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**The Fiscal 2004 Budget: Evaluation and Issues
— Directions for Subsidy Reform to Promote
the Devolution of Authority to Local Government —**

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Overview

I. Primary Balance Set to Improve Slightly in Fiscal 2004

The fiscal 2004 budget will be the third austere budget in as many years, as the general account budget remains at the 2003 level, the fiscal investment and loans program (FILP) have been cut by 10% as compared with 2003 and local government budget proposals have been cut by around 2%. Government bond issuance will nominally reach nearly ¥37 trillion but, in view of the carrying over of loan repayments (hidden borrowing) under special accounts, is effectively likely to top ¥38 trillion. The balance of long-term debt of central and local governments (end of fiscal 2004 forecast) remains at ¥719 trillion, up ¥24 trillion on the fiscal 2003 revised forecast and is equivalent to 143.6% of nominal GDP, the highest among the developed nations. Local government budget proposals for fiscal 2004 are expected to cut expenditure on public works, civil servants' salaries, etc. and the funding shortfall at local government level is likely to see a slight improvement. As a result, the primary balance deficit of central and local governments in fiscal 2004 is expected to see a slight improvement, falling to ¥25.5 trillion (equivalent to 5.1% of nominal GDP) as compared with ¥26.9 trillion (5.4% of nominal GDP) in fiscal 2003.

II. The Road to the Restoration of Soundness to Government Finance Will be Difficult

However, as things stand, it will be extremely difficult for the government to achieve its target of putting the primary balance back into the black by the

beginning of 2010, which is one of the election promises in the Liberal Democratic Party (LDP) manifesto. The reasons are as follows:

(i) The decline/stagnation of tax revenues is likely to be greater than the reduction in expenditure achieved under deflationary conditions

A comparison of fiscal 2004 expenditure (excluding the general account + ordinary accounts, government bond expenses, government debt expenses, transfers) with fiscal 2001 expenditure reveals that the reduction in expenditure will be of only ¥3 trillion, while the fall in tax revenue will be of ¥9 trillion. This shows not only that the expenditure reductions do not go far enough, but also how difficult it is to redress the fiscal balance when deflation has yet to be halted.

(ii) Social security costs are still rising

Owing to natural growth in conjunction with population aging, social security costs relating to pensions, medical care, etc. will be ¥2.2 trillion yen greater than in fiscal 2001. Although the fiscal 2004 budget achieves a negative price indexation of pensions (-0.2~0.3%) and reduces medical service fees (the drug price element is reduced by 1%), the overall reduction in expenditure will be only around ¥100 billion. Without a fundamental reform of the pension and medical care systems, it will be difficult to prevent social security costs from ballooning.

(iii) The *sanmi-ittai* ["three-in-one"] reforms have lacked thoroughness

On the instructions of the Prime Minister, measures to cut subsidies by ¥1 trillion were included in the fiscal 2004 budget, but these are inadequate in both scope and

content. The reform of subsidies has been reduced to little more than a tweaking of numbers and a standoff between central and local governments over the transfer of sources of tax revenue. Only around one-third of the ¥1 trillion will actually lead to a reduction in the expenditure of central and local governments. Although the government deserves some credit for cutting local allocation tax by nearly ¥1 trillion yen by encouraging local government bodies to reduce their expenditure, it is regrettable that a full-scale reform of the allocation tax system has been postponed.

III. There Must Be a National Debate if Japan is to Return to a Policy of Higher Taxation

Against this backdrop, it has been decided that the 2004 reform of tax systems will include increases in the tax burden on the household sector totaling nearly ¥1 trillion (although the actual tax increase is small if set against the reduction in taxes on the corporate sector and considered in net terms). Looking ahead to fiscal 2005 and beyond, the government has revealed that it is considering a progressive reduction of fixed-rate tax cuts (which reduce taxes by ¥3.3 trillion) and a 1% increase in the rate of consumption tax (generating ¥2.5 trillion in additional revenue), suggesting the possibility that Japan will return to a policy of higher taxation in the near future. It is true that, from a medium-to-long term perspective, Japan's population is aging the fastest of all the developed nations and that the government will eventually have to confront the issue of raising the national burden to a level comparable to that imposed in European countries. However, it is essential that the government should strive to obtain the understanding and agreement of the Japanese public for the return to such a policy, and the national

debate on this issue must be pursued still further. The Koizumi Administration must seek the approval of the people of Japan, paying due regard to the following considerations:

- (i) The return to a policy of higher taxation should not be made when the economy has attained a predetermined real growth rate, but rather when the prospect of Japan pulling itself out of deflation has been ascertained (e.g. when it is judged that the conditions are favorable to Japan maintaining the target nominal growth of 2% or above set in the LDP manifesto).
- (ii) As symbolized by the confusion over the reform of the expressway public corporations, opinion in Japan is divided over the level of social capital infrastructure required in Japan, and it is a matter of urgency that a national consensus be achieved.
- (iii) With regard to the relationship between payments and burden relating to social security (pensions, medical care, etc.), the government must give the people of Japan a clear indication of the options — whether the social security system should offer higher payments in return for a heavier burden, lower payments in return for a lighter burden, or something in between — and strive to obtain a consensus. To this end, it is vital that there be a broad-ranging debate of the desirable level for the real national burden rate, an issue on which the recent reforms were ambiguous.
- (iv) It is a matter of urgency that Japan build a new system under which the central government gives a clear indication of the national minimum level of social security that it should assure and local governments, with the approval of local residents, decide for themselves the appropriate level of burden and payments, thereby allowing the provision of a diversity of administrative services.