

# JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

## Japan's Financial Situation: A Proposal to Raise the Consumption Tax

by Kiyooki Fujiwara, Nippon Keidanren

The all-out efforts by the government of Japan to fix the country's Non Performing loan (NPL) problem in recent years finally seem to be paying off. That said, the costs associated with resolving the mountain of bad debt has pushed Japan's fiscal situation into its worst condition since the end of World War II.

As a result, Japanese policymakers will have to grapple with how to maintain a balance between financial restructuring and the necessary reform of the social security system, and local government finances. Nippon Keidanren, the Japan business federation, believes the key to economic health lies in a substantial, phased increase in the consumption tax.

### NPL Problem Ending

The proposed budget for 2004 is currently under deliberation in the Diet. Assuming easy sailing, the legislature will approve the budget by the end of March 2004, and it will go into effect the following month (Japan's fiscal year begins April 1st).

The government's Council on Fiscal and Economic Policy publicly releases its "Basic Policy" statement every June, which marks the starting point for debate on the following year's budget proposals. Just two years ago, the "Basic Policy 2002" identified NPLs as Japan's top priority and set forth a number of measures to be taken.

But the following year's Basic Policy report, released in June 2003, simply stated "the bad debt issue will be brought to an end in 2004." The very fact that measures related to bad debts were barely worth mentioning in the Basic Policy report – and hardly debated by the ruling parties and government – is a clear and welcome indication that the NPL issue is no longer severe.

Indeed, the actual funding support provided by the Deposit Insurance Organization of Japan to financial establishments peaked after reaching approximately ¥6 trillion in the year 2000. The actual figure for 2002 was only half (¥3.15 trillion) of that of the peak year.

Since the establishment of the Deposit Insurance Corporation of Japan eleven years ago, some ¥25 trillion in public funds have been disbursed to rescue troubled financial institutions. But those outlays seem to be gradually decreasing, and it seems the government will meet its ambitious targeted date – the end of 2004 – for the shedding of Japan's bad debt.

### Worsening Fiscal Situation

In recent years, many have advocated fiscal expansion, including public works, to jumpstart economic growth. The Japanese government has agreed and has poured huge amount of public funds to deal with the bad debt problem. As a result, Japan's fiscal deficit has reached its highest point since the end of World War II, which has only been exacerbated

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## Japan's Financial Situation: A Proposal to Raise the Consumption Tax

by the long-term recession that started in 1991.

The government of Japan is becoming acutely aware of the dangers associated with the issuance of new national bonds. Last November, for the first time, the Finance Ministry's Fiscal System Council acknowledged fiscal peril in its "Proposals Concerning Formulation of the 2004 Budget," by stating that, "Together with the decreased savings rate, the increment in the issuance of national bonds threatens the credibility of the national bond system and may invite hikes in interest rates beyond what could be expected from the economic situation." The Finance Ministry, always quick to challenge foreign rating organizations for their reductions in the ratings of Japanese bonds, has finally been forced to admit the possibility of the degradation in their value and the dangers of "crowding out."

With the strong progress been made in dealing with the overhang of bad debt, Japan's economy is gradually recovering and there are indications that the corporate sector, in particular, will exhibit a heavy demand for capital this year

and next. But if a large-scale issuance of new bonds continues, interest hikes might be a most undesirable by-product, which could push Japan's economy back into recession once again. Accordingly, the Koizumi government has stated that a "recovery in the primary balance" by 2013 is the most important financial policy issue facing Japan.

However, as an indication of the heightened dependence on public bonds, of the ¥82.1 trillion in expenditures in the budget proposal for the 2004, the "primary balance" deficit is a projected ¥19 trillion (Japan's fiscal deficit now stands at ¥36.6 trillion), indicating virtually no improvement. Thus, the route to recovery remains unclear.

Some comparison may be illustrative. The fiscal health of US Federal and state governments has deteriorated along with that of Japan<sup>2</sup>. But the United States improved its financial health during the 1980s and 1990s by boosting revenues and reducing spending (a combination of imposing spending caps and adopting a pay-as-you-go policy). There are many lessons that Japan, which must resolve its

huge primary balance deficit, can learn from the United States.

### Japan's Aging Society

Japan's depressed birth rate/aging society is advancing at the world's fastest pace, with the resultant financial burden expected to increase exponentially. Of publicly-funded pensions, half of the basic portion will be provided from the national treasury. And 50 percent of the costs of medical care for senior citizens aged more than 75 will be covered from public funds.

In the future, when Japan's baby boomer generation reaches retirement age (around 2009), the financial burden is expected to increase rapidly. Policymakers must begin to grapple now with the painful choices of how to pay for it.

### Local Government Finances

In Japan, the percentage of funding provided by the central government to local governments is quite high. Of the ¥86.2 trillion in local government income, ¥32.2 trillion comes from local tax revenues, ¥15.1 trillion from municipal bonds, and ¥6.9 trillion from other sources. And fully 37 percent (¥32 trillion) comes from

<sup>2</sup> The ratio of income/expenditures of the national and local governments, compared to the GDP, is 6.8 percent for Japan and 6.9 percent for the United States as of the end of 2004, demonstrating the worst numbers among the G7 countries.

the national government in the form of allocations to municipalities, grants (a so-called “local allocation tax”) and subsidies (a so-called “local transfer tax”).

The goal of the Koizumi administration is to increase financial support to local jurisdictions, not only to increase the discretion of local governments, but more importantly, to return to discipline in local finances. As a symbol of reform, a shift of tax collection from the central to localities (either by allowing local governments to capture some tax revenue now collected by the central government or by providing local governments with new sources of tax revenues) is under consideration.

### Japan’s Consumption Tax

Financial demands including improvements to expenditure/income ratios, dealing with an aging society, local financial reform, and other significant challenges will dominate political decision-making for the next 20 years. While reducing expenditures and reviewing social security payments is obvious, consideration of measures to increase revenues will also be necessary.

But under the Japanese government’s present income

structure, the income tax and the corporate tax are at an unrealistically low 10 percent level of receipts. To maintain corporate international competitiveness, an increase in corporate taxes is out of the question. Moreover, measures to increase income by depending only on the income tax, as in the United States, will not be sufficient to meet the financial demands described above. The appropriate alternative is a gradual increase in Japan’s consumption tax.

In the US, state taxes are imposed on retail sales but the rate is virtually at the same level as Japan’s 5 percent. In the EU countries, where the aging of the population is advanced, a value-added tax (VAT) of 15 – 25 percent has been introduced. In aging societies, in which senior citizens should help with the tax revenues, a high expectation is placed on the consumption tax.

If the consumption tax is established as a source out of which the central government can pay for looming social security costs and support local governments, Japanese citizens will find it easier to accept.

That said, incrementally raising the consumption tax rate presents a number of issues that must be fully considered. First is the impact on

consumption itself, including a negative effect on the overall economy. A rapid increase in taxation will pour cold water on enthusiastic consumption, acting as a shackle on economic growth. Thus the timing of any increase is important.

Moreover, a consumption tax is inherently regressive. Lowering the tax rate on food items and some kinds of subsidies for child-rearing households will be essential to helping boost Japan’s birth rate (which stands at a dismal 1.3 percent). Disincentives to child-rearing households should be avoided at all costs.

Finally, people are suspicious of big government. If the consumption tax increases in parallel with expanding financial demands, it will pave the way to a large government. In light of intensified international competition, the status of “big government as a big burden” is clearly disadvantageous from the standpoint of the promotion of industrial progress. ■

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## Outlook for US-Japan Relations in 2004

By Jim Auer, Vanderbilt University

The overall US-Japan bilateral relationship is reassuringly strong and healthy in economic and political arenas, but security challenges may loom large for leaders of both countries during the coming year.

On the economic front, the prospect of a dual recovery of both economies could revive the competitive frictions of the past. And though there are few bilateral trade irritants, the dollar-yen exchange rate could become a contentious issue if the United States allows a somewhat weaker dollar to support its own recovery while Japan pursues a counter-policy of export-led growth on the back of the yen.

There could be political changes too, as both countries will hold national elections in 2004. All US presidents and Japanese prime ministers value the bilateral relationship, of course, but Bush and Koizumi have formed a close personal bond which has appreciably strengthened since September 11, 2001.

But it is on the security front where the momentum of change could produce the most dramatic changes for the relationship in 2004 and beyond. Late last year, Japan announced its decision to participate in ballistic missile

defense with the United States and committed elements of its Air and Ground Self-Defense Forces to Iraq. These steps continue a transformation of Japan's security posture begun years earlier. Japan has maintained a Maritime Self-Defense Force oil tanker and several destroyers in the Indian Ocean to directly support US and British operations in Afghanistan, as well as indirectly in Iraq since November 2001.

But domestic criticism for this engagement is misplaced – for Japan to help its allies in the Gulf region is not in any way a slide down a slippery slope towards militarism. Rather, the actions are a fairly limited and pragmatic Japanese response to direct and indirect threats to its own security.

### **The Menace of North Korea to Japan**

Beyond the global threat posed by terrorism, Japan is also threatened by a more proximate threat, the Democratic Peoples

Republic of Korea (DPRK), ruled by the enigmatic Kim Il Jong. Many experts believe North Korea maintains a force of approximately 200 Nodong missiles, most of which are hidden in caves but which can be rolled out quickly and capable of hitting virtually any target in Japan with conventional, chemical, or biological, if not nuclear weapons, in a relatively brief period of time.

North Korea is a failed state economically which almost certainly will be unified someday with South Korea under the latter's leadership. But there is a risk that, unlike the similarly failed state of East Germany, North Korea's military leaders might choose to commit a spectacular mass suicide, rather than submit to a political demise. National suicide would end the regime of the DPRK, but in doing so, could cause hundreds of thousands or even millions of Japanese casualties if missiles were lobbed over the border.

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Deterring North Korea might be harder than was to contain the former USSR – Soviet leaders were no friends of Japan or the US, of course, but at least they understood the deterrent capability and responded in ways the West comprehended. Nor does China seem to pose an explicit and aggressive threat to Japan, even if its leaders express little appreciation for Japan’s generous annual Overseas Development Assistance (ODA) and its lack of nuclear capability. But the alternatives to deterring North Korea are virtually non-existent.

North Korea has always dismissed South Korea as a “puppet state of America.” But rather than present a united Japan-US front to pressure Pyongyang to deal directly with Seoul as a price for economic assistance, the US, particularly during the Clinton Administration, granted North Korea unprecedented direct access to negotiate with Washington. Even when North Korea fired a missile over Japanese territory in August

1998, the Clinton Administration met in New York with DPRK officials several days later and encouraged Japan to speed up its payment for the construction of nuclear reactors in North Korea.

The Bush Administration has not taken steps to effect a regime change in North Korea as it did in Iraq. But recognizing the danger posed to Japan if left alone too much longer, Bush included North Korea on his “axis of evil,” list and has insisted to China, Russia, North and South Korea that Japan be included as a member of six-party talks. And he has told North Korea it must resolve the abductee issue and allow abductee family members who are still in the DPRK to leave.

By geographical happenstance, Japan is located very close to three nuclear-armed nations that have been historically hostile. Accordingly, the Koizumi Cabinet has decided to pursue missile defense cooperatively with the United States – not to achieve offensive superiority to Russia,

China or to North Korea, but to provide Japan a minimal level of what must be characterized as an exclusively defensive capability against an incoming missile attack. To label this capability as “offensive” or “destabilizing” is grossly inaccurate. Indeed, it would be more accurate to say that Japan’s leaders would be irresponsible if they did not take this rather minimal defensive action.

### **Japan’s Role in Afghanistan and Iraq**

The deployment of Japanese forces to the Indian Ocean since late 2001 and to Iraq beginning this year has been welcomed by US. But it is misleading for some in Japan to point to the deployments as evidence that Tokyo is one of Washington’s “best” allies. While dispatching Self-Defense Forces (SDF) far beyond Japanese soil constitutes a giant step for Japan, the commitment is quite minimal by international standards.

More importantly, these are still actions of “rear area support” (koho shien). Since 2001, the Maritime Self-Defense Force has been tasked with refueling US and British warships. This is a great assistance but, unlike the US and British carriers, the Japanese ships,

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## Outlook for US-Japan Relations in 2004

which are located in relatively safe areas, are not allowed to fight unless directly attacked. The Air Self-Defense Force units will carry Japanese soldiers and equipment to Iraq and the soldiers deployed will not be there to militarily engage but instead to help with the Iraqi reconstruction. Indeed, Japanese forces are supposed to withdraw if their environments become too dangerous.

Washington is well aware of the limitations under which the Japanese forces will operate. And while this limited assistance is sincerely appreciated, it does not go unnoticed that British, Australian, Polish and other governments have put their young men and women directly in harm's way as part of the fight against international terrorism.

### **Has Koizumi Acted Illegally or Unwisely?**

The commitment of SDF to the Gulf has been portrayed by the

remnants of the old Japan Socialist Party and some in the media as illegal, and by the major opposition Democratic Party of Japan and even by some in the ruling Liberal Democratic Party as, at the very least, politically unwise. But Prime Minister Koizumi and his Cabinet, maintained in power by a coalition between the LDP and Komeito party, have acted realistically and pragmatically, not slavishly obedient to the US.

To the contrary, Koizumi has done what many of his LDP predecessors have done – maintained close relations with the United States, not only because he has a personal affinity for George W. Bush (after all, he likes Russia's Putin and China's Hu Jiantao too) but because it is in Japan's national interest to do so. Success is not assured but the alternatives are much worse.

If the policy fails, Koizumi might fail politically. But far worse,

Japan's security might be seriously compromised. If it succeeds, Japan can continue to live in peace and continue to reform and rebuild its economy. In either case, as Japan goes, so goes the US in the Asia-Pacific region.

The cautious steps undertaken by the Koizumi cabinet are prudent and support the broad objectives of the bilateral security relationship. Given the alternatives, Koizumi's decision is both wise and reasonable, and the outlook for US-Japan relations in 2004 is promising. ■

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# Revitalizing the WTO Negotiations

*Nippon Keidanren Position Paper, January 2004*

The success of the current round of WTO negotiations (the Doha Development Agenda) is essential for the world economy to grow and for developed and developing countries alike to maximize their national welfare through the improvement of the business environment.

Nippon Keidanren supports Japan's multi-layered trade policy through bilateral and regional liberalization in parallel with multilateral liberalization, and at the same time recognizes that the multilateral approach based upon the WTO is the foundation of the international trading system. We strongly urge the WTO Members to bring the negotiations back on track.

Learning from the failed Cancun Ministerial conference (September 6-10, 2003), WTO members need to continue their efforts to accelerate the negotiations with new ideas and flexibility. Urgent steps are clearly needed, especially in light of the fact that the General Council meeting in December 2003 postponed substantive negotiations to another day. Keidanren favors the resumption of WTO negotiations immediately based upon the 'Derbez Text' that was proposed in Cancun.

Nippon Keidanren believes that in order to make progress, it is essential to advance the negotiations on agricultural and to resolve the issues critical to developing countries. We urge WTO members to make every effort to achieve this worthwhile goal.

## **Nippon Keidanren's WTO Priorities**

Success in the WTO is best achieved by pursuing the following priorities:

- Improving market access for non-agricultural products (formulas should apply to all Members and adoption of sectoral approaches in conjunction with these formulas);
- Launching negotiations on trade facilitation and concluding within the timeframe of DDA;
- Promoting trade in services negotiations (submission of the initial offers, improving substantially the level of natural treatment and full liberalization of market access, liberalization of the movement of natural persons);
- Improving antidumping agreements (concrete progress on the negotiations need to be realized;

- Liberalization and development of rules and commitments regarding IT and e-commerce.

Nippon Keidanren believes that the establishment of clear and comprehensive rules for foreign investment within the WTO is important. But pragmatic approaches related to the circumstances of the negotiations, including the consideration of plurilateral agreements by interested major developed and developing countries, should be seriously examined.

We urge the WTO members to remain committed to the deadline of January 1, 2005 with a single-undertaking formula. We will continue to positively cooperate with the Japanese government, governments of other members and industries all over the world to enable the negotiations to proceed and reach a successful conclusion. ■

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For more information about Nippon Keidanren, the Japan Business Federation, and other position papers on domestic and international issues, please see <http://www.keidanren.or.jp/>

### 2005 WORLD EXPO IN JAPAN

The 2005 World Expo will be held in Aichi, Japan from March 25 to September 25, 2005.

The theme – Nature's Wisdom – is intended to fuse Asia's traditional wisdom with modern science and technology to create a better world where humankind and nature can co-exist in harmony.

So far, 125 countries are registered to participate in the 2005 World Expo, including the United States.

More information on the Expo 2005 in Aichi, Japan can be found at: <http://www.expo2005.or.jp/en/>

Some 15 million visitors from Japan and around the world are expected to attend.

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KKC fosters a deeper understanding of Japan's basic social structure. Furthermore, it conducts public affairs activities to improve the Japanese people's recognition of Japan's global role.

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