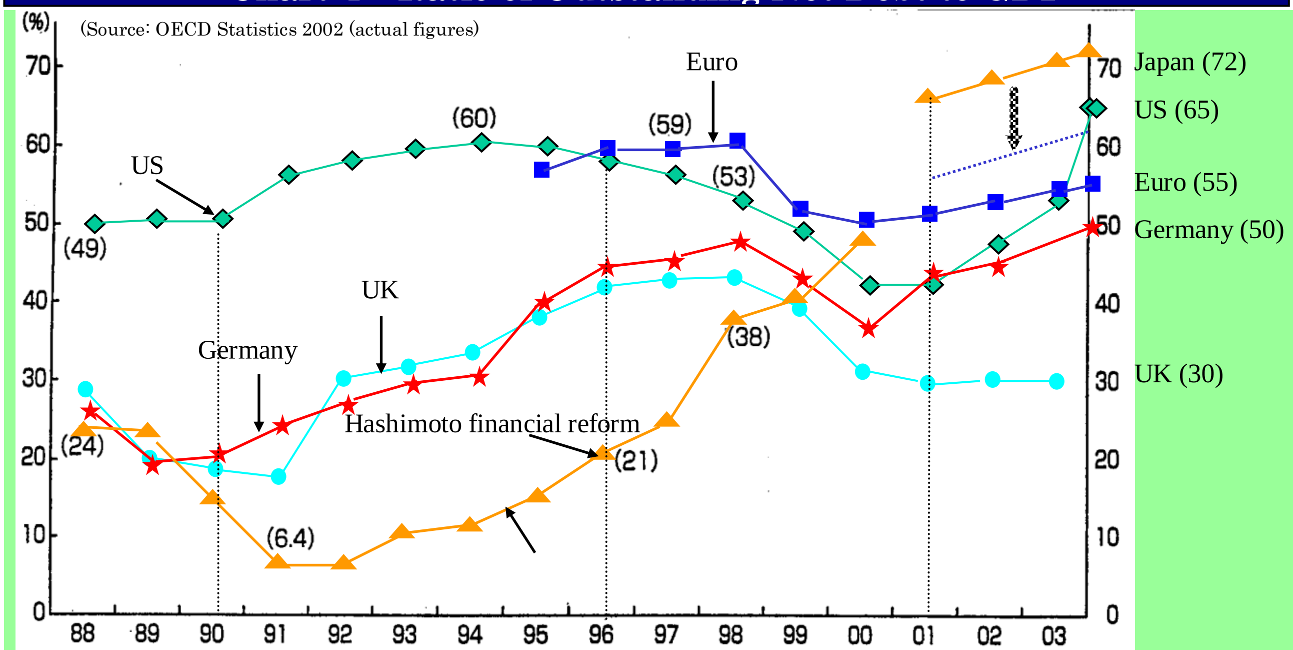
1. According to the National Accounts released by the Cabinet Office, Japan is not an excessive debtor nation. It has a surplus of assets. Additionally, it holds ¥224 trillion in obligations overseas (as of December 2002), which has probably reached close

to ¥300 trillion by now.

2. If we consolidate the ratios of Japan's "total debt" and "net debt" to GDP, we have Chart 2. Chart 3 shows a breakdown of financial assets. In FY 2003, the government intervened in the exchange market on a large-scale, buying dollars and selling yen, to check the appreciation of the yen, which brought about increases in the amount of short-term government bonds (debt) and an increase in financial assets due to the purchase of US treasury bonds (foreign currency reserves)

3. Chart 4 graphs the proportion of "net debt" to GDP. Japanese newspapers have only published "the relation of total debt to GDP," creating the impression that Japan is the only country with such an immense problem. However, this is a gross error. Japan's debt problem should be viewed in terms of "net debt," which is 50 to 60 percent if viewed as a "ratio of net debt to GDP," or the same level as in the United States and Europe. The problem is that this ratio (the government's capacity to repay debt) has been rising rapidly since 2001. The reason is that budget austerity has brought about a negative nominal growth rate (minus 2 % for the period 2001～2004), and tax revenue, which is proportional to nominal GDP, has decreased dramatically. This occurred because deflation has squeezed investment down to an insufficient level.

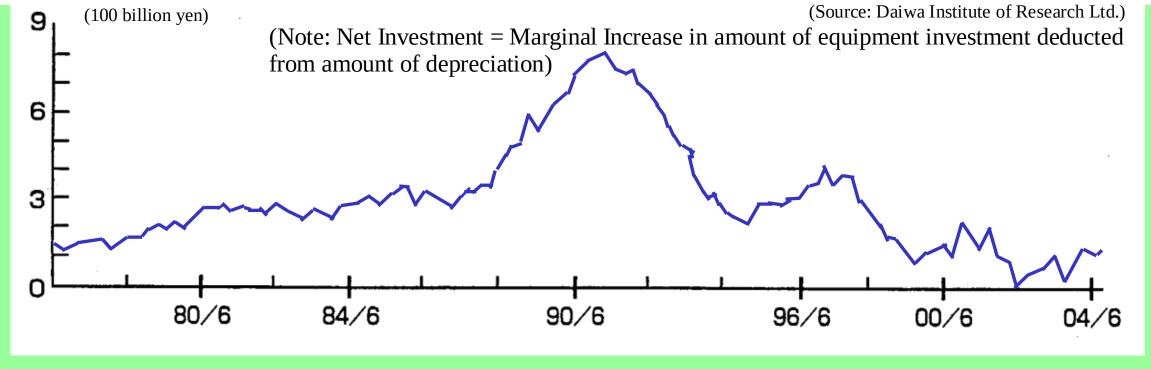
## Chart 4 Ratio of Outstanding Net Debt to GDP




(Notes)
1. Japan inflated the outstanding debt by including debt for local government sewage system projects.
2. After 2002, figures are estimates.
3. Excluding the amount of inflated debt since 2001, Japan's "Ratio of Net Debt to GDP" is probably around 60 percent.

Japan inflated the debt

## Chart 5　Net Investment in All Industries




**A Serious Dearth of Public and Private Investment**

Chart 5 graph shows net investment in all industries in Japan. “Net Investment“means the balance of "the marginal increase in the amount of equipment investment deducted from the amount of depreciation." As this chart shows clearly, net investment of private equipment for all industries was almost zero in 2002, and investment in small and medium-sized enterprises did not expand. It is obvious that the economy is contracting.

The ratio of Japan's public investment to GDP is very low in comparison to Europe and the United States. In those economies, military expenditures are the main form of public investment. In the United States, military spending accounts for 4 to 5 percent of GDP. State governments also contribute significantly to public spending for investments such as roads, the environment, and other areas.

The Council on Economic and Fiscal Policy formulated this policy: "As Japan's public investment as a proportion of GDP is high compared to the United States and Europe, it should be reduced to an equivalent level (January 6, 2001)," which was adopted by the Koizumi Administration at a Cabinet Meeting. This is a serious error. What in the world were they looking at when they made that terrible mistake?

This policy has accelerated deflation, impoverished the nation, reduced public investment even though private investment has not increased, shrunk the economy, rapidly reduced tax revenue, and diminished corporate motivation to invest. The view that "public investment does not contribute to an increase in the GDP growth rate" is at variance with the facts. An analysis of the multiplier effect of public investment conducted by a private research institute found that it was an adequate 1.5.

Fiscal retrenchment during a deflationary period causes the economy to shrink, fiscal deficits to swell, and government debt to increase. This was the lesson of the 1930s. Let's take a look on Chart 6 to see the measures that the United States took to extricate itself from its crisis.

1. Fiscal retrenchment (reductions in public spending) and increased taxes during a deep recessionary phase will cause prices to fall even further and negatively impact GDP growth. The rapidly declining tax revenue then aggravates deflation

(contracting the economy and creating a credit crunch).

2. To bring the economy out of a deep slump, policies stimulating demand through sustained fiscal spending will raise prices, increase nominal GDP, and increase tax revenue, which decreases government debt.

3. In a deflationary phase, private investment does not grow. Public investment and policies favorable to investment are needed to induce private investment. In a matter of time, private investment will emerge.

4. "The national burden ratio for government debt" is a figure obtained by dividing nominal GDP into government debt. What should be done is to lower the "**national burden ratio**" by increasing tax revenue through economic expansion. This is "fiscal discipline."

In the United States, President Roosevelt, who took office in March of 1933, stabilized the financial system by adopting measures to reorganize the banking system, which stressed the infusion of public funds, issued more government bonds, and increased public spending to stimulate private demand.

In Japan, Korekiyo Takahashi, who became Finance Minister in January 1932, increased public spending through a policy whereby the Bank of Japan would underwrite government bonds. This stimulated private demand, improving tax revenues. Government debt decreased.

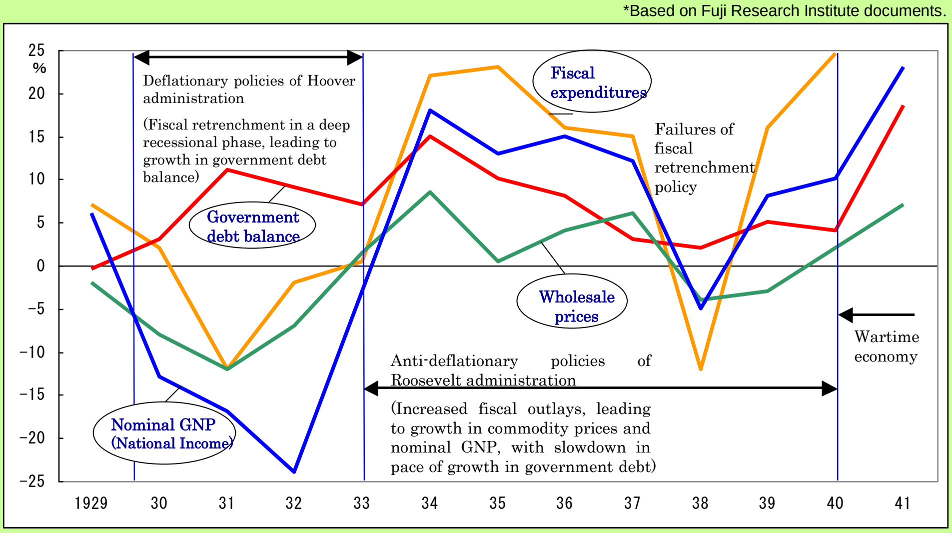
Both Japan and the United States have increased tax revenue using fiscal policy to stimulate demand, which led to a reduction in government debt.

**History Lessons in Battling Deflation**

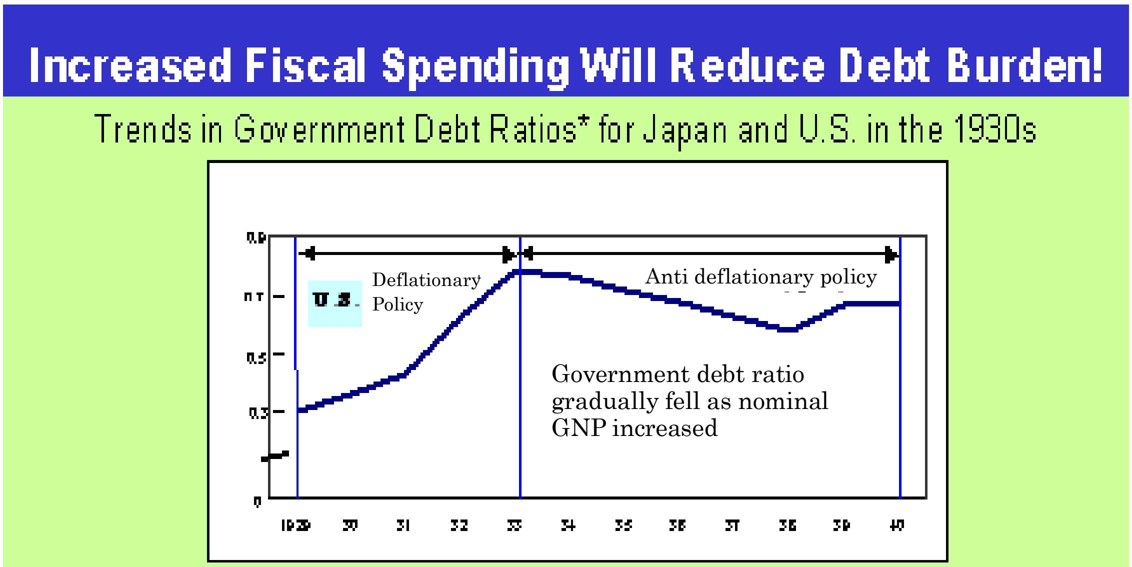
Year-on-year change in government debt balance, fiscal spending, wholesale prices, and nominal GNP

U.S. Escape from Deflationary Spiral in the 1930s

*Based on Fuji Research Institute documents.




Note: Fiscal expenditures include estimates.




Fiscal Discipline Index

**The Koizumi Cabinet's Economic Blunder**

Let's take a look at the result of the Koizumi Cabinet's economic policies from FY 2001 to 2004. If we compare them to FY 2000, we see the following:

1. Four consecutive years of fiscal austerity (¥1.6 trillion reduction in public investment) have resulted in bringing about a depression, and dramatically reduced tax revenues (Compared to ¥50.7 trillion in FY 2000, FY 2003 was ¥41.7 trillion and ¥43 trillion was forecast for FY 2004 for a total reduction of ¥26 trillion); tax revenue in the FY 2005 budget bill is ¥44 trillion, which is merely the 1986 level. In other words, Japan's economy has contracted and fallen back to the economic capacity it had 19 years ago.

2. The Financial Services Agency has pushed forward the unnecessary disposal of nonperforming loans, and is putting one healthy company after another out of business. This in turn withers company operations, leads to a credit crunch, downsizes the economy, and reduces tax revenue.

3. During this period, nominal GDP was a minus 2 percent (real growth during a deflationary period is nothing more than an illusion). National disposal income ultimately fell to a negative ¥3 trillion in 2003, and the savings rate plummeted from 9.8% to 6.1% (end of 2002). The public is breaking into its savings in a desperate attempt to protect its livelihood. What will happen if taxes are raised at a time like this?

**Four years have passed since the Koizumi Cabinet came to power, and not even one economic indicator has improved during this time.** Japan's economy is a disaster. Establish a "Japan Resuscitation Investment Program"

Japan has over ¥1,400 trillion in private savings and deposits, as well as the government-managed ¥90 trillion in foreign currency reserves and ¥160 trillion in external and internal investments and loans (both of which were capitalized using our savings and deposits). The question is how this should be used for "us, the people."

I therefore would like to suggest the "establishment of a ¥150-200 trillion Japan Resuscitation Investment Program." It is realistic and should be continued for a minimum of five years.

1. ¥50 trillion for investment tax credits: To prevent a hollowing out of domestic manufacturing, 15 to 20% of the amount invested should be credited against the enterprise's corporate tax, or should be paid to investors a government investment subsidy.

2. ¥50 trillion for national disaster prevention, environmental conservation, and forest protection: To prevent national disasters as well as the destruction of the environment and forests.

3. ¥50 trillion for a government bond administration fund: This fund will be established in order to stabilize the erratic fluctuation of bond prices due to speculation, and applied to preserve the integrity of the bond market and to stabilize long-term interest rates. The government will intervene in the market when appropriate.

4. ¥50 trillion for reserves: To be applied to increases in items 1 and 2.

To finance the program, long-term government bonds will be issued and sold on the market. At the same time, the Bank of Japan would, when market conditions dictate, buy back bonds on the secondary market, pumping money into the market. This formula is the same as the one adopted by the United States in the 1930s to stimulate the economy. It was a huge success.

For the bonds issued in items 1 and 2, the US Treasury bonds held by the government as foreign exchange reserves (¥90 trillion) and domestic and external loans and investments will be used as security. Furthermore, more than ¥100 trillion in funds will be remaining in financial institutions. The market will thus have sufficient capacity to absorb these activities. Even so, appropriate intervention using the fund in item three will likely make the market function smoothly in order to prevent short-term buying and selling by bond speculators.

To allegorize in more immediate terms, each Japanese citizen has a ¥3.8 million term deposit in the bank. Due to the government's deflationary policies, a person was laid off. So, he decides to open a noodle (ramen) shop. Using the term deposit as collateral, he asks the bank to loan him ¥2 million. The bank does so immediately. With this, his family is able to scrape by. If a lot of people started businesses this way, the economy would recover and life would probably become easier.

Foreign currency reserves are foreign currency that the government holds ready for when necessary. They do not need to be increased that much. However, in Fiscal 2003, these reserves increased markedly because ¥33 trillion worth of dollars was bought to stave off appreciation of the yen. Moreover, the short-term bonds that the government issued to do that turned our individual savings and deposits into foreign exchange reserves, transferring them to US Treasury bonds because although the Bank of Japan did the underwriting until September of 1999, it has been selling off the bonds on the market since October of that year.

The money that was converted to US Treasury bonds is capital that should properly be used by the public. If they cannot be sold, then liquidation by leveraging them is a totally reasonable approach.

If this course is realized, it will breathe new life into Japan's demand deficient economy, land prices will bottom out, stock prices will rise, and nominal GDP will grow 2 or 3 percent within one or two years. Five years from now, nominal GDP will probably be ¥580 to 600 trillion, and tax revenue will climb back to ¥55 to 57 trillion.

Government debt will gradually decrease, and the ratio to GDP will likely stabilize at 40 percent in terms of net debt. The saying, "If the economy expands, income will double, and everything will be solved," is attributed to Osamu Shimomura, the theoretical pillar for Japan's rapid economic growth in 1960's. Now is the time for the Japanese people to remember these words of wisdom.

（ This is a partial translation of an article written for the March 2005 edition of

"VOICE," a monthly magazine published by PHP KENKYUSHO.）