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Fiscal Management by the Hatoyama Administration: an assessment of the FY2010 budget

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Summary

1. The administration of Prime Minister Yukio Hatoyama led by the Democratic Party of Japan (DPJ) has called for a "shift from concrete to people," and this is reflected in the FY2010 budget, which is notable for a decrease in public works spending and a rise in social security spending. Other key policy pledges, including child allowances and free public high school education, will be implemented as planned, although the DPJ administration has decided to effectively maintain the provisional gasoline and other automobile-related taxes at their current rates despite its election pledge to repeal them. In this regard, the government has been successful in sending signals to the public about the direction of its policies. However, the administration's decision to boost spending amid a sharp fall in tax revenues has already caused concerns about its ability to manage fiscal policy in the future. Subsequent to the efforts to streamline the FY2010 budget by a panel tasked with cutting wasteful programs, it has now become obvious that ever increasing social security spending cannot be sustained merely by eliminating wasteful public spending.

2. Assessment of the Hatoyama administration's fiscal management and its future challenges are as follows:

(1) Positive points

- An improvement in transparency of the budget formulation process

Considering that the high level of transparency - including the transparency in budget screening sessions - would not have been realized without the change of government, the Hatoyama administration's efforts are worthy of commendation.

(2) Future challenges

(i) <u>Reviewing the JPY207 trillion allocated under the general-account and special-account budget as proposed in the *DPJ Manifesto*</u>

The government needs to adopt a new approach by budgeting effectively over multiple years – instead of on a single year basis, putting emphasis on the general account budget.

(ii) <u>Do not avoid mentioning tax hikes in policy discussions</u>

Growing expenditures without tax hikes is dangerous. To maintain confidence in the government's fiscal management, the government needs to draw up a plan to ensure sound public finances and consider specific measures to secure revenues.

(iii) <u>Carry out reform integrating taxation and spending policy</u>

The government needs to consider how much wealth should be redistributed to

individuals through the government's spending policy upon a debate on the basic question of what degree of fairness the tax system can achieve.

１. Introduction

The Cabinet approved the FY2010 budget in December 2009, the first under Prime Minister Yukio Hatoyama. The drafting of the budget was delayed due to the change of government, stoking fears that it would drag on into the next year. However, it was eventually announced on December 25, almost exactly the same day as budgets in previous years. It marked a fairly drastic change from past budgets in that expenditures on public works shrank while spending on household-related programs such as child allowances increased. This budget reflects the Hatoyama administration's motto of shifting the focus "from concrete to people." Despite the difficulty to deliver some of its manifesto pledges in FY2010, including repealing the provisional rates in gasoline and other automobile-related taxes (the government has decided to maintain these taxes at their current rates), expenses for key pledges, such as providing child allowances and offering free public high school education are actually included in this budget as planned. In this respect, the government has managed to adhere to the direction of its policy pledges despite the shortage of revenues.

Yet, despite the reduction of expenditures on certain programs in the *DPJ Manifesto*, Japan still faces financial difficulties. As the economic slump is expected to shrink tax revenues to JPY37 trillion, the government will have to issue JPY44 trillion in new bonds, surpassing tax revenues for the first time in 63 years. Against this backdrop, the Hatoyama administration has launched an aggressive spending policy without tax increases, stoking worries about its financial management. The government has decided to freeze any Consumption Tax increase for four years, and although the abolition of certain income tax exemptions will be carried out as planned, it will be on a limited scale. Despite the Government Revitalization Unit's efforts to reduce wasteful spending, reductions in spending identified by the budget screening panel were much lower than the DPJ had initially expected. Clearly, eliminating wasteful programs alone is not enough to compensate for growing social security spending. Furthermore, the government had to rely on more than JPY10 trillion of nontax revenue (mainly "hidden reserves (*maizo-kin*)" to secure the revenues.

There are issues with the budget drafting process that need to be considered. During the budget formulation process in December of last year, discussions stalled over how key manifesto pledges should be implemented in the face of a shortage of revenues.

However, after priority project recommendations were brought to the government on December 16 by the DPJ, the stalemate was resolved. This in itself is acceptable, but as a result, the style of decision-making processes that the Hatoyama administration had wanted to pursue, (i.e. that government policies are under the sole control of the government, and the DPJ should not be involved in them) broke down in the first year of budget drafting. Next year, the government needs to establish a more transparent budget drafting process, and clarify its relationship with the DPJ.

This paper summarizes the FY2010 budget presented by the Hatoyama administration after strenuous negotiations, and points out the issues to be tackled in future fiscal management.

２. The FY2010 Budget

In the general account budget for FY2010, total expenditures reached a record high of JPY92.3 trillion, an increase of nearly JPY4 trillion from the previous year. Tax revenues will fall to JPY37.4 trillion, while nontax revenues (JPY10.6 trillion) and revenues from government bonds (JPY44.3 trillion) will be appropriated to replenish the financial shortage (**Chart 1**). General expenditures will be increased by JPY1.7 trillion from the year before to JPY53.5 trillion due to the increase in social security spending. Tax grants from the general account to local governments will be increased by JPY900 billion from the year before to JPY17.5 trillion, taking account of the drop in tax revenue of local governments due to the economic slowdown. Debt-servicing costs will be around the same as last year on expectations that relatively low interest rates will continue. Approximately JPY700 billion, which is the amount equivalent to the shortfall in revenues in the FY2008 settlement announced in July 2009, was accounted for as a refund to the Settlement Adjustment Fund.

Chart 1: Outline of the FY2010 Budget (General Account)

	FY2009	FY2010	FY2009→FY2010
Revenues	88.5	92.3	3.8
Tax Revenues	46.1	37.4	-8.7
Other Revenues	9.2	10.6	1.4
Government Bond Issues	33.3	44.3	11.0
Expenditures	88.5	92.3	3.8
National Debt Service	20.2	20.6	0.4
Local Allocation Tax Grants, etc	16.6	17.5	0.9
General expenditures	51.7	53.5	1.7
Social Security-Related	24.8	27.3	2.4
Contingencies for Economic Crisis Response and Regional Revitalization	—	1.0	1.0
Refund to the Settlement Adjustment Fund	—	0.7	0.7

Source: Ministry of Finance.

(1) Expenditures

a. General expenditures

General expenditures totaled JPY95 trillion at the stage of the budget request in October, but in the end the government managed to trim JPY3 trillion from this amount. Initially, the government aimed to cut the JPY3 trillion through its Revitalization Unit's budget screening efforts, but it was able to cut only JPY700 billion from projects that were deemed wasteful. Then, the Ministry of Finance trimmed more than JPY2 trillion based on the budget screening results and the DPJ’s priority project recommendations to cut expenditures and postpone some projects.

The details of FY2010 general expenditures show a drastic change in the budget (**Chart 2**). What is particularly striking is the public spending cut, which reflects the new government’s philosophy, and the increase in social security spending. Public works spending was slashed by a staggering 18.3%. Since FY2003, public works related expenditures have generally been reduced by 3% every year, and have been hovering around JPY7 trillion for the past few years. However, in the FY2010 budget, they were cut all the way down to JPY5.8 trillion. Although the cost of constructing new *shinkansen* (bullet train) lines has been secured, the budgets for road, port and airport improvement were all reduced by more than 20% from the previous fiscal year. On the other hand, social security related expenditures increased by 9.8% to JPY27.3 trillion, reflecting the need to finance child allowances estimated at JPY2.3 trillion. As a result of other expenditures being contained, social security related spending now accounts for over 50% of the total general expenditures.

General expenditures include JPY1 trillion of Contingencies for Economic Crisis Response and Regional Revitalization[1]. The government has also set a ceiling of JPY1 trillion for activities incurring debt in later years, details of which are not stipulated in the budget. Therefore, the final size of expenditures on major costs is still unclear. While the government also earmarked JPY2 trillion of funds for economic stimulus without limiting its usage, this could also lead to the rise of public works-related expenditures and loosen the government's tight control of budget spending and scope. While such a vague budget may be interpreted as a means to enable flexible spending in the prolonged economic recession, it can also be deemed as a negative effect of the government's preoccupation with the superficial appearance of the initial budget and spending curbs on a single year basis.[2]

Chart 2: Changes in Major Budget Expenditures

	FY2009	FY2010	Change (FY2009 to FY2010)	% change (FY2009 to FY2010)
Social security-related	24.8	27.3	2.4	9.8%
Education & Science	5.3	5.6	0.3	5.2%
Former Military Personnel Pensions	0.8	0.7	-0.1	-9.3%
National Defense	4.8	4.8	0.0	0.3%
Public Works	7.1	5.8	-1.3	-18.3%
Economic Assistance	0.6	0.6	-0.1	-7.5%
Promotion of SMEs	0.2	0.2	0.0	1.1%
Energy	0.9	0.8	-0.0	-1.7%
Food Supply	0.9	1.2	0.3	33.9%
Miscellaneous	5.1	5.2	0.1	2.6%
Contingencies for Economic Crisis Response and Regional Revitalization	–	1.0	1.0	–
Reserve Funds for Emergency Economic Countermeasures	1.0	–	-1.0	–
Contingencies for general purpose	0.35	0.35	0.0	0.0%
Total	51.7	53.5	1.7	3.3%

Source: Made by MHRI based upon releases by the Ministry of Finance.

1 It is understood that Reserve Funds for Emergency Economic Countermeasures (JPY1 trillion) in the 2009 budget have been renamed Contingencies for Economic Crisis Response and Regional Revitalization.

2 Expenditures charged to future fiscal years are separately announced by the Ministry of Finance every year as the "Estimates Affecting Future Fiscal Years".

b. **The programs contained in the *DPJ Manifesto***

Among programs contained in the *DPJ Manifesto* that were originally planned for FY2010 are the provision of child allowances (halved from the initial amount), free public high school education, income compensation for farmers (model projects), intensive handling of the pension recording problems, a solution for the shortage of doctors, the gradual elimination of highway tolls, employment measures, and the elimination of the provisional rates in gasoline and other automobile-related taxes. However, fund shortages have forced the administration to abandon some of these programs. The child allowance (though cut in half), free public high school education and income compensation for farmers are to be implemented as promised, whereas the scrapping of the provisional rates in gasoline and other automobile-related taxes was virtually abandoned, and the elimination of highway tolls was significantly scaled down. During the process of determining the budget, the DPJ submitted priority project recommendations, such as the maintenance of the provisional rates in gasoline and other automobile-related taxes, setting an income cap on child allowances and raising medical service fees. This expedited the conclusion of the budget negotiations. Eventually, the government accepted the gas/automobile-related tax recommendations (see page 15), but rejected setting an income limit for child allowances.

With respect to child allowances, the government entered into discussions with local governments about the possibility of transferring some of the burdens to them. Initially, the government had expressed its willingness to implement the child allowance program as its own responsibility, so local governments resisted the partial burden strongly. However, the Finance Minister and the Minister of Public Management, Home Affairs, Posts and Telecommunications finally reached an agreement that local governments will continue to pay the amount currently paid by them under the child benefit program. Currently, there is a child benefit program administered by local governments. This program is currently paid by the central government, local governments and employers.

The monthly rate of the child benefit (with a household income cap) is JPY10,000 for a child younger than 3, and JPY5,000 for a child in the 3-12 age bracket (JPY10,000 for a third child). The newly introduced child allowance program will make use of this child benefit program. Of the annual child allowance of JPY156,000 per child, the central government will be responsible for the amount exceeding the cost of the current child benefits. The central government, local governments and employers will continue to maintain their current shares of child benefit expenses. As a result, their respective shares will be JPY610 billion for local governments, JPY145 billion for employers, and

JPY1.7 trillion for the central government (at the stage of budgetary requests, the central government was requested to pay JPY2.3 trillion) (**Chart 3**).

Chart 3: Key Policies in the *DPJ Manifesto*

Key items	Budgetary Requests	FY2010 Budget
Child allowance (halved from the initial amount)		
Effectively free public high school tuition	2.3	1.7
Individual (household) income support for agriculture	0.46	0.39
(model projects)	0.56	0.56
Pension record problem		0.09
Phased measures to relieve the doctor shortage etc.	0.15	—
Elimination of highway tolls (phased measures)	—	0.1
Employment measures	0.6	0.017
Abolition of provisional rates in gasoline and other	0.27	(0.17)
automobile-related taxes	(2.5)	
Total (including the abolition of provisional tax rates	6.9	3.1

Source: Made by MHRI based upon releases by the Ministry of Finance.

The government has held on to the free public high school education program, successfully allocating JPY400 billion in the budget as requested. Tuition fees (approximately JPY120,000 per year) will not be collected from families with children who attend public high schools. Families with children who attend private high schools will receive financial support covering part of their tuition fees (up to approximately JPY120,000 per year, with a further amount to be provided to low-income families). The budget also includes JPY560 billion (the full amount requested) for compensation for farmers (approximately JPY330 billion for model projects and approximately JPY220 billion for use of rice paddies to improve self-sufficiency). On the other hand, spending on the program to eliminate highway tolls was drastically slashed to JPY100 billion from JPY600 billion at the initial budget request stage (the details are yet to be decided). Spending on intensive measures to fix public pension record problems was also cut to JPY90 billion from the initially requested amount of JPY150 billion.

Spending on employment measures was kept low at JPY17 billion since JPY350 billion is scheduled to be infused later from the general account to the labor insurance special account in the FY2009 second supplementary budget (refer to Appendix). Provisional rates in gasoline and other automobile-related taxes were abolished with respect to more or less half of the automobile weight taxes, resulting in JPY170 billion of lost revenues to the government, which is considerably lower than the JPY2.5 trillion if provisional tax rates were abolished with respect to all gasoline and other automobile-related taxes.

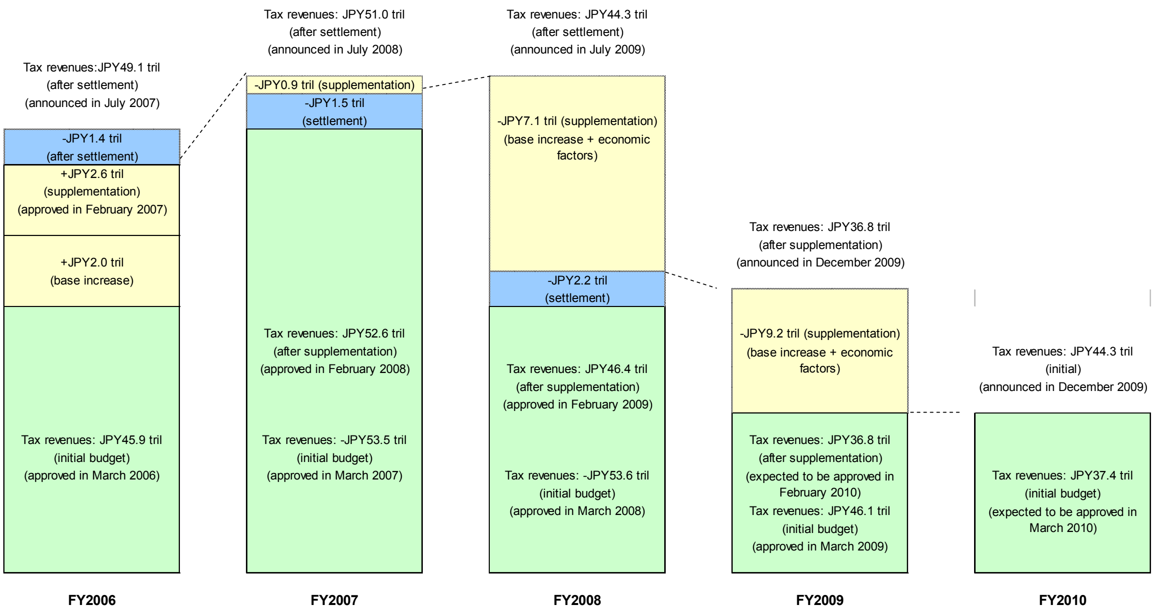
As a result, the cost of policy measures contained in the *DPJ Manifesto* was cut to JPY3.1 trillion in the FY2010 budget, less than half of what was asked for by the budgetary request (initially JPY6.9 trillion).

(2) Revenues

a. Tax revenues

The economic downturn is expected to reduce tax revenues to approximately JPY37 trillion in FY2010. The trend in recent years shows that tax revenues estimated in the initial budget are significantly reduced after the supplementary budget and the settlement of accounts (**Chart 4**). In the second supplementary budget for FY2009, tax revenues for FY2009 were revised down to JPY36.8 trillion as a result of the decline of corporate tax revenues from JPY10.5 to JPY5.2 trillion, and income tax revenues from JPY15.5 to JPY12.8 trillion (refer to Appendix). Tax revenues for FY2010 are projected at JPY37.4 trillion, almost the same level for FY2009, because the nominal growth rate for FY2010 is projected to be 0.4% (government forecast). If the economy improves even modestly, a downward adjustment in the middle of FY2010 might be avoided. However, since Japan is in a state of deflation, an upward adjustment of tax revenues cannot be expected and therefore, tax revenues for FY2010 are expected to remain weak.

Chart 4: Adjustment of Tax Revenue



Source: Made by MHRI based upon data released by the Ministry of Finance.

b. Non-tax receipts

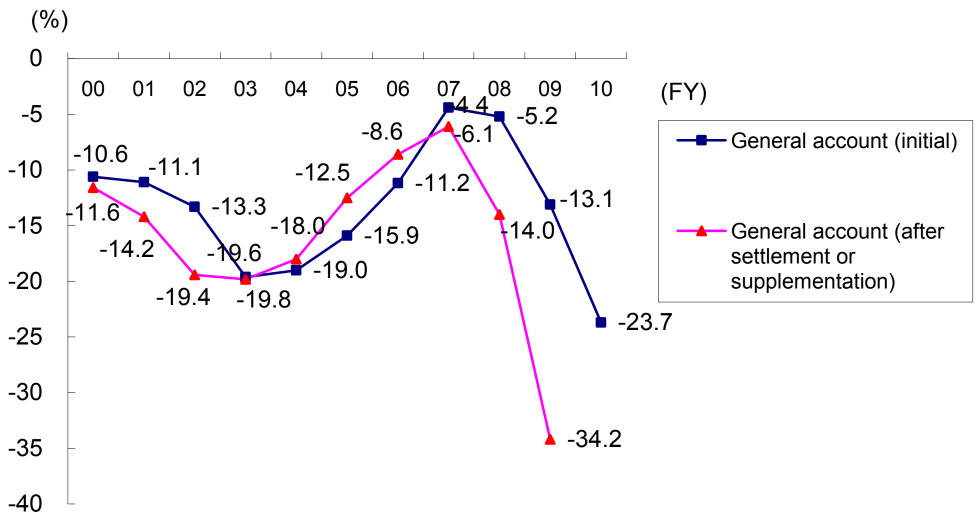
The government secured a record JPY10.6 trillion from non-tax receipts (mostly so-called “hidden reserves *(maizo-kin)*”, including tapping into (i) reserves and retained earnings in the special account, and (ii) savings created by slashing or scaling down public-interest corporations programs that are wasteful (JPY1 trillion). Of the JPY10.6 trillion, JPY4.8 trillion (JPY3.4 trillion of reserves plus JPY1.4 trillion of retained earnings) will come from the Special Account for Fiscal Investment and Loan Program, JPY2.9 trillion from the Special Account for Foreign Exchange Funds, and JPY0.2 trillion from seven other special accounts[3]. From the “hidden reserves ” in the special account, the government used JPY4 trillion in FY2007, JPY4.2 trillion in FY2008, and JPY9.2 trillion for FY2009. In FY2010, a record high amount of “hidden reserves” will be used.

“Hidden reserves” consist mostly of reserves which are in the special account and can be used only once. Should further “hidden reserves” be discovered in whatever way, they should initially be used to reduce the national debt. There is no substantial difference between (i) spending with “hidden reserves” while deferring the repayment of the national debt and (ii) appropriating “hidden reserves” for the repayment of the national debt while issuing new government bonds. The only difference is the superficial appearance of the budget. In other words, the reliance on “hidden reserves” may also be deemed as a negative effect of the government’s budget formulation which places sole importance upon the general account.

What highlights the deterioration of public finances in the FY2010 budget is that even if the “hidden reserves” are used, the primary balance of the government’s general account is still deeply in the red, posting shortfalls of JPY23.7 trillion (**Chart 5**). Japan’s primary balance improved from minus JPY19.8 trillion in FY2003 to minus JPY6.1 trillion in FY2007, but since then, it has deteriorated due to the prolonged economic slump. In FY2009, the government deficit rose to JPY34.2 trillion. Even with the infusion of more than JPY10 trillion of “hidden reserves” into the state coffers, Japan’s primary balance in FY2010 is expected to be worse than that in FY2003.

[3] Social infrastructures Improvement, Food Supply, Trade Reinsurance, Fiscal Investment and Loan Program (Investment Account), Registrations, Patent Registration, and Agricultural Mutual Aid Reinsurance.

Chart 5: The Primary Balance of Central Government (General Account)



Note: The primary balance is calculated as follows: national debt-service minus government bond Issues. Settlement-basis up to FY2008, supplementation-basis up to FY2009, and initial-basis For FY2010.

Source: Made by MHRI based upon data released by the Ministry of Finance.

c. Revenue from government bonds

As explained above, although the government decided to limit the issuance of bonds to JPY44 trillion in FY2010, clearly this will not have any significant effect. The government provided as follows in the *Principles of Budget Formulation* (*Yosan hensei no kihon hoshin*) (December 15, 2009 Cabinet Decision). "The level of bond issuance should be consistent with the governmental attitude that attaches great importance to fiscal discipline. [Text is omitted] Given the current tough economic situation, the government needs to approve government bond issuance to some extent for fiscal expansion in the near future." "[Text is omitted] the issuance of government bonds in FY2010 will be limited to JPY44 trillion, which equals the sum of the bond issuance planned by the previous government in the first supplementary budget for FY2009." The government may have used this figure to gain market confidence regarding its ability to restore fiscal discipline because this JPY44 trillion attracted attention at the early stage of the budget drafting process. At present, since interest rates remain low, the government's commitment to bond issuance is having some effect. However, the problem is whether such a commitment will continue to function effectively in 2011 onwards.

To address this issue, the government is considering establishing stronger fiscal discipline in the budget formulation process for FY2011. The new budget formulation process has four key pillars (**Chart 6**). One of the objectives is to draw up budgets with a view to future years and propose the government's approach to achieve fiscal discipline. Specifically, in the FY2011 budget, the *Medium-Term Fiscal Policy Framework* (*Chuki zaisei furemu*) for expenditures and revenues over the next three years from FY2011 to FY2013 will be established. In line with this, the *Fiscal Management Strategy (Zaisei un-ei senryaku)* showing how the medium and long-term fiscal discipline should be achieved will be proposed. According to the *Principles of Budget Formulation*, details of the *Fiscal Management Strategy* will be worked out in light of (i) the reduction of Japan's structural budget deficit, and (ii) the reduction of the government debt-to-GDP ratio over the medium and long term, while referring to the fiscal consolidation measures of other countries. The details of fiscal discipline policy scheduled to be announced in June 2010 are unknown. However, given that the DPJ's fiscal management is causing substantial concerns, the government needs to propose measures, as specific as possible, on how to secure revenues, along with its objectives for restoring fiscal health.

Chart 6: The Budget Formulation in FY2011 Onward

The first pillar: Adopt a top-down budget approach with a view to multiple-year appropriation	● Realize a virtual multiple-year budget formulation ● Formulate a Medium-Term Fiscal Policy Framework for expenditures and revenues over the next three years (FY2011-FY2013) ● Formulate a Fiscal Management Strategy including the medium to long-term fiscal discipline
The second pillar: Transparency and visualization of the budget formulation and execution process	● Enhance information disclosure via the Internet regarding budget formulation and execution ● Compare budget estimates with actual results (revenues and expenditures) along with the formulation of the Medium-Term Fiscal Policy Framework
The third pillar: Eliminate wasteful budget execution, including irresponsible spending to use up the budget at the end of fiscal year	● The Budget Inspection Team will put together and announce achievement results and improvement plans after the end of each fiscal year. ● Consider classifying expenses into larger categories
The fourth pillar: Show achievement results by introducing the Policy Achievement Goals Manifestation System	● Full-scale implementation of the Policy Achievement Goals Manifestation System ● Each Ministry will set forth Policy Achievement Goals and Achievement Plan which are consistent with the Medium-Term Fiscal Policy Framework

Source: National Policy Unit.

３. The FY2010 Tax Revision

Now, let us turn to the FY2010 tax revision. Among the issues raised in the debate over the FY2010 tax revision, the following drew particular attention: (i) the abolition of the deduction for dependents with regard to the national individual income tax (referred to herein as the "Income Tax") and local individual inhabitant tax (referred to herein as the "Inhabitant Tax"), (ii) the elimination of provisional rate in gasoline and other automobile-related taxes and the whether to introduce the environment tax, (iii) the tobacco tax increase, and (iv) the elimination of some of the STMs.

(1) Partial abolition of the deduction for dependents with regard to the Income Tax and the Inhabitant Tax

During its election campaign, the DPJ administration called for the repeal of the deduction for dependents with regard to Income Tax, to secure a stable revenue source to pay for child allowances. However, in FY2010, this will only be carried out on a very limited scale.

Initially, the government intended to abolish all general income tax deductions (JPY380,000 per person) for families with dependents, excluding people with physical disabilities and older people (aged 70 and over). But in the end, in line with the coverage of the child allowance program, it decided that only families with children aged 15 and under will be excluded from the eligible list for general income tax deductions for families with dependents. General deductions for families with dependents in the 23-69 age bracket will remain unchanged because they will not be subject to the new tax cut such as the child allowance program. With respect to special deductions for families with children in the 16-22 age bracket (JPY380,000 yen + JPY250,000 (premium portion) per person), families with children in the16-18 age bracket are no longer eligible for the premium portion because they will benefit from free public high school education. Similar measures will be taken for the Inhabitant Tax. The government has decided that families with children aged 15 and under are no longer eligible for the general deduction of Inhabitant Tax (JPY330,000 per person) and families with children in the 16-18 age bracket are no longer eligible for the premium portion (JPY120,000 per person). Savings created by abolishing dependent care tax exemptions for families with children aged 15 and under are estimated at JPY0.5 trillion yen from the Income Tax, and JPY0.4 trillion from the Inhabitant Tax.

As a result of the introduction of child allowances and the abolition of tax deductions for families with children aged 15 and under, the burden on families will change as follows[4] (**Chart 7**). Assuming that a family has one dependent, a 10% tax rate is imposed on

[4] In fact, general deduction for this age group (children aged 15 and under) from Income Tax will be abolished from January 2011, and from Inhabitant Tax from June 2012.

taxable income (in fact, a 10% tax rate is imposed across the board on the Inhabitant Tax) and the monthly child benefit for children in the 3-12 age bracket is JPY5,000 per child, under the current taxation system. Then, since JPY380,000 and JPY330,000 are deducted respectively from the Income Tax and Inhabitant Tax under the current system, the abolition of these two deductions would make the amount of tax payable by that family will increase by JPY71,000 (=JPY38,000 + JPY33,000). If a family has a child under 3 and is a recipient of child benefit, their allowance will increase by JPY36,000 (=JPY156,000 – JPY120,000) after the introduction of the child allowance program, resulting in a tax increase of JPY35,000 (JPY36,000 – JPY71,000= -JPY35,000). If a family has a child in the 3-12 age bracket and is a recipient of child benefit, their allowance will increase by JPY96,000 (=JPY156,000 – JPY60,000) after the introduction of the child allowance program, resulting in a tax decrease of JPY25,000 (JPY96,000 – JPY71,000 = JPY25,000).

A family that is not currently the recipient of child benefit will receive JPY156,000 after the introduction of the child allowance program. This benefit will be worth JPY85,000 (JPY156,000 – JPY71,000 = JPY85,000). Families with children in the 13-15 age bracket will receive a similar benefit. For a family with a child in the 16-18 age bracket, the benefit will be worth JPY120,000 thanks to the introduction of free public high school education, but their tax will increase by JPY37,000 in terms of Income Tax and Inhabitant Tax because of the abolition of the special tax deduction for families with dependents. This means that their benefit will be worth JPY83,000 (JPY120,000 - JPY37,000 = JPY83,000). Families with dependents aged 19 and over will see no changes.

In reality, the number of children and tax rate brackets are different from family to family, so the impact on families of the introduction of the child allowance program and the partial abolition of the deduction for families with dependents is not limited to the cases given above. But generally speaking, families with primary school children that have not been eligible to receive child benefits because of the income cap and those with junior high or senior high school children will both benefit greatly from the child allowance program and free public high school education.

Chart 7: The "Child Allowance and Free Public High School Education" and the Abolition of the Deduction for Dependents (Income Tax and Inhabitant Tax)

Age of dependent	Younger than age 3	3-12 years old	13-15 years old	16-18 years old	19-22 years old	23-69 years old	Aged 70 or older
Plus factors	JPY156,000	JPY156,000	JPY156,000	JPY12,000	No changes		
	Child allowance JPY156,000	Child allowance JPY156,000	Child allowance JPY156,000	Free public high school education JPY12,000			
	Of which are child benefits JPY120,000	Of which are child benefits JPY60,000					
Minus factors	Abolition of deduction for dependents (Income Tax) JPY38,000	Abolition of deduction for dependents (Income Tax) JPY38,000	Abolition of deduction for dependents (Income Tax) JPY38,000	Abolition of premium portion of deduction for dependents (Income Tax) JPY25,000	No changes		
	Abolition of deduction for dependents JPY33,000	Abolition of deduction for dependents (Inhabitant Tax) JPY33,000	Abolition of deduction for dependents (Inhabitant Tax) JPY33,000	Abolition of premium portion of deduction for dependents (Inhabitant Tax) JPY12,000			
	JPY71,000	JPY71,000	JPY71,000	JPY37,000			
Net benefit	① Households which were recipients of child benefits: -JPY35,000 ②Households which were not recipients of child benefits: +JPY85,000	①Households which were recipients of child benefits: +JPY25,000 ②Households which were not recipients of child benefits: +JPY85,000	+JPY85,000	+JPY83,000	±JPY0		

Note: All figures are calculated assuming one dependent, a 10% tax rate, and a monthly child benefit of JPY5,000/month for children aged 3 to 12.
Source: Made by MHRI.

(2) Abolition of the provisional rate in gasoline and other automobile-related taxes

The government has decided to repeal the system setting forth the provisional rate on gasoline and other automobile-related taxes (worth JPY2.5 trillion), but maintain the current level of taxation "for a while" with regard to the gasoline tax, local gasoline tax, light-oil delivery tax and automobile acquisition tax. With respect to the automobile weight tax, the original tax rates (without the provisional tax rate) apply to next-generation automobiles (electric cars, hybrid cars, etc.), whereas the current provisional tax rates or similar rates continue to apply to gasoline-fueled cars with high CO2 emissions. As a result, about half of the provisional tax rates on the automobile weight tax, worth JPY166 billion, will be cut **(Chart 8)**.

In the case of the environment tax (global warming prevention tax), the government has decided to explore the possibility of its introduction in FY2011.

Chart 8: FY2009 Tax Revenues from Automobile-Related Taxes

(JPY trillion)

		FY2009	Original tax rate	Provisional tax rate
National Taxes	Gasoline tax	2.6	1.3	1.3
	Liquefied petroleum gas tax	0.01	0.01	-
	Automobile weight tax	0.6	0.28	0.36
	Total	3.3	1.6	1.7
Local Taxes	Local gasoline tax, liquefied petroleum gas tax, automobile weight tax (transferred tax)	0.6	0.4	0.2
	Automobile acquisition tax	0.25	0.17	0.08
	Light-oil delivery tax	0.9	0.4	0.5
	Automobile and light vehicle tax	1.8	1.8	-
	Total	3.6	2.8	0.8
Grand total		6.9	4.4	2.5

Source: Made by MHRI based upon data released by the Ministry of Finance.

(3) Tobacco tax

The government has announced that the tobacco tax rate will be increased by JPY3.5 per cigarette from October 2010 (in total, an increase of JPY5, including the amount raised by tobacco manufacturers), resulting in the retail price of a pack of cigarettes rising from the current JPY300(approx) to JPY400(approx). The government estimates this will bring in JPY160 billion this fiscal year to central and local governments. However, because this figure depends upon cigarette consumption, its achievement is uncertain.

(4) Special Taxation Measures

Even before taking office, the DPJ was intent on tackling Special Taxation Measures (STMs). However, in the tax revision for FY2010, the government decided to keep most of the measures intact. In FY2009, the STMs resulted in revenue losses of JPY7 trillion to the government, except the provisional gasoline taxes, which brought in more income (**Chart 9**). STMs are classified into three major categories; “income tax-related”, “corporate tax-related” and “others”. The cost of items under the “others” category, including tax exemptions for naphtha totaling JPY2.7 trillion, is the highest among the three categories. The second highest is the income tax-related category, which includes tax exemptions for housing loans and the dividend tax relief. The corporate tax-related category – the main target in the elimination of STMs – will only generate a JPY800 billion revenue increase. And since a large portion of the JPY800 billion comes from R&D promotion and other activities aimed at improving corporate productivity, the drastic reform of this category was considered difficult from the outset.[5]

The FY2010 tax revision saw the continuation of many STMs, resulting in a revenue increase of a mere JPY100 billion. The tax on naphtha, which is rather exceptional in the world, remains unchanged, whereas some of the STMs, including the tax incentives to help strengthen information infrastructure for businesses under the corporation tax-related category, were eliminated. The tax incentives for R&D small and medium-sized enterprise investment promotion continue to apply for a further two years. The government has already stated that it will enact a law for the improvement of transparency of STMs and undertake a drastic overhaul of the STMs over the next four years. While the overhaul itself seems reasonable, the government would find it difficult to secure large revenue from it.

Chart 9: Special Taxation Measures (FY2009)

(JPY billion)

	Revenue loss (Estimate)	Revenue Increase (Estimate)	Difference
Income Tax-related	1,582	-	-1,582
Mortgage loan tax credit	856		
Dividend tax relief	320		
Corporate Tax-related	1,138	+331	-807
R&D incentives tax credit	254		
SME investment promotion tax credit	250		
Special rule of corporation tax rate for SMEs	110		
Entertainment expenses not qualifying for deduction		+331	
Others	4,631	+1,899	-2,732
Provisional rates in gasoline and other automobile-related taxes		+1,899	
Tax exemption for naphtha	3,594		
Total	7,351	+2,230	-5,121

Source: Made by MHRI based upon the "Heisei 21nendoban sangyo zeisei handobukku" (*FY2009 Handbook of industrial taxation).*

(5) Programs carried over to FY2011 and beyond

As described above, not all of the key tax revisions proposed by the Hatoyama administration were implemented in the FY2010 tax revision. Most will be carried over to the next fiscal year and beyond (**Chart 10**). This is partly because there was not enough time for discussions due to the change of government, and partly because large

[5] Referring to the revision to the U.S. tax system in 1986 (the revision to broaden tax bases by reviewing the tax incentive scheme), some are calling for a tax revenue increase through an overhaul of the current STMs. However, the U.S. revision includes the elimination of investment tax credit, depreciation rates cuts, capital gain tax raises and tax increases in pension investment management, etc. Its details differ greatly from those of Japan's STMs.

scale tax increases were avoided due to an Upper House election scheduled this year. In fact, the postponed reforms include measures to reduce corporate income tax rates for small and medium-sized businesses (from 18% to 11%), but many are measures to raise tax.

Chart 10: Key Points in the FY2010 Tax Revision and Programs Carried Over to FY2011 Onward

FY2010	FY2011 onward
・ Abolish general deductions for dependents (15 and under) with regard to the Income Tax and the Inhabitant Tax; reduce special deductions for dependents (abolish the premium portion) ・ Abolish provisional rates in gasoline and other automobile-related taxes, while maintaining the current level of tax rates "for the time being" ・ Abolish some Special Taxation Measures ・ Raise the tobacco tax rate (from JPY300 to JPY400 per pack) ・ Raise the gift tax exemption from JPY5 million to JPY15 million	・ Abolish the deduction for a dependent spouse with regard to the Income Tax and the Inhabitant Tax ・ Lower the reduced tax rate for SMEs in corporation tax (from 18% to 11%)。 ・ Introduce an environment tax (global warning prevention tax) ・ Review Special Taxation Measures (enactment of a law improving the transparency of the Special Taxation Measures) ・ Introduce a taxpayer identification number system ・ Introduce a "refundable tax credit" ・ Raise the Consumption Tax

Source: Made by MHRI.

Among them is the elimination of the deduction for a dependent spouse. This, along with the scrapping of deduction for dependents, was clearly stated in the *DPJ Manifesto* as a revenue source to pay for child allowances. However, since the deduction for a dependent spouse bears no direct relation to the shift in the government's child support policy "from income tax deduction to allowances," this tax deduction was excluded from the 2010 tax reform list. The government has decided to discuss this issue in the massive reform of the Income Tax for the next fiscal year and beyond.

The introduction of the environment tax (global warming prevention tax) was also put on hold to avoid creating the impression that the government was going off half-cocked. However, the tax is considered an important means to achieve CO2 reduction goals set by the Hatoyama administration in coming years. Also, as a revenue source this tax is expected to make up for lost revenues resulting from the elimination of provisional rates in gasoline and other automobile-related taxes. The government is expected to couple the introduction of the environment tax with the full abolishment of these provisional tax rates.

Other important tax reforms include a taxpayer identification number system and refundable tax credit. The former will be discussed in a project team that will be set up within the Government Tax Commission during FY2010. Since the taxpayer identification number system is indispensable to implementing refundable tax credit, its early introduction is desirable. Refundable tax credits are regarded as an important step in implementing a broad range of policies, including allowances for low-income people, a cap on income in the child allowance program (or the child tax credit program), and the alleviation of the Consumption Tax (value-added tax). A method for approving an amount equal to the Consumption Tax burden on food as tax credit will take an important role if the Consumption Tax rate exceeds 10%. There is a growing perception that multiple tax rates currently in force in Europe will not be desirable as a measure to ease the regressivity of VATs because of the difficulty in administering them. As a means to reduce the regressive impact of the Consumption Tax while at the same time making use of the advantages of the broad tax bases in our Consumption Tax system, the Consumption Tax credit (like the GST credit in Canada) is promising. If such a method eliminates the public's tendency to avoid Consumption Tax hikes, the government will be able to secure a stable long-term revenue source. The DPJ has been in favor of introducing refundable tax credits, so we can expect to see progress in this area from FY2011.

４. Assessment of the Hatoyama administration's fiscal management and its future challenges

This paper has attempted to summarize the main points of the FY2010 budget. Finally, let us make an overall assessment of this budget and consider the fiscal challenges to be tackled in coming years.

The Hatoyama administration's fiscal policy management deserves commendation for the rise in transparency of the budget formulation process. The Government Revitalization Unit's budget screening process has played a certain role in a new initiative to cut wasteful government programs. With very little time for discussions and the lack of clarity in selection criteria applied for screeners and target programs, some criticized the way this budget screening was conducted. However, it is quite important that the Hatoyama administration broke the tradition of closed discussions among bureaucrats in the budget formulation process and made it open to the public. Such a high level of transparency would never have been realized without the change of power. The administration intends to foster a more transparent budget drafting and executing process for FY2011 onward (**Chart 6**). To do so, the government has to review this year's fiscal budget formulation process and make further efforts so that this transparency stays.

On the other hand, there are three main issues to be considered. First, the government should review the JPY207 trillion budget (including the general and special accounts) that the DPJ proposed in its manifesto. Despite its initial enthusiasm, the budget formulation fell into its conventional practice of paying attention only upon the general account on a single year basis at the peak of the budget formulation process. This led to the government's curbs upon issuance of new government bonds by tapping into the "hidden reserves."

Secondly, the Hatoyama administration should not avoid discussions on tax hikes. The government is seeking to expand expenditure without raising taxes, but this approach is dangerous. The market will most likely lose confidence in the new government if nothing is done to address the debt problem. The Hatoyama administration should retract its previous statement, and start discussing specific measures to increase taxes while at the same time indicating clear fiscal goals. As became apparent during the 2010 budget drafting process, savings from cuts of wasteful spending fall far short of rising expenditure on the social security programs that Japan needs. The government must present clear long-term fiscal goals, and steadily take measures to secure revenues or make preparations to that end. The taxpayer identification number system and refundable tax credit aimed at easing the regressivity of the Consumption Tax are important in this regard.

Thirdly, the government needs to move forward tax reforms and spending reforms in a unified manner. The Hatoyama administration is working to reduce public works spending and introduce child allowances. However, slashing spending on public works will weaken the government's function of redistributing income to poor local districts. A child allowance program with no income cap does not have an income redistribution function. Consequently, under the new government, the income distribution function will be weaker as a whole than that of its predecessors. The Hatoyama administration needs to ask itself whether this is consistent with its political philosophy.

If the government seeks efficiency in one policy, it must seek to achieve equality in other policies. It is necessary to keep a balance among different policies by taking into account both tax and expenditure. If the government cannot achieve sufficient fairness through the tax system due to the difficulty of taxing highly mobile capital and other reasons, the role of government spending as an income redistribution function will be all the more important. The government needs to consider the basic question of what degree of fairness the tax system can achieve, and how much wealth should be redistributed to individuals through the government's spending policy. A mere shift of the focus of financial support away from corporations to households is not enough to achieve the DPJ's policy goals that attach great importance to families. It is necessary to establish a system that ensures adequate redistribution of income to individuals.

Appendix: The FY2009 Second Supplementary Budget

The second supplementary budget for FY2009 includes allocations of JPY7.2 trillion for an economic stimulus package (scale of operation JPY24 trillion) aimed at preventing the Japanese economy from sinking into a double-dip recession, and the adjustment for the shortfall in tax revenues (**Chart A**).

Chart A: FY2009 Second Supplementary Budget

Expenditures	Revenues
1. Economic stimulus package: JPY7.2 trillion (a) Employment, environment, economy, and measures to ease anxiety in people's daily lives: JPY3.7 trillion (b) Support for local governments: JPY3.5 trillion 2. Reductions in existing expenditures: -JPY7.3 trillion (a) Suspension of the execution of the FY2009 first supplementary budget: -JPY2.7 trillion (b) Decrease in local allocation tax grants due to lower tax revenues: -JPY3 trillion (c) Reductions in reserves for economic emergency Responses: -JPY0.15 trillion (d) Reductions in reserves for general purpose: -JPY0.1 trillion (e) Reductions by eliminating disused existing expenditures: -JPY1.4 trillion	1.Tax revenues: -JPY9.2 trillion (after FY2009 first supplementary budget: JPY46.1 trillion → JPY36.8 trillion) 2. Government bond issues: JPY9.3 trillion (a) Construction bonds: JPY0.1 trillion (b) Special deficit-financing bonds: JPY9.2 trillion (after FY2009 first supplementary budget: JPY44.1 trillion → JPY53.5 trillion)
Total: JPY0.08 trillion	Total: JPY0.08 trillion

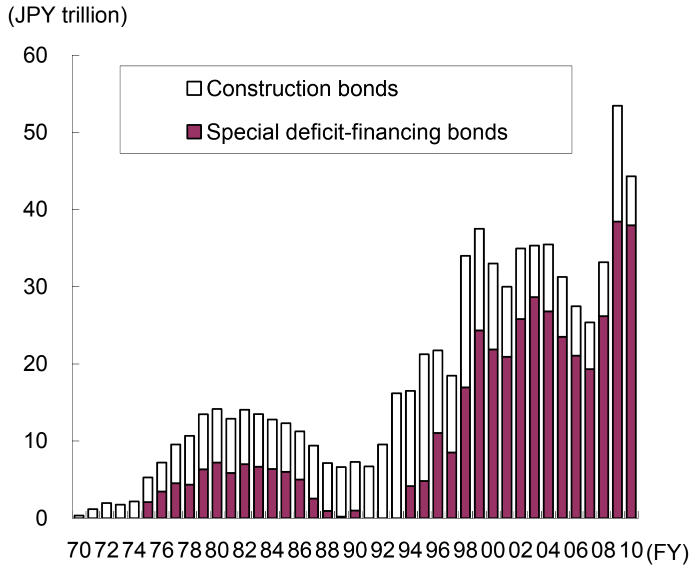
Source: Source: Made by MHRI based upon data released by the Ministry of Finance.

Of the JPY7.2 trillion economic stimulus package, JPY3.5 trillion was appropriated for the payment of local allocation tax grant, and the remaining JPY 3.7 trillion was used for demand stimulating measures. The main elements of the measures are employment (JPY614 billion), environment (JPY776.8 billion), business (JPY1.5742 trillion), and people's daily lives (JPY784.9 billion). In the area of employment, as part of emergency measures, JPY264 billion was allocated to expand the housing scheme for the poor or needy who are unemployed, and to create jobs in priority areas such as nursing care services, medical services, agriculture, environment and energy. JPY350 billion was allocated to strengthen the function of the unemployment insurance system. In the area of environmental polices, JPY594.5 billion was allocated to extend the period in which eco-points can be used, introduce the eco-point system for housing construction, and promote environmentally friendly cars. In the area of business, JPY1.1742 trillion were allocated to create the "Counter-Recessionary Emergency Credit Guarantee System" and expand safety-net loans, whereas JPY400 billion was allocated to reinforce housing finance, including mortgage rate cuts for the Flat 35S of the Japan Housing Finance Agency. In the area of people's daily lives, funds were allocated for the continuation of measures to reduce the burden of the medical care system for the elderly, and provide livelihood support through welfare benefit programs.

Resources to fund the implementation of the second supplementary budget for FY2009 come from JPY2.7 trillion included in the first supplementary budget for FY2009 for which the Hatoyama administration decreed the suspension of execution, and JPY1.5 trillion including the Reserve Funds for Emergency Economic Countermeasures and reserve funds in the FY2009 initial budget and the elimination of disused existing expenditures.

With regard to adjustments for the shortfall in tax revenues, tax revenues were revised down from JPY46.1 trillion in the initial budget to JPY36.8 trillion. As a measure to cope with the fall in tax revenues, the government decided to issue additional deficit bonds of JPY9.3 trillion (including the amount appropriated to local allocation tax grant). As a result, the total issuance of government bonds after the second supplementary budget for FY2009 increased to JPY53.5 trillion from JPY44.1 trillion (**Chart B**).

Chart B: Trends in New Government Bond Issues



Note: FY2009: based on the budget after supplementation
FY2010: based on the initial budget

Source: Made by MHRI based upon data released by the Ministry of Finance.

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