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From the Crossing the Network Column: Japan's Economy

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"Budgets to Retrench and Balance Accounts but Void of Policy Are Main Source of Tax Increases"

Fiscal Deficits Increases under Fiscal Retrenchment

On February 27, I was invited to speak at the public hearing of the House of Representatives Standing Committee on Budget and stated my views concerning the budget for the 2006 fiscal year. Speakers at these public hearings have twenty minutes at the outset to present their opinion regarding the proposed budget and the government's fiscal policy, then a representative from each faction of the Budget Committee poses questions to the speaker to discuss the points at issue.

After the Koizumi Cabinet was inaugurated, I was called to speak at the House of Representatives Standing Committee on Budget, exactly four years earlier on February 27, 2002. At that time, I sounded a warning: "If fiscal austerity is adopted during a period of deflation, the fiscal deficit will increase and government debt will grow, therefore fiscal austerity should absolutely not be adopted." The result has been just that. The budget for FY2002 was the second consecutive year with an austerity budget (successive reductions in the amount of annual expenditures) in the past 47 years, and over April and May of the same year in which this budget was in effect, Japanese government bonds were downgraded by leading rating firms in the United States (Standard & Poor's and Moody's Investors Service). The reason for the downgrade was that Koizumi's deflationary policies had been forecast to cause nominal GDP (gross domestic product) to falter, and the ratio of government debt to GDP to probably rise. In other words, Koizumi's "deflationary-spiral" budget triggered the downgrade. Today with four years having passed since that time, the fiscal deficit has expanded and government debt has grown, just as I figured.

I am not a fortune-teller, nor a prophet. Adopting fiscally austere policies during deflation brings the economy to a furious halt. The deflation worsens further, increasing the fiscal deficit as government debt accumulates. This is the lesson of the 1930s Great Depression in Japan and the United States. In the United States, a policy that has failed once is never embraced again. This is the fundamental doctrine of a wise and strong nation. Therefore, fiscal retrenchment and deflationary policies are not enacted under any circumstances. However, in Japan, because this sort of historical experience was forgotten and a policy of austerity along with huge tax hikes was launched in 1997, stock prices crashed and a financial crisis was set off.

Koizumi's Reforms, the Same Mistake as Hashimoto's Fiscal Reorganization

The dual pillars of Koizumi's Structural Reforms are a "reduction in the fiscal deficit through fiscal austerity" and "accelerated disposal of non-performing loans." The target of the former has produced results that are the exact opposite of what was intended, markedly ratcheting up the fiscal deficit with the corresponding accumulation of government debt. Judging from the experience of the 1930s, this is to be expected. Since the Koizumi Cabinet was put together, every single economic indicator has taken a turn for the worse. Comparing FY2000 to 2001 when the Koizumi Cabinet made its start and the years since, nominal GDP has dropped from ¥513 trillion to ¥504 trillion (in 2002, it was ¥497 trillion); tax revenue has fallen from ¥51 trillion down to ¥42 trillion (FY2003), and even though this number has managed to recover to ¥47 trillion in FY2005, it has not eclipsed the tax revenue level of 18 years ago. To put it briefly, the economy has been downsized; nominal GDP is at the level of 10 years ago; and tax revenue has fallen nearly to what was 20 years ago. Accelerating this trend even further is the budget for fiscal 2006.

Austere, Tax Hike Budget to Balance Accounts but Void of Policy

The main content of the FY2006 Budget is (1) total budgeted general account expenditures of ¥79.7 trillion (for first time in eight years, this figure is under ¥80 trillion); (2) total government bond issues of ¥29.9 trillion (below the ¥30 trillion mark); (3) increase in individual income taxes, referring to the abolition of the fixed-rate tax reduction; (4) abolition of the IT investment promotion tax, and the establishment of an information infrastructure enhancement tax scheme for industrial competitiveness; (5) reduction in public investment (a 4.4% cut from the previous year); (6) fiscal investments and loans to be reduced 12% from the previous year to ¥15.5 trillion (the lowest level in 28 years, since 1978); (7) tax revenue of ¥45.9 trillion (equivalent to the 1986 level, or tax revenue of 20 years ago); (8) nominal GDP growth rate of 2%, and a GDP deflator (composite index of commodity prices) of zero (deflation to dissipate); (9) increased burden on the public of ¥2.2 trillion over FY2005, due an aggregate of the amount in FY2006 from abolition of the fixed-rate tax reduction (¥1.6 trillion), partial abolition of the increase in deductions for public pensions (¥200 billion), and an increase in pension and unemployment insurance premiums (¥400 billion).

This is a "budget to retrench and balance accounts but void of policy and is the main source of tax increases," and it includes hardly any incentives for attempting to increase tax revenue. Tax revenue will not rise with this budget.

Therefore, there is no other course but to raise taxes.

Follow the Example of Former United States President Clinton

In December 1985, the Balanced Budget Act was enacted during the Reagan Administration. This law consisted of: (1) the establishment of annual budget deficit targets to balance public finances by 1991, six years later; and (2) in the event the budget deficit exceeded the target figure, even defense expenditures could be cut by the presidential sequester order. However, the numerical targets, which were laid down without consideration of the economic realities, were unrealistic. Former President Bush, who had publicly promised not to raise taxes during the election (1988), eventually had to initiate a tax hike and other measures, and the fiscal reform of only numerical targets without consideration for the underlying economic reality ended in failure.

In 1993, President Clinton, who is a member of the Democratic Party which took over the administration after a 12 year lapse, gave a speech to the Congress immediately after assuming office, and laid out a fundamental policy for fiscal reconstruction to be executed in the following manner: (1) both public and private sector expenditures were to be moved from consumption to investment in order to expand employment; (2) respect was to be given the family and labor; (3) budget compilation was done using conservative estimates; and (4) government expenditures were reduced, and an equitable tax system introduced.

What attracted particular attention was the policy of having "both public and private sector expenditures moved from consumption to investment in order to expand employment." The features of this budget were as follows: (1) a positive fiscal policy with annual expenditure increases of 3~3.5% over the year before; (2) a high-priority on increasing the amounts of investment items, and implementing investment focused on items related to road and railway transportation, regional development, as well as education and training, etc.; (3) reduction in the number of government employees by 30,000; and (4) a result that government maintenance expenditures over the eight years he was in office were far below the inflation rate.

"Small government" means minimizing the percentage government maintenance expenditures account for in the budget, and does not mean reducing total spending. The keywords of Clinton's policy are "positive fiscal policy," "investment tax reduction," "increased amounts of public investment," "reduction in government maintenance expenditures," and "adoption of specific rules related to social security."

Compared to the successful Clinton, Koizumi's budget is without a doubt lacking, and has few if any steps to increase tax revenue. Fiscal austerity is adding to the fiscal deficit, dividing the nation and cause "disparity" in all aspects. It is no exaggeration to say that the root of all evil is fiscal austerity. The richest country in the world Japan should think about using its own money for itself. Reversing policy is the only solution.