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## **Japan's New Government**

Once a year or so, I like to take some time to catch up on what's been going on in Japan. This is usually rather difficult, because most all analysis available in the English language, from magazines, newspapers, brokerage research and so forth, is completely worthless. Why this should be is a puzzle; nevertheless, it's the way it is year after year. The "Japan" you hear about in the English media (and investment reports) is mostly a fantasy.

So, I have to piece it together from direct sources. I suppose it would be impressive if I were to say that I consult with my broad array of contacts in the Japanese government and industry. Actually, I read the local newspaper.

This year is particularly exciting, because of the change in government as the result of elections at the end of August. The Democratic Party of Japan won an impressive 308 of 480 seats in the Lower House, which is the most influential of the two Houses of government. They had 126 seats previously. The Liberal Democratic Party ended up with 119 seats, from 331. It was the second time the LDP lost control of the Lower House since the formation of the party in 1955. The DPJ won an Upper House majority in 2007, so they now have control of both houses.

The LDP's longevity is normally ascribed to "conservatism" among Japanese voters, a sort of genetic proclivity toward foot-dragging. I always thought this was baloney. In 1995, those same supposedly "conservative" voters elected, as governor of Tokyo prefecture, a former songwriter and television comedian who ran as an independent, and whose entire campaign budget amounted to \$800. Yukio Aoshima handily defeated the well-funded LDP candidate, a former cabinet official backed by five political parties. Of course, Tokyo is the most important and influential of the prefectures, comparable to California, New York and Florida rolled into one. With 35 million people, the Tokyo metropolitan area has about 30% of the total population of Japan. Also in 1995, voters in Osaka -- the second-largest urban area with 18 million people, which you could think of as Massachussets and Texas combined -- elected "Knock" Yokoyama, another former comedian who also ran as an independent. (Born Isamu Yamada, he does not seem to have a first name besides "Knock".) He defeated a former national Vice Minister who was backed by all the major political parties. Yokoyama was known for arriving at campaign events on a bicycle.

That was fourteen years ago. Just two years earlier, in 1993, the LDP lost control of the Lower House for the first time. A coalition of eight opposition parties (most of which

later combined into the DPJ) managed to install Morihiro Hosokawa for a brief, 10-month stint as prime minister. (After retiring from politics, Hosokawa took up pottery, and his work is quite popular.)

Nor should we overlook Junichiro Koizumi, who served as prime minister from 2001 to 2006, the longest stretch of any prime minister over the preceding thirty years. He was a member of the LDP, but many do not appreciate what an oddball Koizumi really was. The closest U.S. Republican would be Ron Paul, and the closest U.S. Democrat would be Dennis Kucinich. Principled outsiders. Koizumi gained popularity not by claiming superiority to the opposition party, the normal political strategy, but by criticizing his own party! Koizumi aimed to break up the system of public works spending, and the systems that financed it. In fact, he co-opted almost all of the "reform" agenda of the DPJ, and, unlike most politicians who only blow hot air, actually tried to implement a lot of it. He succeeded on many fronts, particularly the restructuring of the postal bank system.

We often say, in the U.S., that the Republicans and Democrats are so much alike that they are really two wings of one political party. You could argue that various factions of the LDP are different enough that they are almost like two opposing political parties. For example, Koizumi was a member of the "YKK trio," a powerful group of LDP politicians who, in 2000, tried to force a vote of no confidence against the LDP prime minister Yoshiro Mori.

Aoshima, the governor of Tokyo prefecture, was replaced in 1999 by Shintaro Ishihara, generally thought of as a "far right" politician. Although he retired from politics in 1995, he re-entered the fray and won as an independent. Ishihara has been described as about as "far right" as Bob Dole, but he does have a tendency to say saucy things in public. More like Pat Buchanan, perhaps. His 1989 book *The Japan That Can Say No* was considered so controversial that the publisher decided not to release an English edition. Nevertheless, bootleg English translations (thought to have been done by the CIA) were quickly circulating around the U.S. Congress. (You can find the entire text online today with a Google search. The actual text is relatively tame -- his co-author was Sony founder Akio Morita -- but it has quite a few interesting bits.) Since then, he has authored ten other books, continuing a literary career that stretches back to his receipt of the Akutagawa Prize for Best New Author in 1956. He has also appeared in six movies.

When I add it all up, I would say that, on balance, there have been quite a few more oddballs and mavericks in Japanese politics over the past two decades than in U.S. politics. Unfortunately, none of this has yet led to a positive outcome.

If we discard the "Japanese voters are conservative" hypothesis, then we are led to consider that the LDP (or the DPJ) was victorious because they actually promised the best possible electoral option at the time. Note that I said "best possible," which doesn't mean that it was a very good option. Often, the choice has been between bad and worse.

The LDP was popular for many years as a pro-business party. They are somewhat like the U.S. Republican Party, and the DPJ is somewhat like our Democratic Party. In Ronald

Reagan fashion, the LDP's "pro-business" stance meant tax cuts -- lots and lots of tax cuts. From 1950 to 1974, the LDP (and its precursor conservative parties) implemented a tax cut every single year. They weren't itty-bitty cuts either, but a machete attack on the tax code. In 1950, they eliminated the national sales tax and cut the top income tax rate from 85% to 55%. In 1953, capital gains taxes on equities were eliminated. In 1955, interest income was made tax-free. In 1956, over 50 new growth-enhancing tax measures were passed. Between 1950 and 1957, the top 55% income tax bracket, which originally applied to income of ¥500,000 in 1950, was raised to apply to income of ¥10 million, or twenty times higher. The result was spectacular economic growth during the glory years of the 1950s and 1960s, before the growth miracle was derailed in the "Nixon Shocks" and worldwide inflation of the 1970s. (I talk about these years in more detail in my book *Gold: the Once and Future Money*.)

During the 1950s and 1960s, and into the 1980s, the opposition party was the Japan Socialist Party. The JSP never gained power in those days, but it was quite influential in promoting a series of welfare and environment-related policies -- once again, rather like our Democratic Party. The JSP pressed for the introduction of environmental regulations to deal with industrial pollution, which had become quite terrible by the late 1960s, and the introduction of a national pension (Social Security) and national health care system. However, these policies were actually co-opted and implemented by the LDP.

In 1949, a law was passed that forbade the government from issuing debt. It had to balance its budget every year. This was to prevent the Bank of Japan from financing the deficit with money-printing, which led to terrible hyperinflation in the late 1940s until the yen was pegged to gold in 1949. Thus, from 1950 to the repeal of the law in 1965, the national government had no debt and no deficit.

The result of the spectacular economic growth of the period was an explosion of tax revenue. Every year, more revenue came in than expected. This justified more tax cuts, and also allowed for the expansion of government spending. Every year a "supplemental budget" was drafted to spend the excess money that was coming in the door.

In this way, the LDP also became the party of spending money. It's amazing how many friends a politician can make when they start throwing the government's money around. Over time, as is true of most political systems I think, there evolved an elite tier of LDP politicians who were concerned with national-scale issues such as keeping the growth going with more tax cuts, and a much larger class of second-tier politicians who didn't understand or participate in the national issues much, but saw their role -- you could even say their "job" -- as distributing the government's largesse to their political allies and the public at large.

This took the form of public works projects. Japan's postwar constitution forbade a regular military, which has been a popular avenue of politicians' pork-barrel schemes in the U.S. Also, in the 1950s and 1960s, the country gained real advantages from further public works. The extremely mountainous terrain of Japan meant that railroads and auto roads demanded a profusion of expensive bridges and tunnels. Many rural dirt roads were

paved for the first time -- indeed, even many city streets were first paved. New rail lines and the famous (and very expensive) "bullet trains" were built. Cities got a profusion of subways and local train lines, the expansion of which continues to this day. (Japan's rail system is a national treasure.) Modern ports were built to handle the ships from the expanding export trade, and also the imports of capital goods and raw materials. Towns in the snowy western side of Japan still celebrate the first arrival of snow removal in winter, in the 1960s. Sewer systems, electric power lines, water lines, gas lines, telephone lines, etc. -- there was a lot of "modernization" to do in those days.

Also, with increasing urbanization, the rural areas were experiencing depopulation. Public works spending was a way to channel funds to rural areas.

Already, by the early 1970s, this public works fiesta was reaching absurd proportions. Prime Minister Kakuei Tanaka (1972-1974) promoted a plan to "remake the Japanese Archipelago," which was an over-the-top orgy of concrete-pouring. I sometimes call him an "evil genius." In March 2009, the *Economist* magazine called him the "paragon of postwar corruption." Before entering politics, he headed a rural construction company.

The amazing run of tax cutting by the LDP ended in the worldwide recession of 1974, but the party avoided any significant tax hiking in the remainder of the 1970s and most of the 1980s. Overall, the Japanese economy did quite a bit better than other developed economies. I have always thought it was the overall guidance of the country -- by the "elite class" of politicians -- that was responsible for the LDP's continuing popularity during this period, not the public-works backscratching by the "second-tier" politicians. In other words, Japanese voters weren't being "bought," they actually appreciated the overall leadership of the LDP, even with its flaws and corruption, and voted accordingly. The public works spending remained relatively restrained, such that in 1989, Japan's government debt/GDP ratio was a manageable 39%.

The LDP, following the lead of Ronald Reagan and Margaret Thatcher, enacted another series of tax cuts in the 1985-1989 period. However, they soon flipped around completely. Beginning with the introduction of the consumption tax (national sales tax) at 3% in April 1989, the LDP became a party of tax hikes and economic decline. The consumption tax was soon followed by an amazing array of unbelievably destructive new taxes, mostly aimed at the property sector. From 1992 to 1998, for example, the capital gains tax on property held less than two years was 90%. Property holding taxes increased by several multiples.

By any measure, this trend toward higher new taxes, for the first time in Japan's postwar history, was rather odd. In 1988, the general government (central and local) actually ran a substantial budget surplus. What were the tax hikes *for*?

The combination of higher taxes and also rather extreme monetary deflation (more detail in my book) brought to an end the LDP's long history of favorable economic management. In the midst of recession, the LDP grasped for huge spending projects as "economic stimulus."

The government did this for essentially the same reason as governments worldwide are doing the same thing today. It has become conventional economic wisdom, and it was pressed upon the Japanese politicians by foreign advisors and governments. However, given the government's already-existing fondness for public works spending since the 1950s, and a whole institutional apparatus for channeling funds into ever more rural construction projects, it was like telling a crackhead that crack is good for you. Nothing they didn't already know.

Japanese voters soon learned what people around the world have learned recently: that nothing so obviously wasteful has any meaningful benefit. Since about 1995, in my opinion, the policy of high levels of public works spending has been more and more unpopular. However, politicians who believe -- incorrectly, I think -- that such spending is the basis of their popularity have been loathe to give it up. In the meantime, the government's debt/GDP ratio has ballooned to 170% of GDP, and looks ready to head higher.

I think most foreign observers fail to understand just how unpopular the "public works state" is today. Koizumi -- the LDP guy! -- did as much as anyone to try to put an end to it. How did such a character become prime minister? He was running against former prime minister Ryutaro Hashimoto, a much more mainstream politician who headed one of the party's largest factions. The LDP held a vote among party members, much the way a U.S. political party selects its candidates in the primaries. During this time (2001), I remember seeing an interview *with the head of a rural construction company*, who said that, to paraphrase, we must stop our wasteful spending, and embark on a new course. Please stop the insanity. In a vote among prefectural party organizations -- the grass roots support of the party, the people whose support was supposedly being bought by government largesse -- Koizumi defeated Hashimoto by an astonishing 87 to 11 percent. (Among LDP parliamentarians, his victory was a much narrower 51 to 40 percent.)

Thus, the theory that the LDP has retained power due to some "iron triangle" of public works patronage and business support also holds no water, in my opinion.

It is usually rather difficult to tell what an electorate wants. You can't just ask them, though a poll for example: "What do you want?" Usually it is a process of trial and error, complicated by the fact that what the electorate wants may be completely different than the notions of the intelligentsia, which fill the universities, conferences, media and airwaves.

However, in the Japanese case, I claim that it is rather easy to determine what the electorate wants. Here it is:

- 1) No new taxes, *especially no increases in the consumption tax.*
- 2) Less government spending, especially public works spending.

That's about it. As is so often the case, I think the voters' solution is a perfectly good economic policy. In any case, any politician who suggests raising the consumption tax usually gets tarred and feathered and ridden out of town on a rail.

This is normally accomplished by a "scandal." Unlike our fixed four-year presidential term, Japanese politics allows for the removal of a prime minister at any time. It is usually accomplished by way of some relatively minor perceived infraction (a "blue dress"), perhaps because this is the quickest and most effective method.

The first prime minister to get the treatment was Masayoshi Ohira, who first floated the consumption tax notion in 1979. He was booted out with a vote of no confidence in May 1980, the aftermath of an espionage scandal.

The second was Yasuhiro Nakasone. He led the LDP to a landslide victory in 1986, on a platform of Reagan-like income tax rate reductions. At the time, he promised no consumption taxes. However, in early 1987, he floated the idea of a consumption tax, prompting a March 1987 demonstration of 160,000 citizens against the tax, which followed another half that size a week earlier. This was really extraordinary. Unlike South Koreans and French, Japanese are not known for large public demonstrations. I don't recall ever seeing one. Nakasone gave up his tax hike plan, but he was tarnished and by the end of the year stepped down as prime minister.

He was replaced by Noboru Takeshita. At first, this seemed like an improvement, but in June 1988 Takeshita unveiled his own consumption tax plan. Need I even mention that his popularity collapsed? He was immediately embroiled in a scandal involving a shady IPO deal. The tax was passed in December 1988 for implementation April 1, 1989. However, as late as April 15, 1989, opposition parties reopened debate on the budget in an attempt to eliminate the new tax. It turned into a death match -- who would die first, Takeshita or his consumption tax? In March 1989, his popularity rating set an all-time low of 7%. Takeshita resigned in scandal on April 25, 1989. His last act was to ram through the delayed budget, including his new consumption tax.

Remember, all this occurred after the general government (including local) ran a *surplus* of 2.1% of GDP in 1988. From the elimination of the national sales tax in 1950 until the introduction of the consumption tax in April 1989, there were no sales taxes or VAT in Japan, at the central, prefectural or local level. In fact, the one-yen and five-yen coins were introduced after the imposition of the tax specifically to make change. Until then, the ten-yen coin was the smallest coin, and all prices were rounded to a multiple of ten yen.

Number four in our gallery of nincompoops is the short-lived Sosuke Uno. He was a "Mr. Clean" who was chosen to renew the LDP's public face after Takeshita's disgrace. He continued to support the consumption tax, however. After 67 days, he was thrown out of office in a sex scandal.

Number five is Kiichi Miyazawa. Although he did not raise the consumption tax, Miyazawa was responsible for a wide range of rather draconian new taxes. Most of these were on property, and were specifically and overtly designed to reduce property values. He was removed in a scandal involving political payoffs and no-confidence vote in August 1993.

Number six brings us to Morihiro Hosokawa, the first non-LDP prime minister. He ran on a platform of tax cuts, and was very popular. However, in February 1994, Hosokawa held a surprise midnight press conference without consulting any of his political allies. He announced that he now favored an increase in the consumption tax to 7%. Two months later, he was removed from office in a scandal involving a trucking company.

Obviously, the consumption tax is the "third rail" in Japanese politics. The odd thing is, Japanese politicians don't seem to realize it. Most of them anyway -- Junichiro Koizumi promised from the start not to raise the consumption tax during his term, and kept his promise. His extraordinary longevity in office was, of course, a complete coincidence. (Koizumi was the longest-serving prime minister since 1972.)

From 1990 to the present, the LDP's economic policy has basically been to spend more money during recession, and to raise taxes during "recovery" -- perhaps accompanied by some rather ineffective attempts to reduce spending. No surprise, then, that the recoveries have been rather tepid at best. It does not take a genius to figure out that the eventual result of ever-higher taxes and ever-higher spending is economic strangulation. However, it remains conventional wisdom around the world today, and has been heartily adopted by the Obama administration.

The latest such recovery was in the 2004-2007 period, when Japan was finally relieved of the monetary deflation that had plagued it throughout the 1990s. During this time, the LDP embarked on what appears to be a rather aggressive round of tax hikes. I looked into it last year and found:

**Payroll taxes UP:** 2004-2017: increase payroll taxes by 0.354% each year, total from 13.6% to 18.3%.

**Comment:** This is a "two-sided" tax, just as in the U.S. So, the real increase is 13.6% (employee) + 13.6% (employer) = 27.2% effective to 18.3%+18.3%=36.6% effective. That's a big rise, from an already high base. Also, in Japan there is NO upper limit on income subject to the payroll tax. This has been ticking up for a few years now already, a steady worsening of macro conditions in Japan. This tax was around 7.5% in 1970.

**Capital gains and dividend taxes on equities UP:** 2001: Abolishment of 1.05% gross option postponed 2yr to 1; 2003: Dividends taxed at "reduced rate" of 10% by withholding for five years. Afterwards, dividends taxed at 20% by withholding. 2003: Capital gains on listed stocks taxed at 10% for five years. 2007: Abolish the current reduced tax rate at 10% for capital gains and dividends starting January 2009. (Move to 20% rate.)

**Comment:** Capital gains taxes on equities were traditionally untaxed in Japan, as is also the case in Germany, Singapore, South Korea and other places. This changed in 1989, with the

introduction of a 20% capital gains tax, but also an alternative tax of 1.05% of the gross sales price. So, if you had capgains of more than 5% or so, you tended to pay the 1.05% alternative, as that was cheaper. MOF has been trying to implement a capital gains tax for decades. It appears that in 2003, the 1.05% alternative was eliminated, but a special 10% capgains rate was applied. Effectively, the capgains rate went from near-zero to 10%. At the beginning of this year, it appears that the change to a 20% capgains rate will be made effective by January 2009. Also, it appears that taxation on dividends has effectively gone up, via the hard-to-avoid dividend withholding tax.

**Taxes on interest income UP:** 2002: Exemption of interest income on Maruyu deposits (for elderly) to be reformed in January 2006 and applied to only those owned by disabled persons etc. Effectively eliminated.

**Comment:** Interest income in Japan was traditionally tax free, or nearly so, by use of a number of various loopholes. It appears that the last of these loopholes are being eliminated. This likely means that interest income is now taxed as regular income, with a 50% top rate.

**Land-related taxes DOWN:** 2001: Long-term holdings of land capgains taxed at 26%. 2001: Suspension of application of the additional tax on capgains on sales by corporations, 10% for short-term and 5% for long-term. Extended to 31 Dec 2003. 2002: Registration and License tax for "qualified fireproof high-medium rise building and its premises" reduced to 2.5% from 5%. 2003: Registration and License tax reduced to 1% for FY2003-FY2005, 2% afterwards. 2004: Capgains on long-term land and housing reduced to 20% from 26%.

**Comment:** The problems in Japan's property sector can be traced in part to an explosion of property-related taxes beginning in 1988 (in the Tokyo area) and spreading to the rest of the country by 1991-1992. These super-high taxes began to come down somewhat in 1998. The trend has been for property-related taxes to ease a bit lower, but they are still much higher than was the case in the 1980s.

**Inheritance taxes DOWN:** 2003: top rate cut to 50% from 70%

**Income taxes UP:** 2003: Spousal allowance of ¥380,000 max to be abolished. 2004: Public pension deduction abolished. 2004: Exemption for elderly (¥500,000) abolished. 2005: "rate of tax credit reduced from 20% to 10%" Ceiling on tax credit reduced from ¥250,000 to ¥125,000. Local inhabitants tax reduced from 15% to 7.5%. Ceiling reduced from ¥40,000 to ¥20,000. 2006: "Remaining half of across-the-board tax credit abolished."

**Comment:** Income tax rates generally fell during the late 1980s and 1990s. For now, the rates appear to be stable, but effective taxes have been heading higher via elimination of various deductions. The "across-the-board tax credit" was a tax cut from around 1998. Basically, you figured your taxes by the normal means, then, on the last line of the return, you reduced the figure by 20%. That's pretty big. In 2005, this reduction was cut to 10%, and in 2006 it was eliminated. In effect, your taxes rise by 25%, not a small figure. If you combine the payroll tax hikes PLUS the elimination of exemptions PLUS the elimination of the tax credit, that adds up to some significant income tax hikes over the past five years or so.

To summarize the summary: Over the past few years, we've had big scheduled increases in payroll taxes, a big increase in income taxes, the effective introduction of a new 10% capital gains tax on equities, and more taxes on dividends and interest income. (The capital gains tax on equities was scheduled to rise to 20% for 2009, but apparently the



10% rate was maintained at the last minute. Japan's bureaucrats clearly want to jack it up to 20% as soon as possible.)

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All of this amounts to an extended introduction as to why the DPJ was victorious in this election, but not victorious in the past.

If we look at the concerns of the Japanese electorate at this time, we can see that they are almost entirely economy- or business-related concerns, not welfare-type concerns. Japan's social programs, such as its excellent and inexpensive health care system, are actually quite effective. Street crime is minimal, schools are relatively good, and the environment is about as well off in Japan as in any developed country today. In short, we have "conservative" problems to solve rather than "liberal" problems to solve. Taxing-and-spending is normally a left-wing pattern of behavior. Spending reduction and tax cuts are normally the policy offerings of the right wing.

We see in today's U.S. Republican Party, for example, a definite tax-cutting wing, and also a definite budget-balancing, spending-reduction wing. Usually these people are completely ignored -- these days, the party in power, whether Democrat or Republican, usually just talks a lot of babble while they steal money for themselves and their cronies - - but nevertheless they find a home within the Republican "big tent."

Ideally, a conservative party will promote business with *lower taxes*, and balance the budget with *lower spending*. If the conservative party is really, really smart, it will even co-opt the best of the liberals' agenda, such as health care reform for example, and implement it themselves. Today's Republicans have no chance of operating on this elevated level. However, this was the LDP of the 1960s, and explains their extraordinary success.

Unfortunately, for the past twenty years, today's LDP has tried to promote business with *higher spending*, and balance the budget with *higher taxes*. Failure is certain.

What Japan had, and needs again, is a really great conservative party. However, what they have to work with is a *liberal, left-wing party*, the DPJ. The DPJ not only has left-wing policies, it has what you could call left-wing DNA. I'm sure you know what I am talking about when I say that a typical party Democrat in the U.S. is completely oblivious regarding traditional Republican concerns. If you were to say, for example, that high corporate or capital gains taxes are hurting businesses and overall economic growth, the Democrat will often have *no idea what you are talking about at all*. Likewise, if a Democrat were to say that healthcare or education costs are eviscerating the middle class in the U.S., or that we are on an unsustainable path of environmental degradation, they find no understanding or even awareness of the problem among party Republicans. In both cases, the matter has somehow been excluded from their worldview.

Imagine, if you can, a typical mainstream U.S. Democrat, like Hillary Clinton perhaps, standing up and saying: "What we need is a huge across-the-board tax cut, and a major reduction in government spending." It's difficult to picture, isn't it?

Thus, we can excuse the DPJ, and its left-wing forbears, if they are having a tough time being a new conservative alternative to the LDP.

The election this year was not the first time the DPJ (and its opposition party predecessors) defeated the LDP. The first victory in the postwar period was a majority win of the less-influential Upper House in July 1989. The Japan Socialist Party ran on a platform of eliminating the brand-new consumption tax, which was implemented just a few months earlier in April 1989. Immediately after their Upper House victory, in December 1989, the opposition parties introduced a bill in the Upper House to eliminate the consumption tax. It was mostly a show, as the bill was certain not to pass the LDP-dominated Lower House. However, it demonstrated the opposition party's strategy ahead of Lower House elections in February 1990.

As the 1990 elections approached, many thought the opposition parties might be able to unseat the LDP, win a majority in both houses, and eliminate the consumption tax. However, the opposition parties backed off before the election, opting instead for a reform that allowed a lower tax rate on food and beverages. Support for the opposition party collapsed, and the LDP won the election.

I might point out that the Japanese bull market also peaked in the period between the tax elimination bill in December 1989 and the Lower House election of February 1990.

After the carpet-bombing of the Japanese economy by the LDP tax-hikers in the 1990-1993 period, particularly regarding property-related taxes, it is no surprise that the opposition parties won their first Lower House victory in 1993 on a platform of -- you guessed it -- tax cuts. Here's how *Businessweek* reported the situation in February 1994:

It's the good news Japan has been waiting for. After more than a year of false starts in the economy, crippling political intrigues, and stock market swoons, Prime Minister Morihiro Hosokawa finally has come through with a stimulus package of generous proportions. With a hefty tax cut for ordinary citizens and benefits galore for big business and banks, the deal, announced in early February, lays the groundwork for a consumer-led recovery.

Hosokawa wrested \$135 billion from Japan's tight-fisted Finance Ministry, a good \$18 billion more than most estimates (table). Unlike earlier packages, which just accelerated public spending, this deal actually puts money in consumers' pockets by mandating a \$55 billion annual income tax cut, retroactive to Jan. 1. That comes to about \$1,100 per household. More consumer demand means companies can restore semi-idle plants to normal production and avoid closings. And stoking spending is just what U.S. trade negotiators want, since they figure a recovering Japan is more likely to suck in imports.

These tax cut promises, by the opposition parties over the years, have tended to be a little coy. The opposition parties have a nasty habit of adding: "Oh yeah, and we're going to raise the consumption tax later," at which point the Japanese electorate drops them in disgust.

One reason for the opposition parties' flip-flopping in this regard is Ichiro Ozawa, formerly one of the top rank of LDP politicians. In 1993, he split with the LDP and formed the Japan Renewal Party. This split destabilized the LDP and enabled the eight-party opposition coalition victory in the Lower House in 1993. Ozawa later became part of the DPJ, and was the DPJ's leader from September 2008 until May 2009, when he handed off to Yukio Hatoyama due to a scandal involving payoffs from a construction company. (Who ever said Japanese politics was boring?)

Here we have some feisty conservative blood in the left-leaning DPJ. A good thing? Alas, Ozawa has also brought along some of the LDP's worst habits. In 1993, he published a political manifesto, translated in English as *Blueprint for a New Japan: the Rethinking of a Nation*. It has a lot of good ideas, such as a reform of the public works machine and a new foreign policy. In fact, I would say it has nothing but good ideas, except for one:

Ozawa wrote that he wanted to raise the consumption tax to 10%.

Zap! The third rail gains another victim. I'm sure Ozawa was at least partially responsible for Morihiro's surprise consumption-tax bombshell in 1994. I can hardly believe how stupid these guys are.

Ozawa is best as an organizer and consensus-builder, which is why he has had a central role in the various opposition party reorganizations over the years. As a result, opposition parties have also tended to include Ozawa's policy prescriptions. For some reason, he has never strayed from his 10% consumption tax plan. In 1996 elections, the LDP promised to raise the consumption tax from 3% to 5%. (There was a mild recovery at the time.) The opposition parties proposed a hike to 10%. The Japanese voter held their nose and voted for the LDP. The consumption tax rose to 5% in 1997, which is widely accused of stifling the economic recovery at that time and leading to a decline back into recession. Maybe those voters know something after all?

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This brings us to the most recent election. With Koizumi ("no consumption tax hike while I'm in office") gone, the LDP was clearly gearing up for a consumption tax hike sooner rather than later. They said they would hike it "as soon as the economy recovers," and noted that they expected 2% growth by the end of 2010. This is part of a plan to run a primary budget surplus within ten years.

The second part of the LDP's plan was "stimulus" via the familiar large public works projects -- the latest generation of which involves quite a few hydroelectric projects.

Indeed, the LDP already passed, earlier this year, a ¥15 trillion "supplementary budget" of spending measures, in line with similarly bloated "stimulus" plans from governments around the world. Just to give an idea of how much ¥15 trillion is: total central government revenue from all sources is estimated around ¥40 trillion in FY2009. The 2010 draft budget is coming in around ¥92 trillion, not including "supplemental" budgets such as this ¥15 trillion spend-a-thon.

Of course this strategy is completely ridiculous. Spending needs to be reduced by immense amounts -- about ¥40 trillion -- and everyone knows it. Certainly the solution for such hyper-bloated spending is not higher taxes, and the economic deterioration they cause.

The DPJ's main proposals were a promise not to raise the consumption tax while in office, and a pledge to reduce public works spending. The DPJ has already delivered somewhat on its lower-spending plans by canceling several projects that had been part of the ¥15 trillion "supplemental" budget. In a surprising show of initiative, the DPJ ordered work stopped on the Yanba hydroelectric project, and a review of all 143(!) hydroelectric projects now under construction. The DPJ also proposed a minor reduction in corporate tax rates for small businesses. Promising work so far.

However, the DPJ was not able to shake its lefty spending habits. Their main policy proposal (aside from not raising the consumption tax, which is really a sort of anti-proposal) is to pay a ¥312,000 (about \$3,000) per year per child stipend until they finish junior high school. Including some other welfare giveaways, the DPJ plans an additional ¥16.8 trillion per year of new spending. They hope to finance this with reductions in public-works type spending, and also some tax hikes such as the elimination of certain spousal deductions on income taxes. The early indications are that such spending cuts won't come anywhere close to covering the DPJ's new spending ambitions.

The existing consumption tax, at a 5% rate, generated ¥10.1 trillion of revenue in 2008. So explain to me *again* why we need a higher consumption tax? The corporate tax -- one of the highest in the world at 40% -- generated ¥10.5 trillion of revenue, and the personal income tax, with a 40% top rate which rises to 50% including prefectural taxes, generated ¥15.6 trillion of revenue.

So, the DPJ's new welfare spending plans alone -- which nobody asked for -- would spend more money than the revenue generated by *the entire personal income tax*. The on-budget amount spent on public works at the national and prefectural level is about ¥22 trillion, by the way -- more than the consumption tax and corporate income tax combined. This does not include supplemental budgets or a whole menagerie of off-budget entities financed via the Fiscal Investment and Loan Program.

Often in these situations, as I mentioned, what the voter wants and what the intelligentsia wants are completely different. A poll of businesspeople by *Nikkei* in September found that the top three economic policies desired were: 1) An income tax cut, favored by over 60% of respondents; 2) Review of the social security system (to reduce projections of

huge future costs); 3) Fiscal restructuring (huge spending cuts). The next five items were: agricultural promotion, deregulation, improvement of working conditions for temporary workers, a tax system to promote corporate growth, and a corporate tax cut.

Thus, out of eight items, we have three tax cut proposals, two spending reduction proposals, a call for deregulation, and one welfare proposal that has nothing to do with childcare. Where's Margaret Thatcher when you need her? The same poll found 41% in favor of an eventual consumption tax hike, while 8.4% favored a consumption tax cut and another 8.0% favored complete abolition of the tax. (Total central government tax revenue in 1988, before the consumption tax was introduced, was ¥50.8 trillion, about ¥10 trillion higher than expectations for 2009.) An October poll of economists, however, found 71% in favor of a consumption tax hike, with 53% in favor of a hike to the 10%-15% range.

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We can understand why the DPJ beat the LDP based on its economic policy stance, but it is also plain to see that the DPJ is not really prepared to deal with the problems at hand. A certain air of panic is creeping into general discussion. "LDP, DPJ ill-prepared to halt Japan's slide toward debt disaster," reported the normally sleepy *Nikkei* in August. "The country appears headed for a fiscal breakdown, but both major parties' campaign platforms lack credible plans for avoiding it."

Around 1995, you could have said: this spending is going to cause a problem in twenty years or so. In 2004, you could have said: this spending is going to cause a problem in ten years or so. Now it is 2009, and the problem looks like it has a timeframe of 3-5 years. They say of debt: it doesn't matter until it matters. Then, it's the only thing that matters. We are now close to the point at which it is the only thing that matters. Japan's debt/GDP ratio could rise to 200% as soon as 2010, and the government is still running deficits on the order of 10% of GDP.

To this we can add the rather substantial additional spending related to a wave of retirees. Japan is in the vanguard on this issue as well, due to demographic realities. The working population has been shrinking by about 1% per year, which is not a problem in itself, but Ponzi finance (pay-as-you-go government pension schemes) requires an ever-expanding pyramid base.

Should be interesting. I think it is safe to say that failure is certain. Then what? Personally, I suspect things will eventually work out well for Japan, after an implosion and probable hyperinflation leads to the disintegration of the existing pattern of behavior. There is some evidence that Japan's elites already understand the likely outcome: the Ministry of Finance has been buying back inflation-indexed bonds in the open market. Japanese are tough. Many seniors today no doubt remember the hyperinflation of the late 1940s, during their childhood. The solution adopted in 1949-1950 was to outlaw government bond issuance, peg the yen to gold, and cut taxes radically. The

aforementioned poll suggests that businesspeople today already understand this strategy, so perhaps it will make a comeback in ten or fifteen years.

Anyone following Japan's political and economic policy failures over the years is struck by how similar they have been to the approach that is now favored by the governments of most every developed country in the world. There is the reliance on huge spending programs, quickly followed by immense deficits and proposals for higher taxes. The government status quo is protected first and foremost. Political parties on either side of the aisle fumble with small tweaks that don't change the overall situation much. There is a general atmosphere of denial and delusion, combined with obfuscation via nonstop happytalk. Maybe Japan's politicians are no worse than anyone else's -- they just had a crisis to deal with, while the others could coast along on empty blather and patronage until now.