Japan 2013

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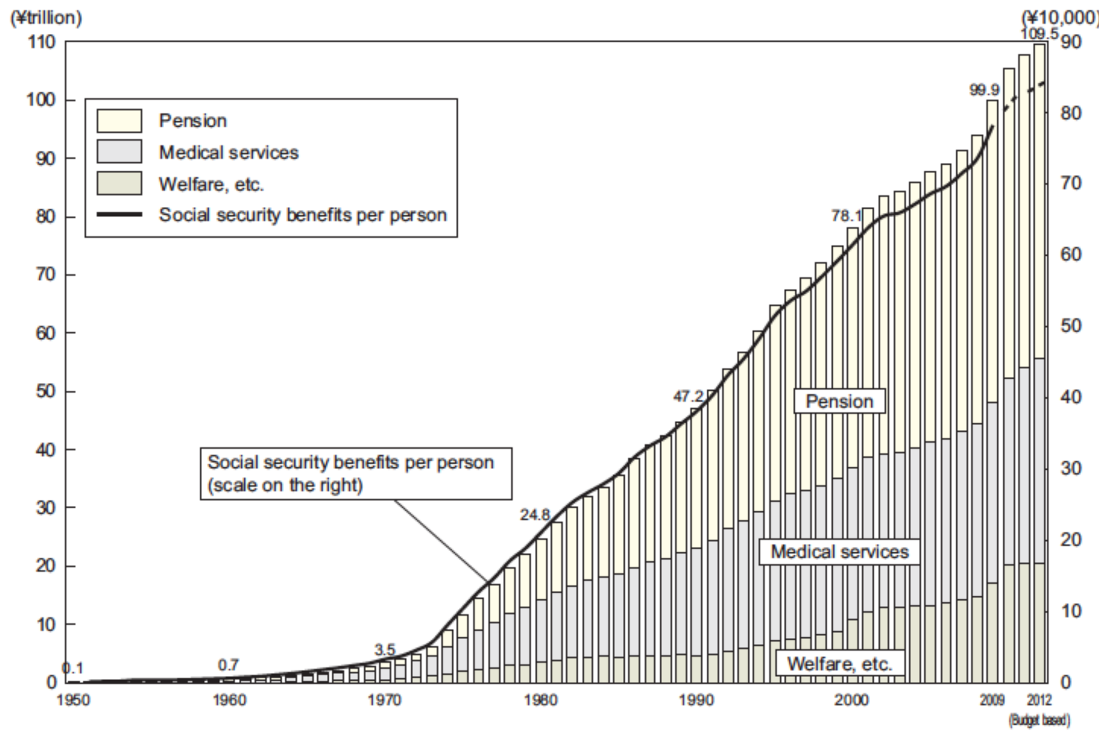
This year has been very exciting, with the introduction of "Abenomics" which is really just money-printing by the BoJ. The other aspects of Abenomics, "fiscal stimulus" and "structural reforms," amount to a big bag of nothing in my opinion.

However, I thought I would start with a look into a portion of the Japanese tax system which is not well understood -- what amounts to the payroll tax. In Japan, this is termed a "social security contribution" and is not officially part of the tax system, although functionally it is a payroll tax just like in the U.S. ("Social Security" refers to all public welfare policies in Japan, including public pensions, healthcare, and all other welfare programs.) "Social security" doesn't appear on the budget of either national or local governments at all, except as a lump-sum payment to the Ministry of Health, Labour and Welfare. The portion on the national and local budgets is actually the funding on top of the revenue from the "social security contributions."

Overview

Trends in Social Security Benefits

	1970	1980	1990	2000	2012 (budget based)
National Income (¥trillion) A	61.0	203.9	346.9	371.8	349.4
Total Benefits (¥trillion) B	3.5 (100.0%)	24.8 (100.0%)	47.2 (100.0%)	78.1 (100.0%)	109.5 (100.0%)
(Breakdown) Pension	0.9 (24.3%)	10.5 (42.2%)	24.0 (50.9%)	41.2 (52.7%)	53.8 (49.1%)
Medical services	2.1 (58.9%)	10.7 (43.3%)	18.4 (38.9%)	26.0 (33.3%)	35.1 (32.1%)
Welfare, etc.	0.6 (16.8%)	3.6 (14.5%)	4.8 (10.2%)	10.9 (14.0%)	20.6 (18.8%)
B / A	5.77%	12.15%	13.61%	21.01%	31.34%



Source: "Social Security Benefits FY2009", National Institute of Population and Social Security Research
FY2010-2012 (budget based) - Estimated by the MHLW
National Income for FY2012 - "Fiscal 2012 Economic Outlook and Basic Stance for Economic and Fiscal Management" (Decided by the Cabinet on January 24, 2012)

(Note) The figures shown in the diagram are social security benefits (¥trillion) of 1950, 1960, 1970, 1980, 1990, 2000, 2009, and FY2012 (budget based).

Expenditures on all "Social Security" were ¥109.5 trillion in 2012.

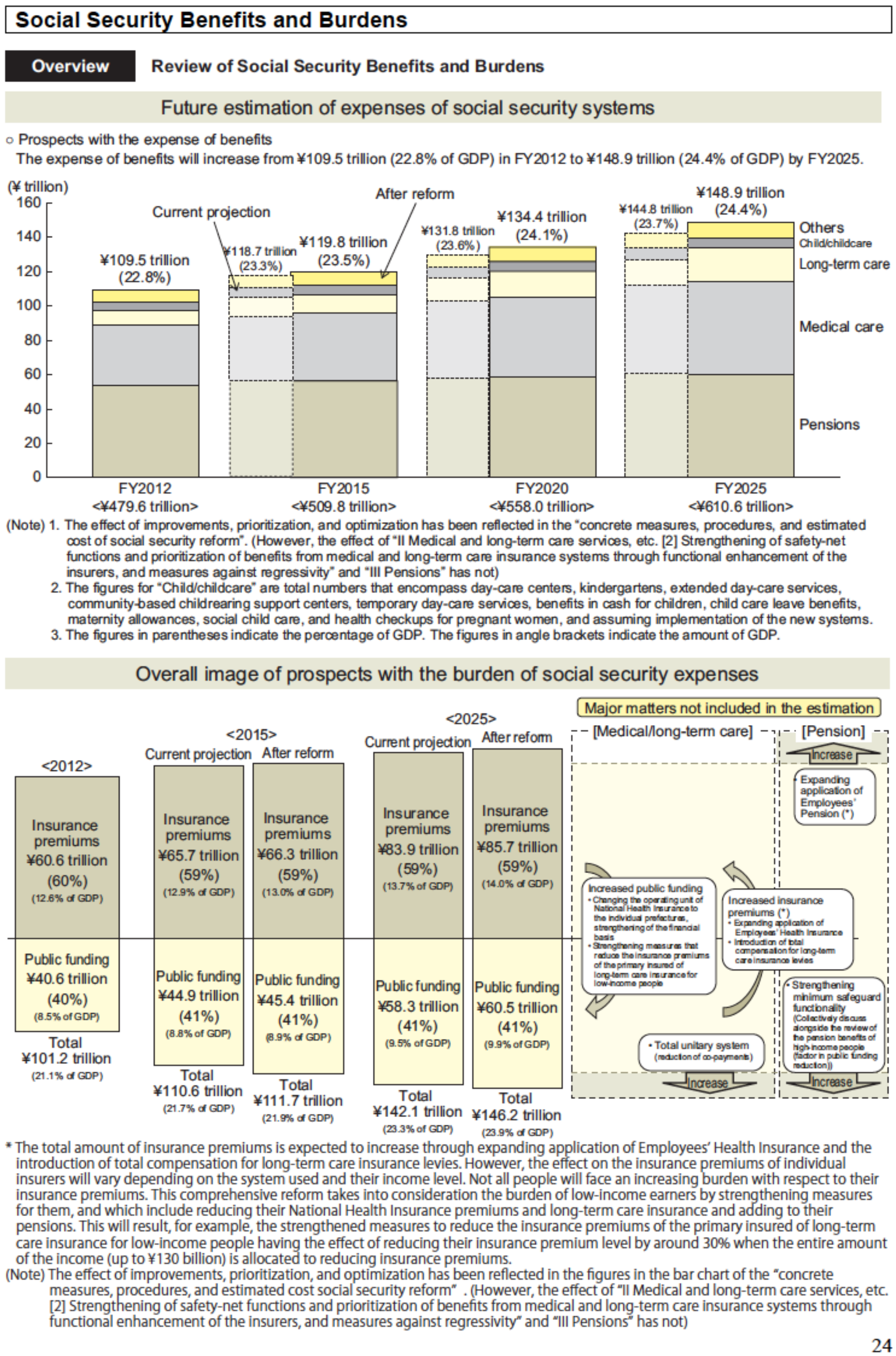
Detailed Data 2 **Changes in Social Security Benefits (in Percentage of National Income) by Category**

(Unit: %)

FY	Social security benefits (in percentage of National Income)				National Income (¥100 million)
	Total	Medical services	Pension	Welfare, etc.	
1951	3.54	1.81	1.73		44,346
1952	4.21	2.20	2.01		52,159
1953	4.29	2.47	1.83		60,015
1954	5.83	2.60	3.23		65,917
1955	5.58	2.75	2.83		69,733
1956	5.05	2.56	2.49		78,962
1957	4.91	2.51	2.41		88,681
1958	5.41	2.24	3.18		93,829
1959	5.23	2.28	2.95		110,421
1960	4.86	2.18	2.68		134,967
1961	4.91	2.39	2.52		160,819
1962	5.15	2.63	2.53		178,933
1963	5.31	2.79	2.53		210,993
1964	5.60	3.05	1.27	1.29	240,514
1965	5.98	3.41	1.31	1.26	268,270
1966	5.90	3.40	1.33	1.17	316,448
1967	5.76	3.35	1.32	1.10	375,477
1968	5.74	3.36	1.33	1.05	437,209
1969	5.52	3.26	1.33	0.93	521,178
1970	5.77	3.40	1.40	0.97	610,297
1971	6.11	3.41	1.55	1.15	659,105
1972	6.40	3.61	1.59	1.20	779,369
1973	6.53	3.58	1.75	1.21	958,396
1974	8.03	4.20	2.38	1.45	1,124,716
1975	9.49	4.61	3.13	1.75	1,239,907
1976	10.34	4.85	3.80	1.68	1,403,972
1977	10.85	4.90	4.23	1.72	1,557,032
1978	11.51	5.19	4.56	1.76	1,717,785
1979	12.07	5.36	4.93	1.77	1,822,066
1980	12.15	5.26	5.13	1.76	2,038,787
1981	13.03	5.44	5.69	1.89	2,116,151
1982	13.67	5.64	6.06	1.97	2,201,314
1983	13.82	5.66	6.23	1.93	2,312,900
1984	13.84	5.58	6.36	1.90	2,431,172
1985	13.69	5.48	6.48	1.73	2,605,599
1986	14.40	5.65	7.00	1.75	2,679,415
1987	14.49	5.69	7.11	1.69	2,810,998
1988	14.03	5.51	6.95	1.57	3,027,101
1989	13.99	5.46	7.03	1.50	3,208,020
1990	13.61	5.30	6.93	1.38	3,468,929
1991	13.59	5.29	6.94	1.36	3,689,316
1992	14.71	5.72	7.49	1.50	3,660,072
1993	15.55	5.97	7.95	1.63	3,653,760
1994	16.34	6.18	8.38	1.78	3,700,109
1995	17.54	6.52	9.08	1.94	3,689,367
1996	17.77	6.62	9.19	1.95	3,801,609
1997	18.16	6.62	9.52	2.02	3,822,945
1998	19.55	6.88	10.41	2.26	3,689,757
1999	20.59	7.24	10.95	2.40	3,643,409
2000	21.01	6.99	11.08	2.94	3,718,039
2001	22.53	7.37	11.78	3.37	3,613,335
2002	23.49	7.38	12.47	3.63	3,557,610
2003	23.53	7.43	12.51	3.59	3,580,792
2004	23.60	7.46	12.51	3.63	3,638,976
2005	23.99	7.68	12.65	3.66	3,658,783
2006	23.75	7.49	12.61	3.65	3,752,258
2007	24.16	7.65	12.76	3.75	3,784,636
2008	26.76	8.42	14.09	4.25	3,515,221
2009	29.44	9.09	15.25	5.09	3,392,234

Source: Up to FY1954 - "Annual Report on National Income Statistics 1978", Economic Planning Agency
From FY1955 to FY1977 - "Long-Term Retroactive Report of National Accounts", Economic Planning Agency
From FY1978 to FY1979 - "Annual Report on National Accounts 2000", Economic Planning Agency
From FY1980 to FY2009 - "Annual Report on National Accounts 2011", Economic and Social Research Institute, Cabinet Office

In 2009, all expenditures amounted to 29.44% of National Income (21% of GDP)! This has more than doubled since 1990 (13.61% of National Income) and is vastly above the level of 1970 (5.77% of NI), which was the end of the great postwar economic boom. (The events of 1971, known in Japan as the "Nixon Shocks," put and end to the great postwar expansion although things still went pretty well until 1989.)



Note that "insurance premiums" (payroll tax revenues) were ¥60.6 trillion.

Here's what the central government's budget looks like for FY2013.

Outline of FY2013 Budget (General Account)

(Unit: billion yen)

	FY2012 Budget (Initial)	FY2013 Budget	FY2012 → FY2013	Notes
(Revenues)				
Tax Revenues	42,346.0	43,096.0	7,50.0	
Other Revenues	3,743.9	4,053.5	309.6	➢ Including surplus carried over from FY2011 220.0 billion yen, which is transferred to Special Account for Reconstruction from the Great East Japan Earthquake.
Government Bond Issues	44,244.0	42,851.0	−1,393.0	➢ Bond Dependency Ratio: 46.3% (FY2012 : 47.6% * Considering the amounts required to fill the gap between targeted one-half National contribution to basic pension and that of 36.5% in initial budget in FY2012)
Construction Bonds	5,909.0	5,775.0	−134.0	
Special Deficit-Financing Bonds	38,335.0	37,076.0	−1,259.0	
Pension Related Special Deficit-Financing bonds	—	2,611.0	2,611.0	
Total	90,333.9	92,611.5	2,277.6	
(Expenditures)				
National Debt Service	21,944.2	22,241.5	297.3	
Primary Balance Expenditures	68,389.7	70,370.0	1,980.3	➢ Adding expenses which are increased in FY 2013 budget, securing financial resources (the amounts which fill the gap between targeted one-half National contribution to basic pension and that of 36.5% in initial budget;2,597.0 billion yen / increasing Transfer to Special Account for Reconstruction from the Great East Japan Earthquake, the cost of Litigation related to the compensation for Type-B Hepatitis patients, etc. ;347.1 billion yen) to FY2012 budget 68,389.7 billion yen, the total amounts are 71,333.9 billion yen.
Social Security	26,390.1	29,122.4	2,732.3	➢ Including transfer to Special Account for Reconstruction from the Great East Japan Earthquake 1,246.2billion yen (550.7 billion yen in FY2012)
Local Allocation Tax Grants, etc	16,594.0	16,392.7	−201.3	➢ Securing the local general fiscal resources which include Local tax, Local Allocation Tax Grants, etc. with equivalent level to previous fiscal year.
Contingency Reserve for Economic Crisis Response and Regional Revitalization	910.0	—	−910.0	
Total	90,333.9	92,611.5	2,277.6	➢ Primary balance : −23.2 trillion yen (FY2012 : −24.9 trillion yen * Considering the amounts required to fill the gap between targeted one-half National contribution to basic pension and that of 36.5% in initial budget in FY2012)

As we see here, tax revenues from all non-local taxes (except the payroll taxes or "insurance contributions") are expected to come to ¥42.346 trillion. Which is a lot less than ¥60.6 trillion. This ¥42.346 trillion includes all individual and corporate income taxes, plus the consumption tax. So, the payroll taxes are a big deal. Unlike the U.S. Federal government, which consolidates both payroll taxes and "social security" expenditures on the national budget, the Japanese central government keeps them "off budget" so to speak. You might say it is "very Japanese." Or, very Enron? (There's a lot more "off budget" in Japan, notably the Fiscal Investment and Loan Program, or FILP, which we talked about last year. See "Japan 2012" at newworldeconomics.com.) The line item for Social Security in the national budget is actually the funding for Social Security expenditures in excess of payroll tax revenues (the "public funding" of ¥40.6 trillion, which includes both national and local governments).

Basically, we have a system that was more-or-less appropriate for the realities of 1970, which is totally inappropriate for the realities of 2013. It just needs to be changed. But, instead of that, the government will choke off all economic activity in a failed attempt to sustain the unsustainable. It's the same story everywhere, just a bit more intense in Japan.

National Burden Ratio

Overview **Trends in National Burden Ratio (in the Percentage of National Income)**

FY	National Tax [1]	General Account tax revenue	Local tax [2]	Tax burden [3]=[1]+[2]	Social security burden [4]	National burden ratio [5]=[3]+[4]	Fiscal Deficit [6]	Latent national burden ratio [7]=[3]+[4]+[6]	National Income (NI)	(Reference) National burden ratio to-GDP ratio	(Reference) GDP
1970	12.7	12.0	6.1	18.9	5.4	24.3	0.5	24.9	61.0	19.7	75.3
1971	12.8	12.0	6.4	19.2	5.9	25.2	2.5	27.7	65.9	20.0	82.9
1972	13.3	12.5	6.4	19.8	5.9	25.6	2.8	28.4	77.9	20.7	96.5
1973	14.7	13.9	6.8	21.4	5.9	27.4	0.7	28.1	95.8	22.5	116.7
1974	14.0	13.4	7.3	21.3	7.0	28.3	3.3	31.6	112.5	23.0	138.5
1975	11.7	11.1	6.6	18.3	7.5	25.7	7.5	33.3	124.0	20.9	152.4
1976	12.0	11.2	6.8	18.8	7.8	26.6	7.2	33.8	140.4	21.8	171.3
1977	11.8	11.1	7.1	18.9	8.3	27.3	8.3	35.6	155.7	22.3	190.1
1978	13.5	12.8	7.1	20.6	8.5	29.2	8.0	37.1	171.8	24.0	208.6
1979	13.7	13.0	7.7	21.4	8.8	30.2	8.7	38.9	182.2	24.4	225.2
1980	13.9	13.2	7.8	21.7	8.8	30.5	8.2	38.7	203.9	25.0	248.4
1981	14.4	13.7	8.2	22.6	9.6	32.2	8.2	40.4	211.6	25.7	264.6
1982	14.5	13.9	8.5	23.0	9.8	32.8	7.9	40.6	220.1	26.1	276.2
1983	14.8	14.0	8.6	23.3	9.7	33.1	7.1	40.1	231.3	26.5	288.8
1984	15.1	14.4	8.8	24.0	9.8	33.7	5.9	39.7	243.1	26.6	308.2
1985	15.0	14.7	8.9	24.0	10.0	33.9	5.1	39.0	260.6	26.8	330.4
1986	16.0	15.6	9.2	25.2	10.1	35.3	4.3	39.6	267.9	27.7	342.3
1987	17.0	16.6	9.7	26.7	10.1	36.8	2.9	39.6	281.1	28.5	362.3
1988	17.2	16.8	9.9	27.2	9.9	37.1	1.4	38.5	302.7	29.0	387.7
1989	17.8	17.1	9.9	27.7	10.2	37.9	1.0	38.9	320.8	29.2	415.9
1990	18.1	17.3	9.6	27.7	10.6	38.4	0.1	38.5	346.9	29.5	451.7
1991	17.1	16.2	9.5	26.6	10.7	37.4	0.5	37.9	368.9	29.1	473.6
1992	15.7	14.9	9.4	25.1	11.2	36.3	4.5	40.8	366.0	27.5	483.3
1993	15.6	14.8	9.2	24.8	11.5	36.3	6.7	43.0	365.4	27.5	482.6
1994	14.6	13.8	8.8	23.4	11.8	35.2	8.1	43.3	370.0	26.6	489.4
1995	14.9	14.1	9.1	24.0	12.7	36.7	9.3	46.0	368.9	27.2	497.7
1996	14.5	13.7	9.2	23.8	12.7	36.5	8.7	45.2	380.2	27.2	509.1
1997	14.5	14.1	9.5	24.0	13.1	37.1	7.7	44.8	382.3	27.6	513.6
1998	13.9	13.4	9.7	23.6	13.5	37.2	10.6	47.7	369.0	27.2	503.3
1999	13.5	13.0	9.6	23.1	13.6	36.7	12.9	48.9	364.3	26.8	499.5
2000	14.2	13.6	9.6	23.7	13.6	37.3	9.9	47.2	371.8	27.5	504.1
2001	13.8	13.3	9.8	23.7	14.3	38.0	9.4	47.4	361.3	27.8	493.6
2002	12.9	12.3	9.4	22.3	14.5	36.8	11.1	47.9	355.8	26.7	489.9
2003	12.7	12.1	9.1	21.8	14.5	36.3	10.5	46.8	358.1	26.3	493.7
2004	13.2	12.5	9.2	22.4	14.3	36.8	8.2	44.9	363.9	26.8	498.5
2005	14.3	13.4	9.5	23.8	14.6	38.4	6.3	44.7	365.9	27.9	503.2
2006	14.4	13.1	9.7	24.2	14.7	38.9	4.6	43.5	375.2	28.6	510.9
2007	13.9	13.5	10.6	24.6	15.0	39.5	3.7	43.2	378.5	29.0	515.7
2008	13.0	12.6	11.3	24.3	16.3	40.6	6.9	47.5	351.5	28.9	494.2
2009	11.9	11.4	10.4	22.2	16.4	38.6	13.5	52.1	339.2	27.6	474.0
2010	12.1	11.5	9.8	21.9	16.8	38.7	11.9	50.6	345.5	27.9	479.2
2011	12.3	11.7	9.7	22.0	16.8	38.8	11.0	49.8	351.1	28.1	483.8
2012	13.0	12.1	9.8	22.7	17.1	39.9	11.4	51.2	349.4	29.1	479.6

Source: Ministry of Finance Japan

(Note) 1. The unit for National Income and GDP is ¥ trillion and is % for others.

2. The figures up to FY2010 are actual numbers, those for FY2011 expected numbers, and those for FY2012 projected numbers.

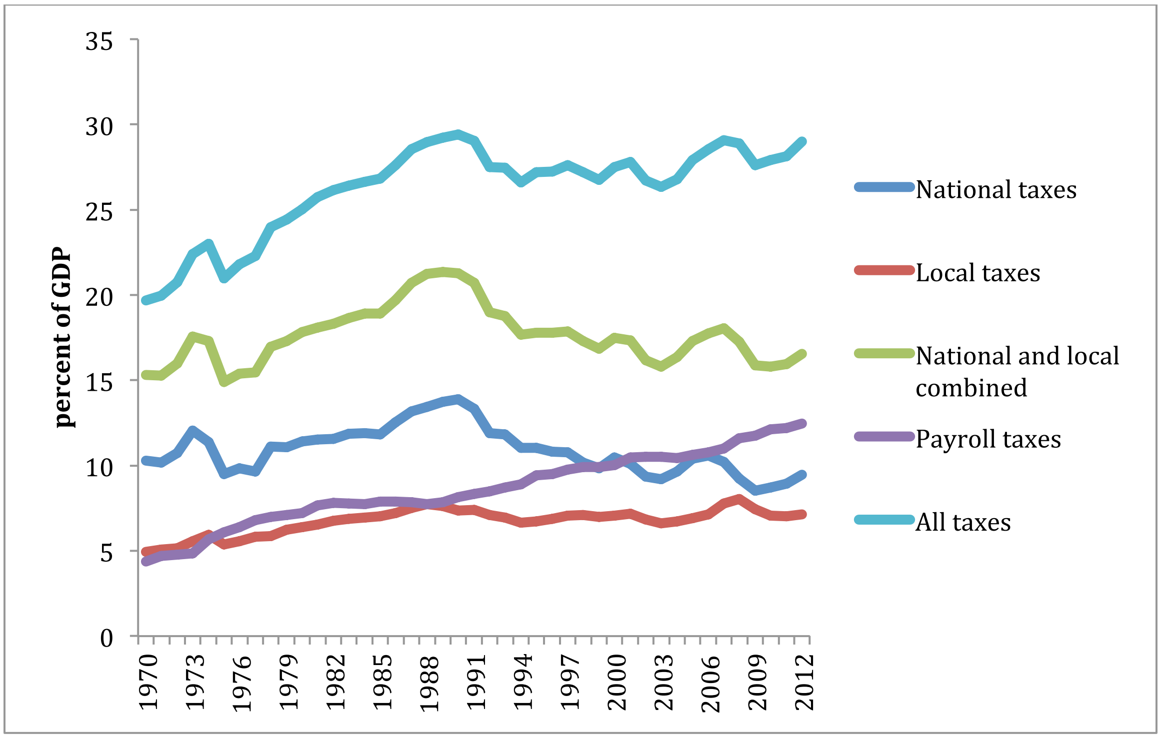
3. The figures on and after FY1980 are calculated based on 93SNA and those up to FY1979 are calculated based on 68SNA. However, figures for tax burdens are calculated based on tax revenues and differ from SNA-based figures.

4. The figures for National Tax include the Special Accounts and the levies on Japan Tobacco and Salt Public Corporation. Special local corporate taxes (the corporate business taxes partly introduced to the national taxes in the FY2008 tax reform. The total amount is transferred to local governments. The tax revenue in FY2012 is 0.5% of the National Income) are included in National Tax.

5. The social security contribution coefficient for FY2009 and FY2010 was adjusted to balance with the actual value in and before FY2008, etc.

6. The fiscal deficit figures indicate deficits in the national and local fiscal balances, and temporary special factors are excluded. More concretely, the long-term debt of the Japanese National Railways and accumulated debt of the National Forest Service were excluded in FY1998, the debt of the Honshu-Shikoku Bridge Authority was transferred to the General Account in FY2003, the influence of transferred assets and liabilities due to the privatization of the Four Highway-related Public Corporations in FY2005, transfer from the Fiscal Loan Fund Account of the Special Account for Fiscal Investment and Loan Program (Fiscal Loan Fund Special Account in FY2006) to the Special Account for the National Debt Consolidation Fund or General Account in FY2006, 2008, 2009, 2010, and 2011, and a transfer from the Japan Railway Construction, Transport and Technology Agency to the General Account in FY2011, etc.

Unfortunately, I don't have good information on changes in payroll tax rates over the years, not even recent years. However, we do have this information on payroll tax revenues as a percentage of GDP (or National Income). What we see from 1970 is that national taxes (individual and corporate income, plus the consumption tax which did not exist before 1989), amounted to 12.7% of NI in 1970 (10.3% of GDP) and 13.0% of NI (9.5% of GDP) in 2012. Not much change there, even despite the introduction of the consumption tax (national sales tax) at 3% in 1989 and its increase to 5% in 1997.



Japan: Tax Revenues as a Percentage of GDP, 1970-2012

I think that payroll tax rates have also gone up more-or-less in line with revenues during this time. Needless to say, this huge increase in taxes is certainly one major reason why the Japanese economy today struggles. Note that payroll tax revenues (as a percentage of GDP) flatlines in the 1980s, suggestive of stable rates during that time, then begins to grow again beginning around 1989. I don't think this is the only factor behind the economic slump since 1990, or even the most important, but it is nevertheless an important one.

The overall tax revenue/GDP ratio (blue line on top) has been stagnant since about 1990, but that is common. Higher tax rates do not produce more revenue, they just smother the economy. It appears that Japanese people have managed to find ways to avoid paying various kinds of income taxes (both corporate and individual), in response to the rising payroll and consumption tax rates, which are presumably more difficult to avoid.

This makes it easy to determine how much net revenue (as a percent of GDP) will be generated by any further payroll/consumption/income tax increases: zero! Indeed, the revenue will be negative in relative sense, since the effect of higher taxes would be a lower nominal GDP (compared to if nothing were done), and multiplying a stable revenue/GDP ratio by a lower GDP indicates less revenue than if nothing was done at all.

Note that total tax revenue as a percentage of GDP was 20% in 1970. This was actually an overt goal of the rather wonderful leaders of that time. They didn't want the government to be larger than 20% of GDP (and they didn't have deficits then either). Believe it or not, in those days, they actually cut tax rates every year because of *the risk that tax revenue might climb above their 20% bogey* -- and slow down their awesome economic expansion. Yes, government leadership on this level does happen, though it is of course rare. This is one reason I recommend in my book *Gold: the Monetary Polaris* that total government spending be kept below 20% of GDP, preferably around 15%. It is a level that is sufficient to fund a number of worthwhile programs, without crippling the private economy. We know this because it works, in Japan during the 1950s and 1960s, or Hong Kong and Singapore today.

> *In the early stages of the state, taxes are light in their incidence, but fetch in a large revenue; in the later stages the incidence of taxation increases while the aggregate revenue falls off ...*
>
> *As time passes and kings succeed each other ... they impose fresh taxes on their subjects--farmers, peasants, and others subject to taxation; sharply raise the rate of old taxes to increase their yield; and impose sales taxes ... until taxation burdens the subjects and deprives them of their gains. People get accustomed to this high level of taxation, because the increases have come about gradually, without anyone's being aware of who exactly it was who raised the rates of the old taxes or imposed the new ones.*
>
> *But the effects on business of this rise in taxation make themselves felt. For business men are soon discouraged by the comparison of their profits with the burden of their taxes, and between their output and their net profits. Consequently, production falls off, and with it the yield of taxation.*
>
> *The rulers may, mistakenly, try to remedy this decrease in the yield of taxation by raising the rate of taxes. ... This process of higher tax rates and lower yields (caused by the government's belief that higher rates result in higher returns) may go on until production begins to decline owing to the despair of business men, and to affect population. ...*
>
> *From this you must understand that the most important factor making for business prosperity is to lighten as much as possible the burden of taxation ....*

--14th century Arab genius Ibn Khaldun

The most recent change in payroll tax policy that I know of was a measure passed in 2003 to raise the payroll tax rate from 13.6% in 2003 to 18.7% in 2017 in small increments each year. This tax rate is paid by both employer and employee (i.e., 18.7%+18.7%), and has no upper limit on income. You can see why it generates so much revenue. I think payroll tax rates are still clicking higher each year from this policy, which is evidenced by the growing revenue of the payroll taxes as a percent of GDP. (According to one source, the rates are 15.448% paid by employer and 14.643% paid by employee as of August 2013. This may be outdated.)

The point is, the Japanese economy has been subject to a steady increase in tax rates, with the usual predictable effects -- no increase in total revenue (as a percentage of GDP), but a deteriorating economy.

To this we can add some new developments for 2013. The top rate for individual income taxes rose by 5% to 55%. (This is on top of payroll taxes, which apply to all payroll income.) Basic deductions on inheritance taxes shrank by 40%, while the top rate on inheritance taxes rises to 55%. Going forward, the consumption tax is scheduled to rise from 5% to 8% in April 2014, although there is some possibility that this could be postponed. It is scheduled to rise again to 10% in October 2015. It appears that the capital gains tax on equities has remained at 10%, although this is scheduled to rise to 20% at some point -- maybe soon since the stock market has been rising so much, and thus presumably stock investors "can afford it." (Capgains on equities were effectively tax-free until 2003.)

Corporate taxes fell, officially from 30% (national) to 25%, although there is a 10% surtax that applies until 2015, resulting in an effective 28% rate. Also, the corporate tax base was "broadened," so it remains a question whether corporate taxes were effectively lowered at all. Local-level taxes push the effective corporate tax rate to 38%. As of 2013, an additional 2.1% surtax was placed on dividends, royalties, interest and technical fees, resulting in a 20.42% tax rate, up from the headline 20% rate. The capital gains tax rate on real estate is apparently 39% for short-term gains and 20% for long-term gains, for individuals. Very high capgains rates on real estate, on the order of 90% short-tem and 50% long-term, were a major issue in the 1990s. They were originally imposed as an overt "bubble-popping" policy beginning around 1990 (1988 in Tokyo), and remained at that level until, I believe, 1998. Which was a little stupid. But, they didn't get where they are by being smart, did they?

Debt and Deficits

Things haven't changed much in the debt and deficits category -- there's a lot of both. For 2013, the national budget plans ¥42 trillion of bond issuance, equivalent to 8.7% of GDP. On top of this, the Government Pension Investment Fund plans to sell about ¥4.7 trillion of bonds. I consider public pension funds (such as the U.S.

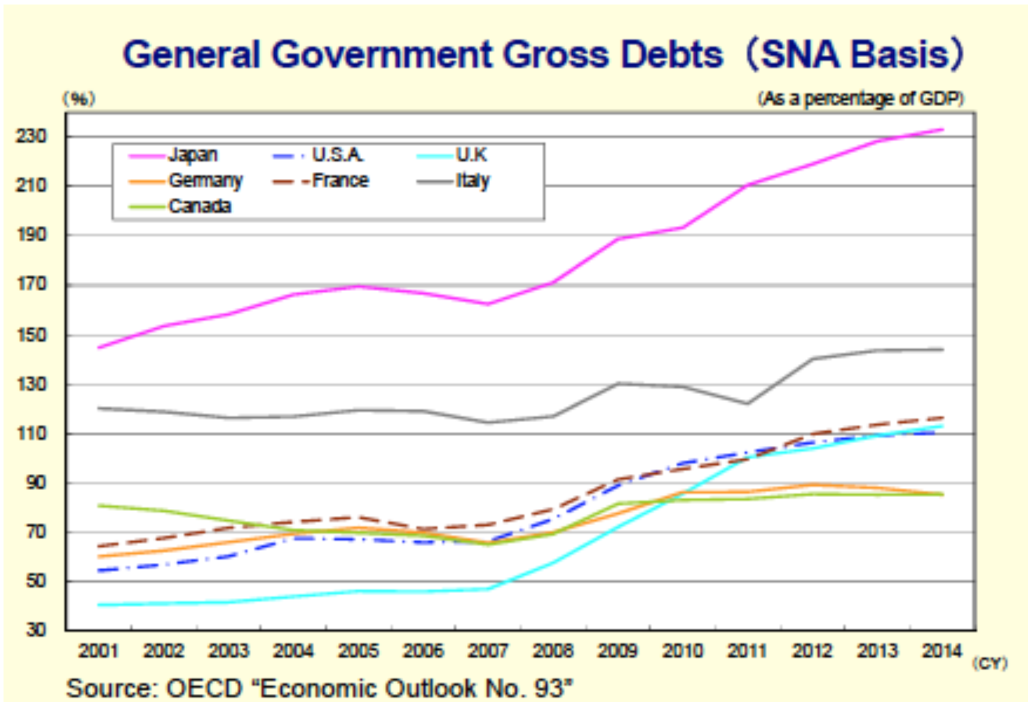
Social Security "trust fund") to be essentially internal accounting conventions, so the "selling" by the GPIF is essentially equivalent to regular bond issuance in my reckoning. More "supplemental budget" spending is likely (¥6.3 trillion in FY2012), as well as debt issuance from local governments, which apparently totaled ¥14.2 trillion in 2011 (other sources show around ¥7.5 trillion; the difference probably depends on categorization of public corporations). All together, it is roughly ¥67.2 trillion of net government bond issuance, equivalent to 12.9% of GDP.

The driver of this is primarily the social security system, no surprise due to the aging population and shrinking number of working-age citizens. A shrinking and aging population, in itself, is not a big problem. Prosperity (i.e. income) is primarily a function of productivity. If workers are productive, then they will be prosperous. A larger number of (presumably less-productive) elderly people simply indicates that more of that income would go toward elderly care, which is not necessarily a problem, since income should go to whatever the highest value use is, and keeping grandpa and grandma alive probably rates pretty highly. A country can certainly be prosperous with these conditions. Indeed, elderly people can contribute a lot to real productivity, even if it is not in the form of for-pay employment. Within the household, elderly people can do all sorts of domestic duties, including cooking, cleaning, caring for and educating children, or caring for other elderly. This is nothing new for Japanese people, who have been doing this for centuries and are quite accustomed to it. (The ratio of old to young, however, is historically unprecedented.) The idea that one "retires," continues to maintain a separate household, and becomes a flat-out burden on the state, private pension funds, or adult children is another novelty which may have to be abandoned.

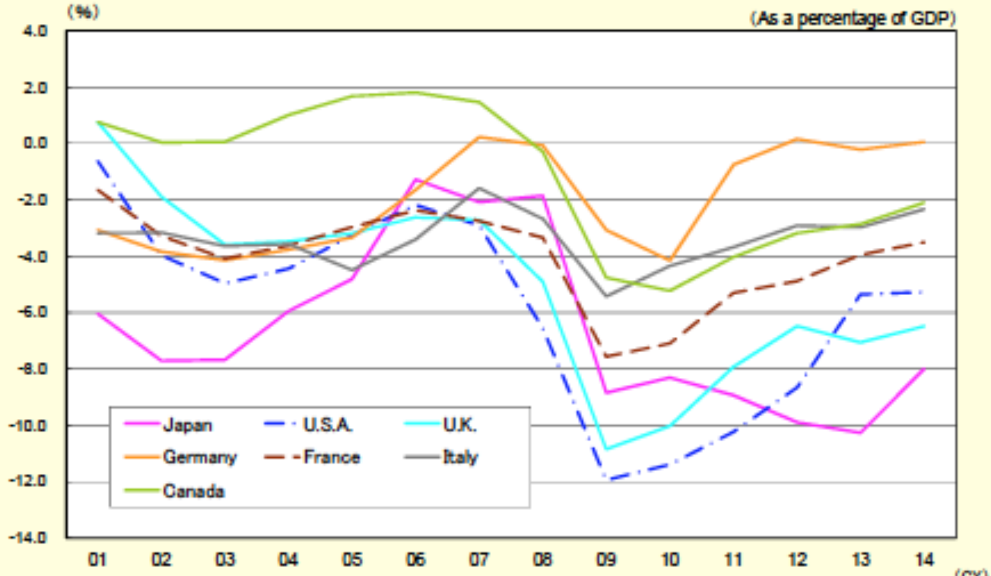
However, it does mean that present arrangements, notably the present systems of central government-funded public pensions and public healthcare, which were basically developed in Prussia and Britain in the late 19th century and mimicked worldwide, won't be appropriate going forward. Thus, new arrangements will have to be made. Most likely, these new arrangements will not emerge until the old arrangements fail completely. This is nothing new for Japan, which has had "old arrangements" fail periodically for about two thousand years. They were carrying swords around town only 150 years ago. The next eighty-year dream of military-industrial empire (it's what people did in those days) ended in literal ashes in 1945.

So what. It happens. Japanese people understand this, much more than Americans, who tend to call these natural cycles of change the "end of the world," and who seem to have no ability to see beyond that. Actually, the world doesn't end, new arrangements are made, and after a surprisingly short number of years -- about five I would say -- people are barely able to remember the old ways. France has been through five republics, two empires, two monarchies and a foreign military occupation since the French Revolution, and yet France is still France. If you were to ask a Frenchman, they would probably say that "nothing ever changes."

If you have a lot of elderly, and not so many working-age people, then the natural solution would be that the elderly would be taken care of with the least cost possible. This means living with children or in other communal arrangements, ideally in a way in which one can provide useful service to the degree one is able, while consuming minimal resources in the form of nursing and medical care. This is basically the polar opposite of the way things are done today. Many excellent arrangements can be developed along these lines, however, which can be far superior than is common today, and at much lower cost.



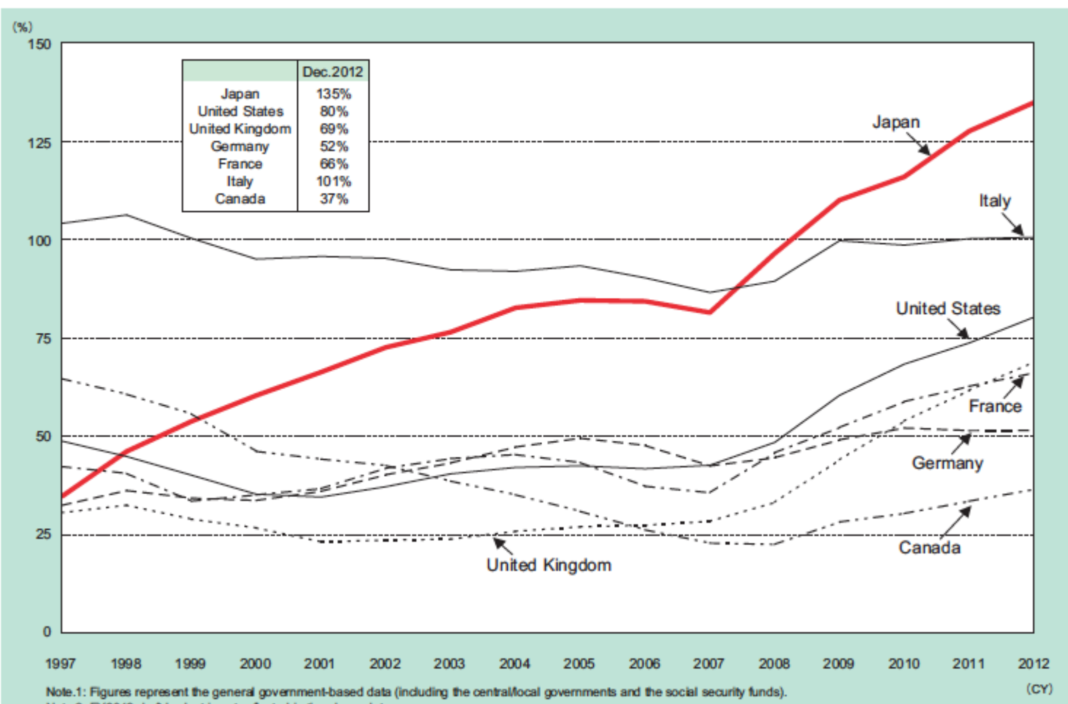
General Government Financial Balances (SNA Basis)



Note: For Japan and the U.S.A., where pension systems are based on a Modified Funded System, the figures exclude social security funds, which are regarded as future liabilities in real terms

Source: OECD "Economic Outlook No. 93"

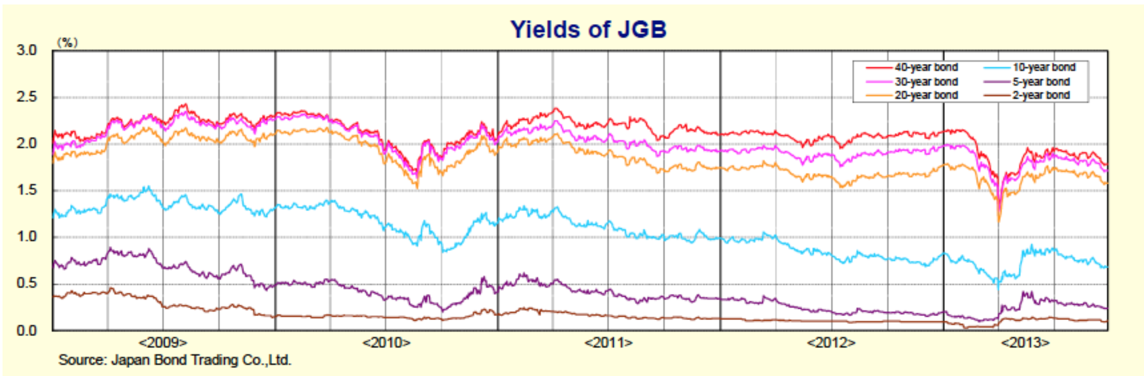
(19) International Comparison of General Government Net Debt to GDP



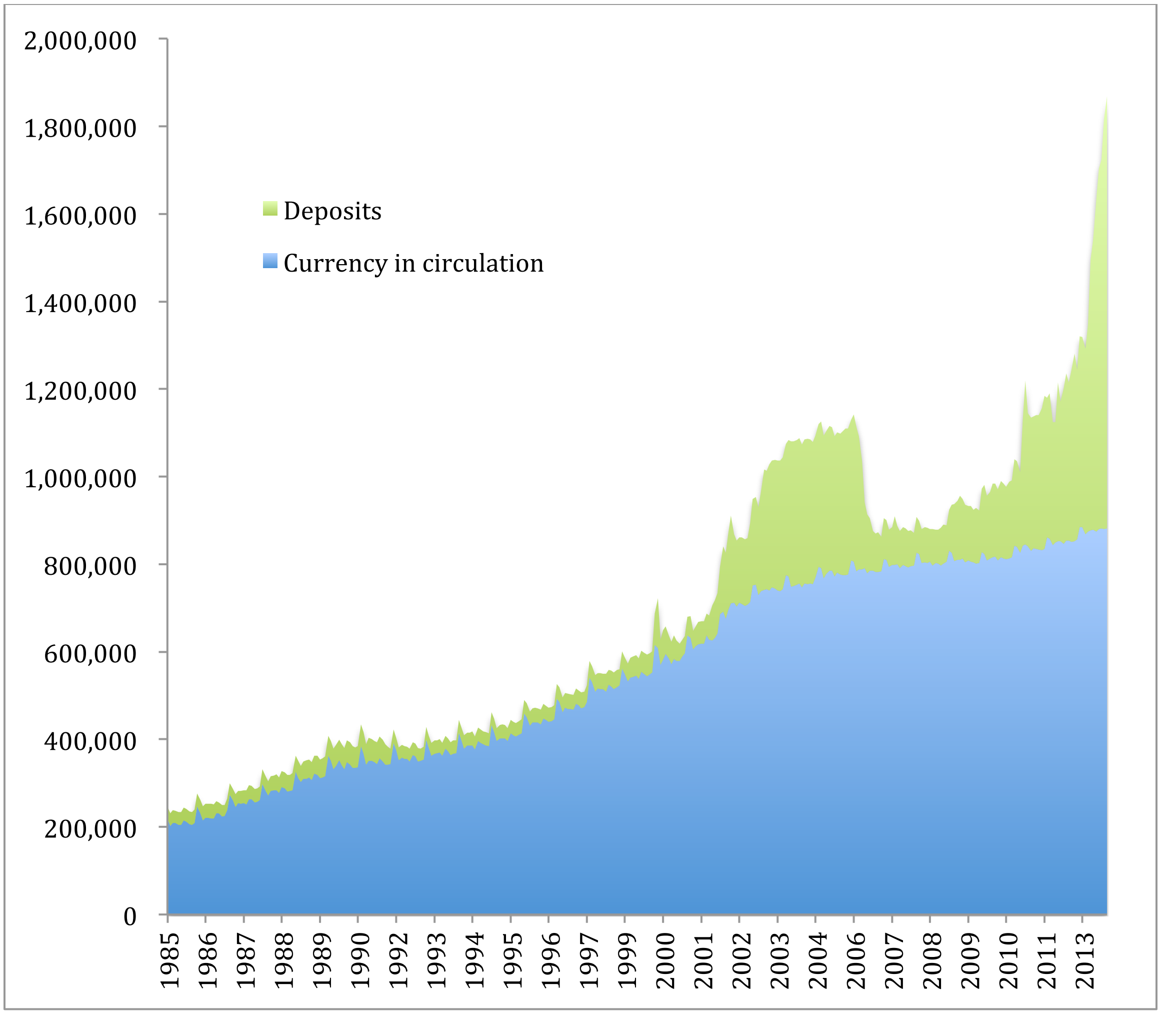
Note.1: Figures represent the general government-based data (including the central/local governments and the social security funds).
Note.2 :FY2012 draft budget is not reflected in the above data.
(Source :OECD "Economic Outlook 90" (December, 2011))

The Bank of Japan

Naturally, nobody wants to buy these bonds, because most anyone can tell they are a stinker, especially with a coupon of 0.7% for ten years. For about a decade, the government has been leaning on domestic banks to pick up the slack, but this appears to have about run its course. Thus, it should be no surprise that the time has come for the BoJ to get busy.

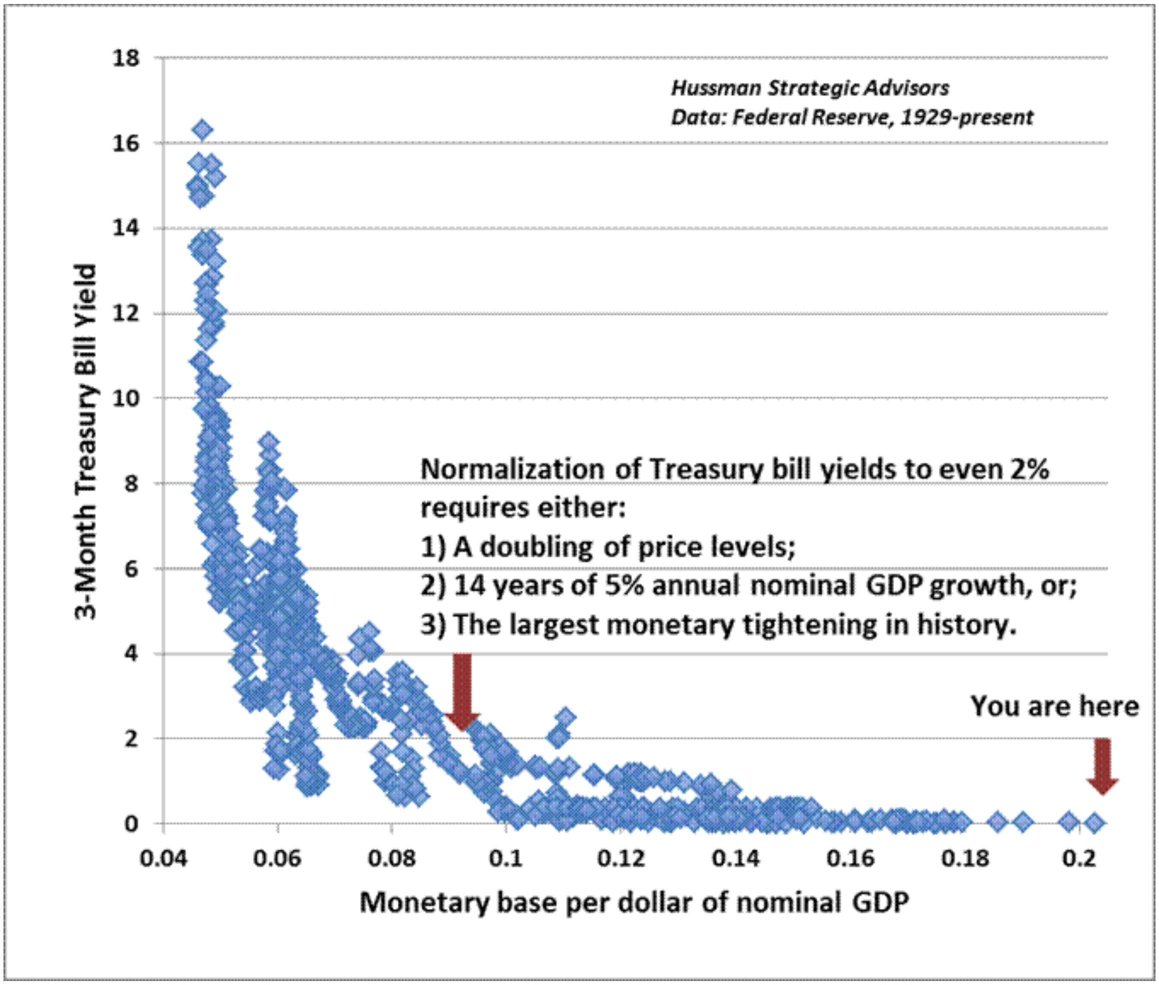


Although the BoJ is credited with introducing "quantitative easing" in 2001 -- the term is a direct translation of the Japanese "ryoteki kanwa" -- the BoJ's efforts until 2012 were actually quite moderate compared to what numerous central banks are doing around the world at this time. Let's take a look at the history of QE in Japan.



Japan: Monetary Base 1985-2013

We can easily see the effects of the original QE in 2001-2006, namely, the increase in deposits. Banknotes in circulation also grew considerably as a percentage of GDP since 1990, which can be attributed in part to declining interest rates, doubt of banks' viability, and the long-standing practice of making transactions in untraceable fashion. (It is quite common for Japanese workers to receive their salaries in the form of banknotes. High earners, such as popular entertainers, sometimes receive shopping bags full of banknotes. Consider the falloff of corporate and personal income tax revenue since 1990.) As John Hussman has indicated, the demand for noninterest-bearing base money often rises as interest rates (the opportunity cost) goes down.

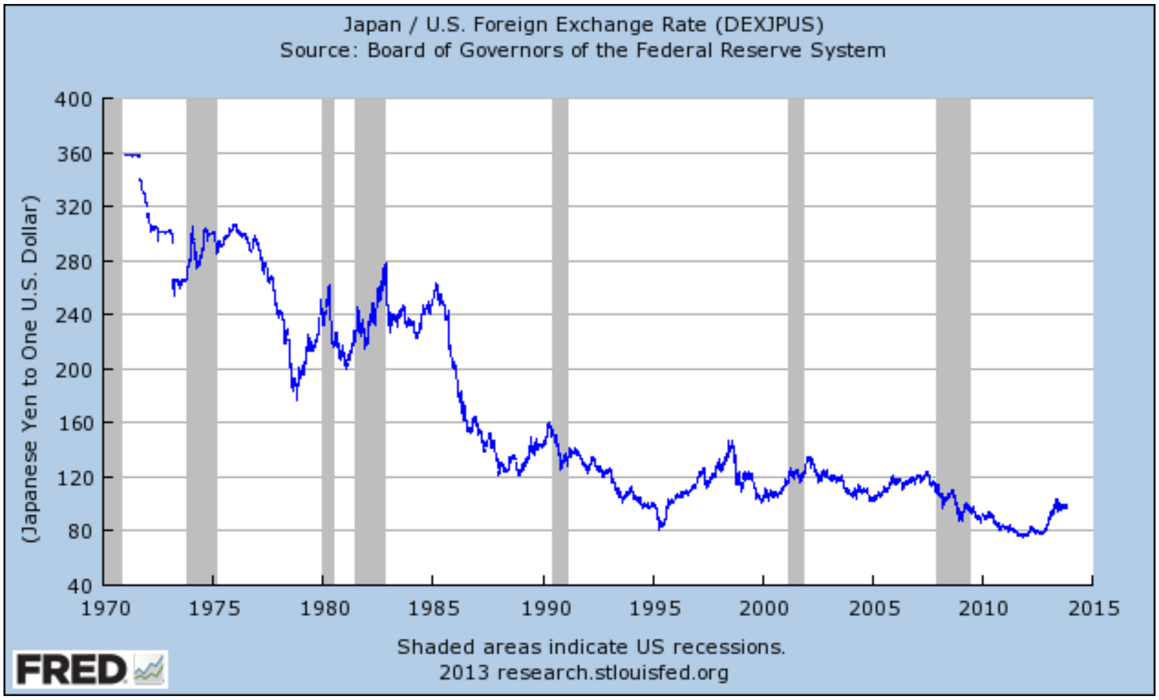


That applies also to banks; however, the BoJ's previous policy caused banks' cash holdings (reserve deposits at the BoJ) to be quite minimal. The result was a rising yen, a sign of demand in excess of supply. This demand was partially met in 2001, with the expansion of bank reserve holdings.

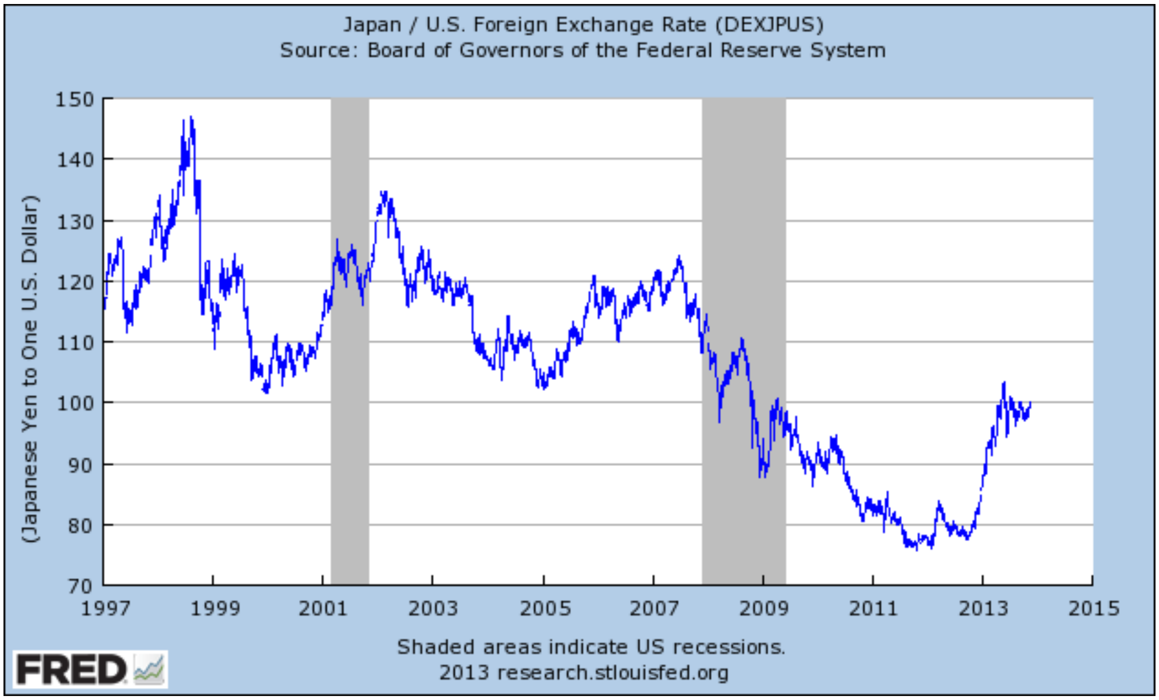
However, we can see that the magnitude of QE in 2001-2006 was really not very great. In five years, base money expanded by about 20% more than it might have otherwise, if QE had not been enacted. In 2006, the QE program was stopped, and bank reserves were returned to minimal levels.

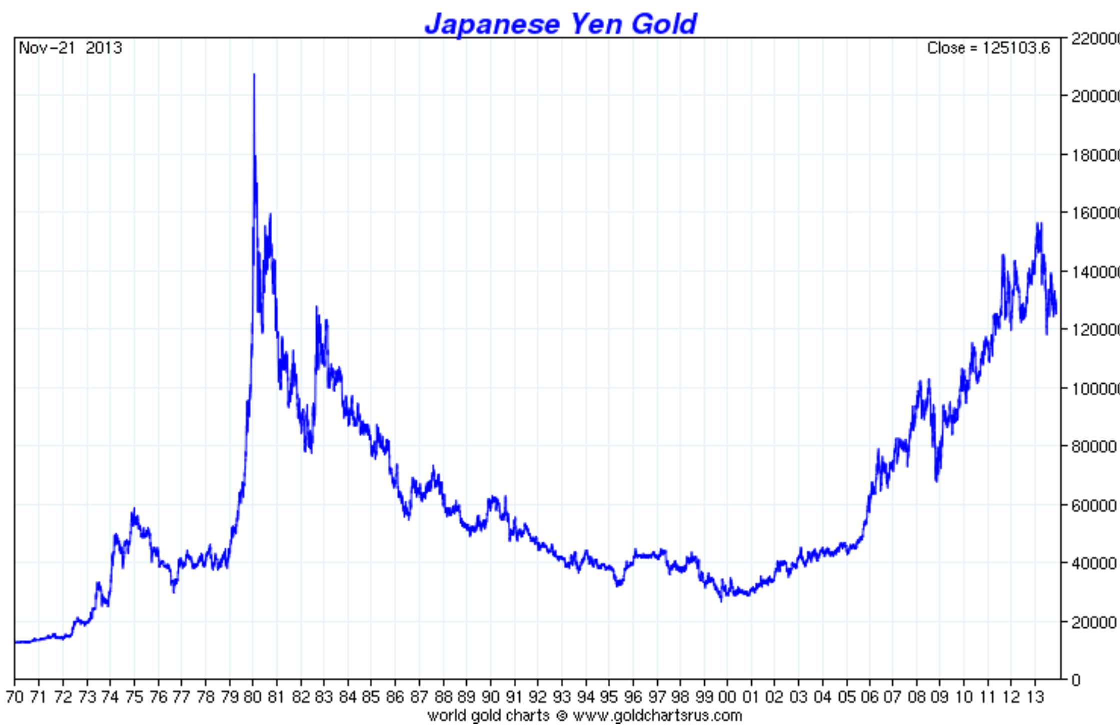
The main effect of this increase in base money supply was not an increase in lending or other economic activity. This did happen to some degree, but that was as much a factor of the worldwide expansion of 2001-2007 than anything, particularly in emerging markets notably China and India. For the most part, the story in Japan was the "broken transmission mechanism" as the Keynesians like to call it, the usual "pushing on a string" that seems to always happen in these cases.

Rather, the main effect was one of ending the tendency towards a currency rise that had been the case since 1985. During the QE period 2001-2006, the yen maintained a fairly stable plateau vs. the dollar around ¥120/dollar. This was not particularly dramatic, but it is worth noting that the dollar itself began its long decline around this period, so the yen was in a sense "keeping up" with the declining dollar.



Indeed, the cessation of QE in 2006 and reduction of bank reserves -- in other words, less base money supply -- was followed soon after with a period of rising yen value vs. the dollar, which eventually took the yen to all-time highs vs. the dollar. The dollar was also declining in value during this time, so the yen was actually declining as well vs. gold. However, in terms of foreign exchange rates, the period was one of painful yen appreciation.

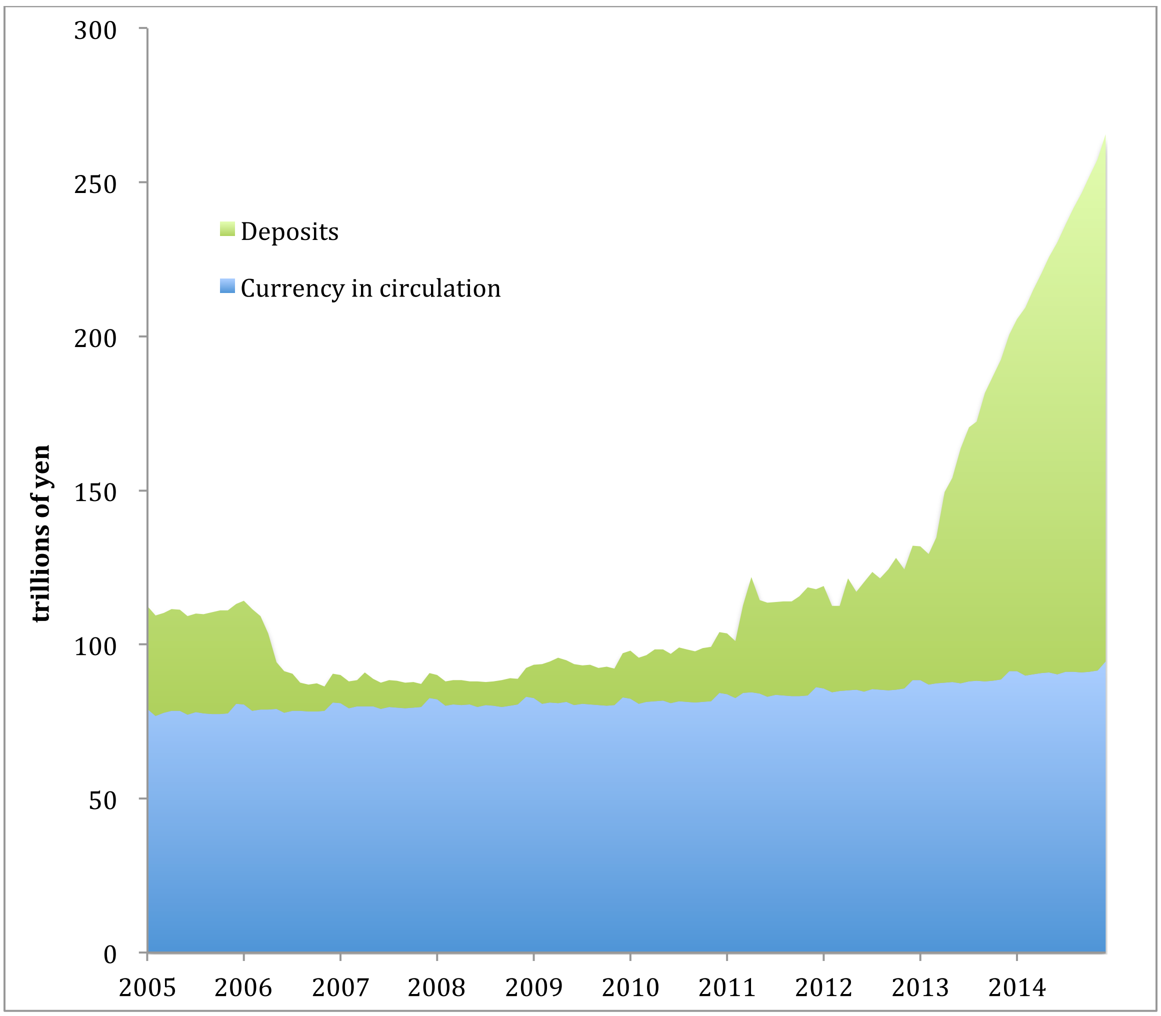




Over the past twenty-five years or so, indeed since the fallout of the Plaza Accord in 1985, the yen has had a central tendency around ¥120/dollar. In terms of trade-competitiveness issues, this seems to be comfortable level for the Japanese economy. Certainly one goal of the "Abenomics" monetary expansion is to return to around these levels, although this is not publicly stated due to political sensitivity.

I think that the declining yen value vs. the dollar will generally be felt as a positive in Japan at least until this level, and likely with some overshoot to perhaps the ¥130/dollar level. If (when) the yen meets and exceeds the ¥145/dollar level hit during the most intense period of the Asia Crisis of 1997-1998, the yen is likely to be perceived as dangerously weak, and thus an overall negative.

The increase in the pace of QE in late 2012 as a part of "Abenomics" is plainly unprecedented in Japan, and indeed the world. The plan calls for asset purchases and monetization at a rate of roughly ¥65 trillion per year until the end of 2014. ¥65 trillion (13.5% of GDP) is conveniently just a bit more than the general government's financing needs.



Japan: Monetary Base 2005-2014 (projected)

Given that roughly half the scheduled window for the latest round of QE has passed, and that the yen has moved roughly half the distance to a target around ¥125/dollar in that time, it may seem that the whole program was rather well calculated.

Perhaps so. But, I suspect that the BoJ will find it quite hard to stop, as the government will probably be quite happy with having the BoJ absorb the entirety of its bond issuance, thus keeping the 10yr JGB yield comfortably below 1.0%. The real excitement would likely come as this government-finance agenda comes in conflict with a decline in the forex value of the yen beyond the ¥145/dollar mark, or its equivalent in terms of euros or other currencies. However, with the Fed also busily easing quantitatively, and the ECB and BoE also apparently ready to join the parade, the yen might not get there so quickly as it would if Japan were acting alone.

Politics and Policy

The rise in the stock market since the introduction of aggressive QE in Japan has been impressive, but the real economy has been stagnant. Calls are going out for, yes, even more aggressive QE. And why not? It seems that it has delivered nothing but advantages; perhaps more QE will deliver more advantages. Goldman Sachs suggests that a further stepup of QE could be delivered around 2Q14, perhaps in the form of the elimination of the scheduled end of the existing QE program at the end of 2014. That would simply make formal what I am expecting in any case.

For both monetary and fiscal policy, the scheduled increase in consumption taxes in April 2014 is providing justification for more "stimulus."

> A statesman when he intends suddenly to augment the taxes of his people, without interrupting their industry, which then becomes still more necessary than ever, should augment the circulating equivalent [currency] in proportion to the additional demand for it.
>
> James Denham Steuart, *An Inquiry Into the Principles of Political Economy*, 1767

Fiscal policy follows the same endless pattern of more spending and higher taxes, that has been the case for most of the past twenty-five years. This has become so habitual that this obviously contradictory strategy can become mishmashed into a single sentence.

> TOKYO (Nikkei) -- The government finalized Monday the outline of a 5 trillion yen ($49.3 billion) stimulus package to counter the impact of next April's consumption tax increase, with plans to roll out an array of pump-priming measures to ease the shock in the first half of fiscal 2014.
>
> A projected upswing in tax revenue will help the government avoid issuing bonds to pay for the spending measures. The Ministry of Finance will raise the fiscal 2013 tax revenue forecast by 1-2 trillion yen from the initially projected 43.09 trillion yen.

"Economic package to focus on quick fixes after sales tax hike," *Nihon Keizai Shimbun*, November 19, 2013.

Unfortunately, Nikkei's english translations of the *Nihon Keizai Shimbun*, which I relied upon for many years for the detailed raw material I needed to find out what was really going in Japan, have been discontinued. Foreign media sources are virtually worthless. Alas, my ability to read the Nikkei in Japanese has withered. But, we can get a decent idea of where things are likely to go by looking at the political platform of the major political opposition party, the Democratic Party of Japan, for 2013.

The DPJ's manifesto is, as one might have guessed, rather disappointing. For the most part, it focuses on healthcare, education, public pensions, and environmental issues, typical of left-leaning parties worldwide including the U.S.'s Democratic party. Unfortunately, with a genuine need right now for major reforms of exactly these public programs, as they have become simply unaffordable in their present state, the DPJ's proposals are simply minor tweaks, mostly with the theme of giving more benefits at ultimate greater cost. But, that is simply the politics of the day; it is not yet time, politically, for major reforms here. That comes after the crisis.

On economic policy, the DPJ is in support of the new consumption tax rate increases. It vaguely promises a plan to produce a primary budget balance by 2020, which is total fantasy.

In 2012, the DPJ was in power. The decision by the Noda administration to pass the scheduled consumption tax hike was widely blamed for the DPJ's landslide defeat in a parliamentary election in December 2012. In the dominant Lower House of parliament, the DPJ lost 75% of its seats, falling from 230 to just 57.[1]

For about the past decade or so, the DPJ has only gained popularity when it has been in opposition to a consumption tax hike, a pattern in Japanese politics going back to the 1970s.[2]

In Upper House elections in July 2013, the DPJ had another huge defeat, with seats falling from 44 up for election to 17.[3]

With no viable opposition, the LDP is able to do more or less what it wants to do, which is: printing money, raising taxes, and handing out money to political cronies.

Conclusions: Tax rates are going up. Spending is going up, mostly from the endless press of social security expenditures, and no meaningful cutbacks elsewhere. In the

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[1]http://en.wikipedia.org/wiki/Japanese_general_election,_2012
[2]http://www.newworldeconomics.com/archives/2009/110109_files/Japan%20Oct09.pdf
[3]http://en.wikipedia.org/wiki/Japanese_House_of_Councillors_election,_2013

absence of meaningful spending reforms, politicians aim to retain their political support by handing out goodies. Debts and deficits are gigantic. This leaves little but monetary policy among tools the leaders are likely to grasp for. Already, the present program is seen as "not enough," leading to calls for more. Declining yen value is the natural outcome, and indeed one unspoken purpose of this plan. This would likely be felt as an overall positive, despite negative effects such as a squeeze between higher consumer prices and stagnant incomes, until around the ¥130/dollar range in my estimation. Oddly, the present pace of yen decline might put the yen around that range by the end of 2014, just in time for the BoJ to declare its QE program a raging success. This would lead to calls for a continuation of the program, if it isn't officially prolonged sometime earlier in 2014. By that time, the Fed, ECB and BoE might also be ramping up their own monetary engines in a "race to the bottom;" thus mitigating further tendency for the yen to fall vs. those currencies. In any case, the lower yen value vs. other major currencies would activate the political pressure towards competitive currency depreciation in countries worldwide.

I don't necessarily expect JGB prices and yields to change much. Between its own bond-buying activity, and guidance of all major JGB holders including major banks and insurance companies, the level of control that has been maintained for years thus far can probably be extended. Official inflation figures can be managed such that they imply the policy outcome that is desired. Despite the supposed goal of producing a 2%+ CPI rate, the problem with this is that it would instigate an end to the BoJ's QE program, and perhaps introduce further selling pressure on JGBs since it is a bit hard to justify a sub-1% yield with the CPI officially at 2%+. In any case, official declaration that the CPI is 2%+ while incomes are stagnant or declining would introduce new political pressures.

All in all, this is a recipe for decline and eventual disaster. The nature of the disaster is now clear. It will be via the printing press. This will eventually obliterate all existing programs and structures, because, although you can print money to infinity, the actual real economic output would decline dramatically. The result would be that there would be a much smaller pie to distribute, which thus means that all public pension, healthcare, other welfare, and other public programs would wither and essentially disintegrate. No matter what the accounting says, these programs must deliver some kind of real economic good or service, which will not be available, at least in the degree or form expected today.

The society that can restructure itself without crisis is rare indeed. Japan today is certainly not one of them, although I have the impression that the typical Japanese citizen would accept that path. The real question is: can the Japanese leadership restructure themselves after the crisis? They have in the past. But, other countries never do, to an adequate degree, and simply grind through centuries of stagnation punctuated by crisis after crisis, as they become gradually poorer and irrelevant on the world stage. Spain and Argentina are more recent examples. Much the same is likely to happen to Britain, particularly if the financial industry leaves London in the wake of world financial turmoil. Any increases in real asset values in Japan are likely to be relatively short-lived. Long-term bull markets don't happen in the midst of long-term economic decline.