STRUCTURAL ASPECTS OF THE JAPANESE BUDGET

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1 Introduction

Japanese fiscal position has been deteriorating over a long time. After the collapse of bubble economy, the Japanese government continues to try to improve the situation and has set targets for fiscal consolidation repeatedly, but it couldn't achieve them. On the contrary, the situation has worsened under the world economic and financial crisis in the last few years.

In this paper, the developments of the Japanese budget structure will be explained first. In both expenditures and tax revenues, there have been factors which have had effects on the enlargement of fiscal deficits. Considering the size of government expenditure to GDP, the most essential problem in Japanese fiscal situation is the lack of tax system which can gain enough revenues as fiscal resources. But such situation means on the other hand there is room to increase the tax burdens to cover the fiscal gap.

As a conclusion it will be pointed out that Japanese fiscal policy faces challenging situation to achieve fiscal consolidation in moderate economic growth under population aging.

The Japanese government has decided its new fiscal consolidation plan on June 22, 2010. The recovery of the fiscal soundness will be pursued along the plan.

2 Trends in the Japanese budget structure after the bubble era

Even in the bubble era around 1990, when the fiscal balance of Japan's general government was in surplus, the fiscal balance of central government was slightly in deficit. After that, Japan's fiscal balance has been deteriorating and the deterioration was mainly in the central government, especially in these 10 years (Figure 1). So the focus of this paper is mainly on the central government.

But it doesn't mean that local governments are more conscious about fiscal soundness. The central government has increased fund transfer to the local governments so that they can cope with the problems under economic downturn. This fund transfer worsened the fiscal balance of the central government on one side, prevented the deterioration of local fiscal situation on the other side. The difference of fiscal situation between the central government and the local governments can be seen caused rather by political power balance.

To the mid-1990s, debt services cost was about half of the central government's fiscal deficit, reflecting a relatively high interest rates at the time of bubble boom. Since late 1990s the greater part of fiscal deficit has been structural (Figure 2).

Despite the huge amount of debt, the portion of interest payment has become rather small as a result of lowering level of interest rates in the sluggish economy. But it contains future risk, as interest rates could go higher when the economic growth become stronger and private investments increase.

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The article is based on the author's personal views and should not be regarded as reflecting official stance of the Japanese Government or the Ministry.

Figure 1

Fiscal Balance Developments of Japanese General Government

(percent)

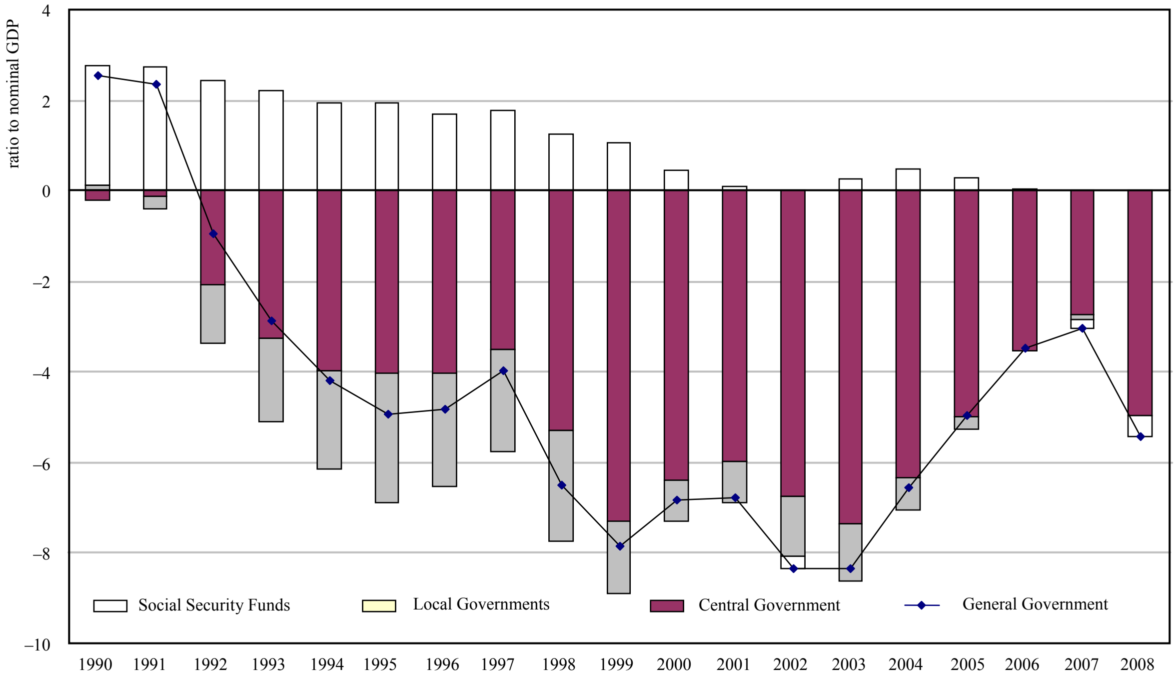


Figure 2

Estimated Structural and Cyclical Fiscal Balance of Central Government

(percent)

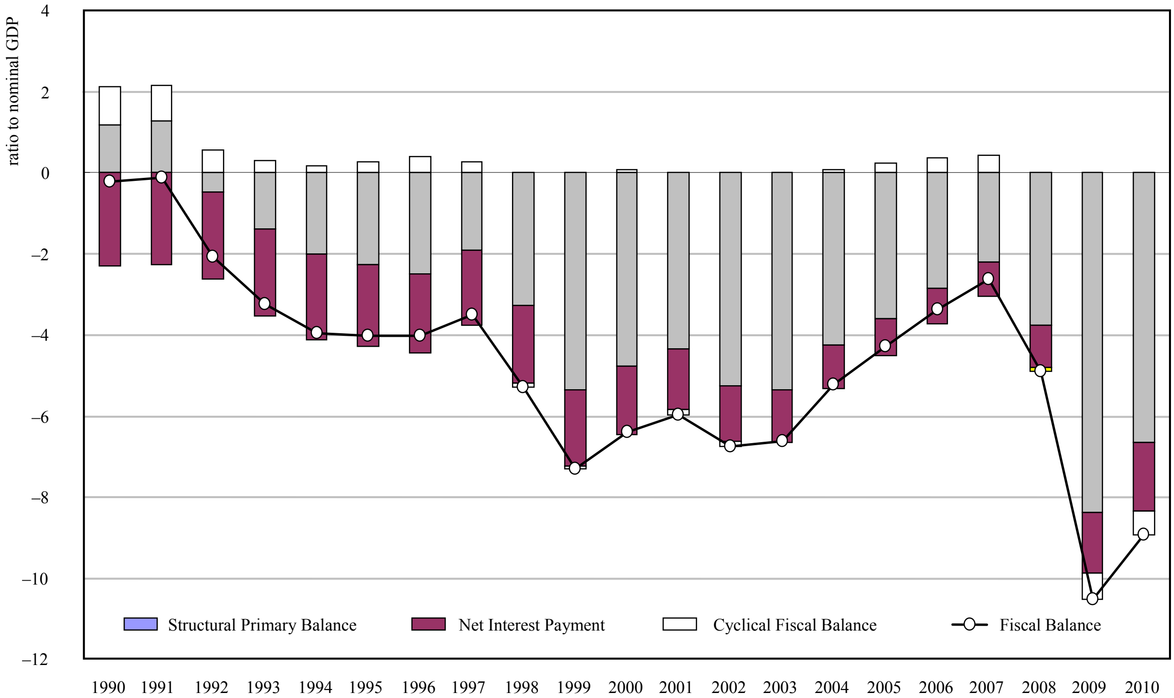
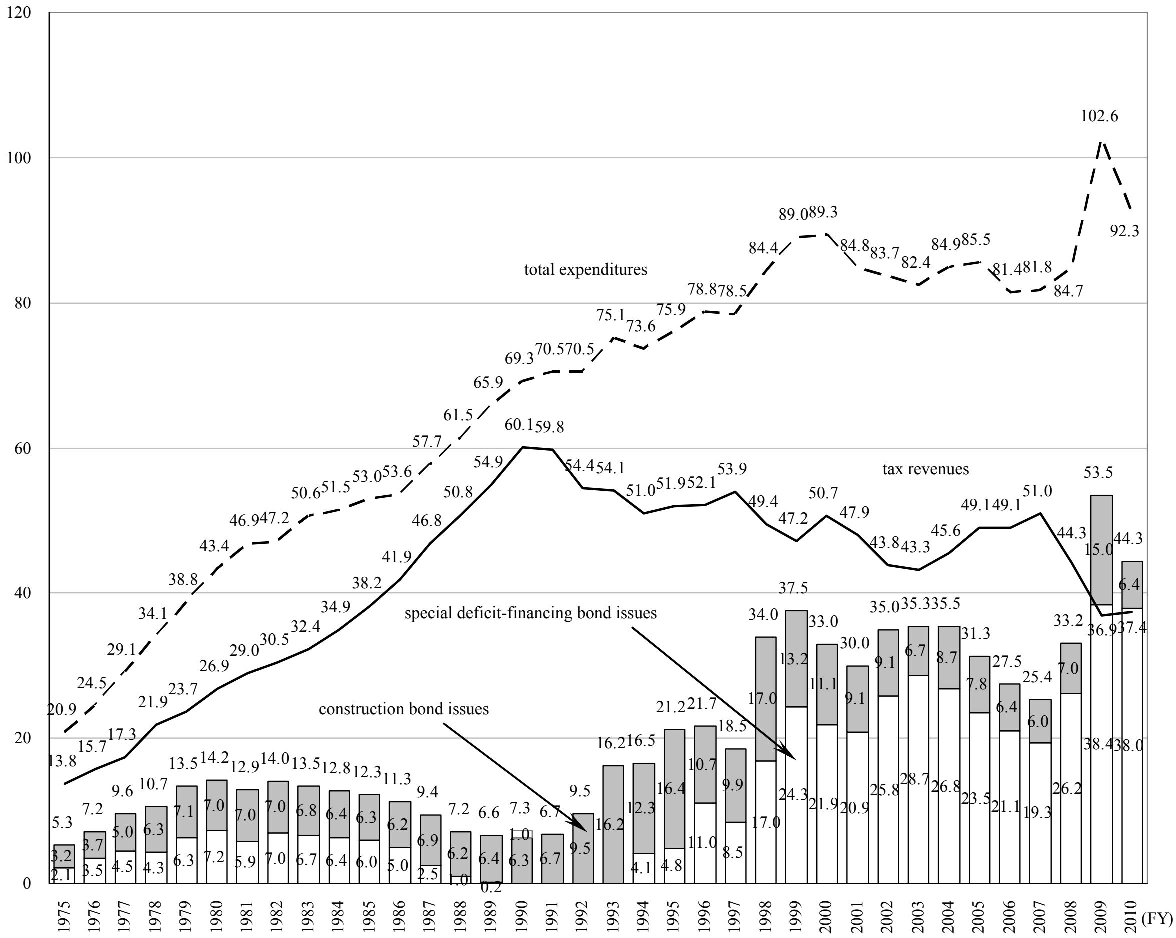


Figure 3

Trends in General Account Tax Revenues, Total Expenditures and Government Bond Issue

(trillion yen)



Notes: FY1975-2008: Settlement, FY2009:Second revised budget, FY2010: Initial budget.
Ad hoc deficit-financing bonds (approx. 1 trillion yen) were issued in FY1990 as a source of funds to support peace and reconstruction efforts in the Persian Gulf Region.

Estimated portions of cyclical fiscal balance in 2009 and 2010 seem rather small despite that in the global economic and financial crisis Japan's tax revenues decline drastically (2008: 44 trillion yen → 2009 and 2010: 37 trillion yen). The biggest lost revenue was the corporate tax revenue, which decreased in 2009 to the level of half of the previous year (2008: 10 trillion yen → 2009: 5 trillion yen). The gap between the estimated cyclical portion and the actual tax revenue decrease suggests that calculation of cyclical components using the output gap and the tax elasticities causes underestimation of cyclical effects on Japanese fiscal balance.[1]

For the deterioration of Japanese fiscal balance, both of the expenditure side and the revenue side have been affected. Trends in total expenditures and tax revenues of general account show that total expenditure continues to increase since late 1970s on the one hand, tax revenues are in

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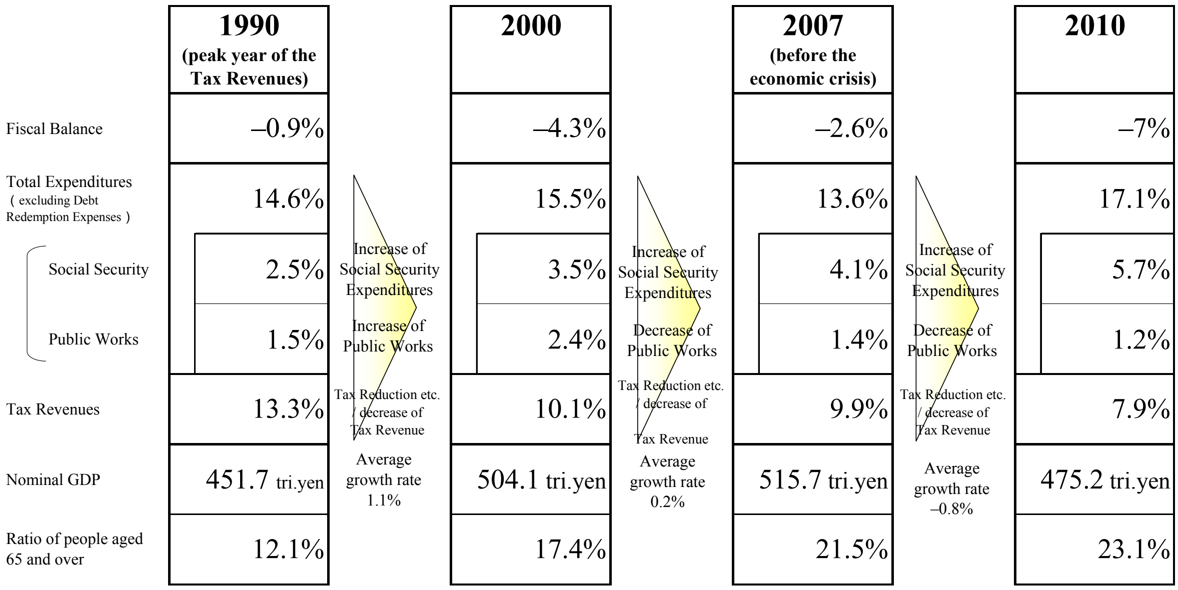
[1] On the calculation of cyclical and structural factor, please see "Cyclical and Structural Components of Corporate Tax Revenues in Japan" by my colleague Mr. Ueda.

Figure 4

Factor Analysis of the Japanese Budget Balance

(percent of GDP)



Figures represent the general account-based data.

downward trend after 1990 on the other hand. As a result bonds issuance has been increasing and accelerates recently as consequences of global crisis. In these two fiscal years, the borrowing becomes bigger than the tax revenues, which is an extraordinary situation never seen since immediately after the World War 2 (Figure 3).

In the increasing trend of expenditures, public works were first increased in order to add public demands in the aftermath of bubble burst, then declined in these ten years. Caused by the population ageing, continuous increase in social expenditures is observed. On the revenue side, tax revenues continue to decrease. Very low growth rate or the decrease of nominal GDP caused by deflation worsens the situation through lowering tax revenues and making fiscal adjustments more difficult (e.g., to decrease the ratio of expenditure to GDP, to restrict the increase of expenditure in growing economy is easier than to cut expenditure actually in non-growing economy) (Figure 4).

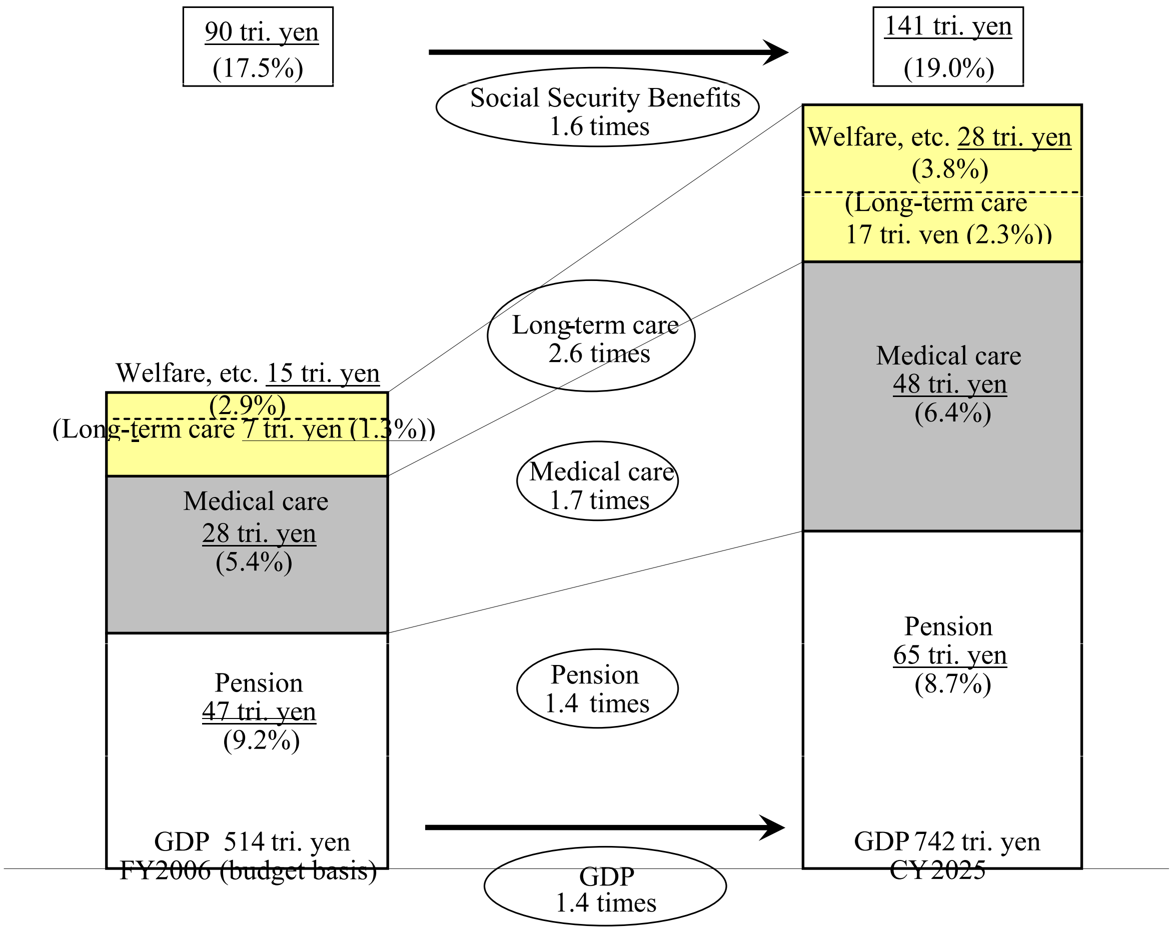
3 Structural problems in expenditures

3.1 Social expenditures

Social security benefits, especially in the area of medical insurance and care insurance, are estimated to expand faster than the economic growth (Figure 5). Behind the increase of social security benefits there is a demographic factor. In Japan, not only the increase of elder people but also the decrease of people at working-age makes the situation more difficult (Figure 6).

Figure 5

Estimation of Future Social Security Benefits



Note: Figures in parentheses represent the percentage of GDP.
Source: Estimation by the Ministryof health, Labour and Welfare (May 2006).

3.2 *Public works*

The level of Japan's governmental investment was once much higher than another advanced countries. The level is declining in these ten years but is still relatively high (Figure 7).

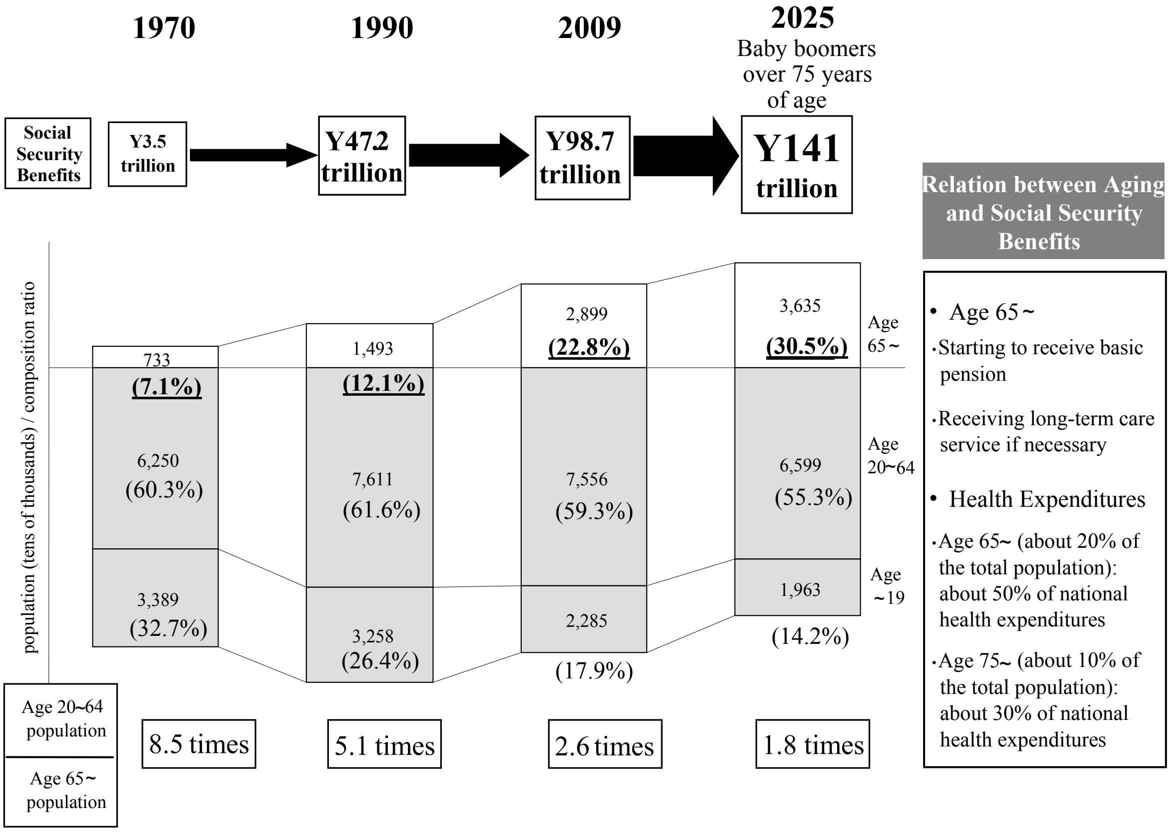
The high level of public works expenditures implies room for reduction, but increase of old infrastructure facilities over 50 years might limit room for expenditure cut as higher cost for repairs and maintenances would be required (Figure 8).

3.3 *Debt service cost*

In these 25 years, size of debt outstanding becomes four times but interest payments have been leveling off under the situation of continuous decrease of interest rate. Now the movement of interest rate seems like hitting the bottom (Figure 9).

Figure 6

Demographic Change as an Important Factor for Social Security Benefits Increase



Note: Baby boomers: born in 1947-49.

4 Structural problems in revenues

After 1990, almost all Japan's major tax reforms were tax reductions except the consumption tax rate increase in 1997 (Figure 10). The motivations of tax cuts were both economic stimulus in recessions and rather structural ones like corporate income tax reduction in order to improve the competitiveness of Japanese companies.

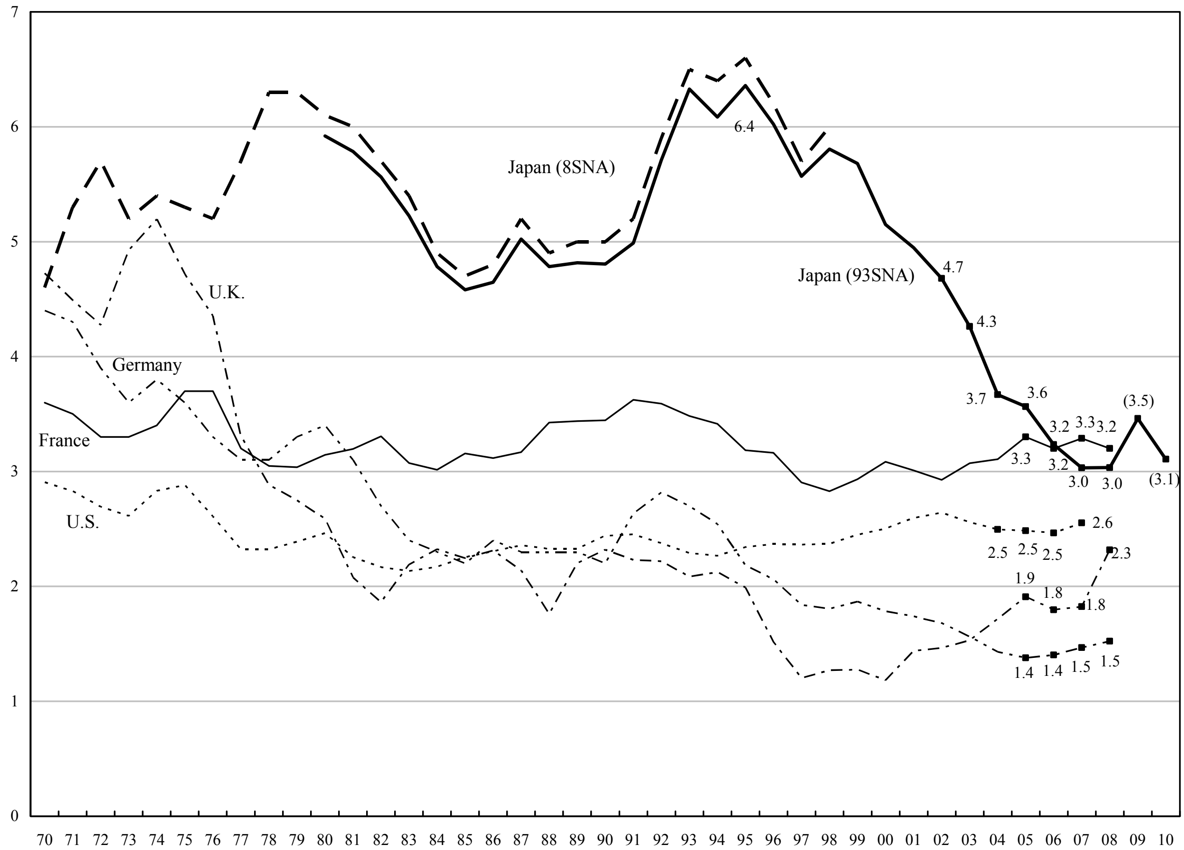
Japan's tax system has not succeeded to produce sufficient revenues, not only because of economic downturn but also as a result of repeated tax reductions.

5 Narrow path to exit

International comparison in OECD countries of the size of general government expenditures (excluding social security benefits) shows that Japan's government is one of the smallest (Figure 11). Even when including social security benefits, Japan's rank is a bit higher but the difference is not so big.

Figure 7

Trend of the Governmental Gross Fixed Capital Formation
(percent of GDP)



Sources: Data on Japan from Cabinet Office, *National Accounts* (fiscal year basis). For other nations: OECD, *National Accounts 2009 Vol. 2*, (calendar year basis).

Comparison of national burden ratio shows same tendencies. Japan's national burden ratio is very low and tax burden is one of the smallest in OECD (Figure 12).

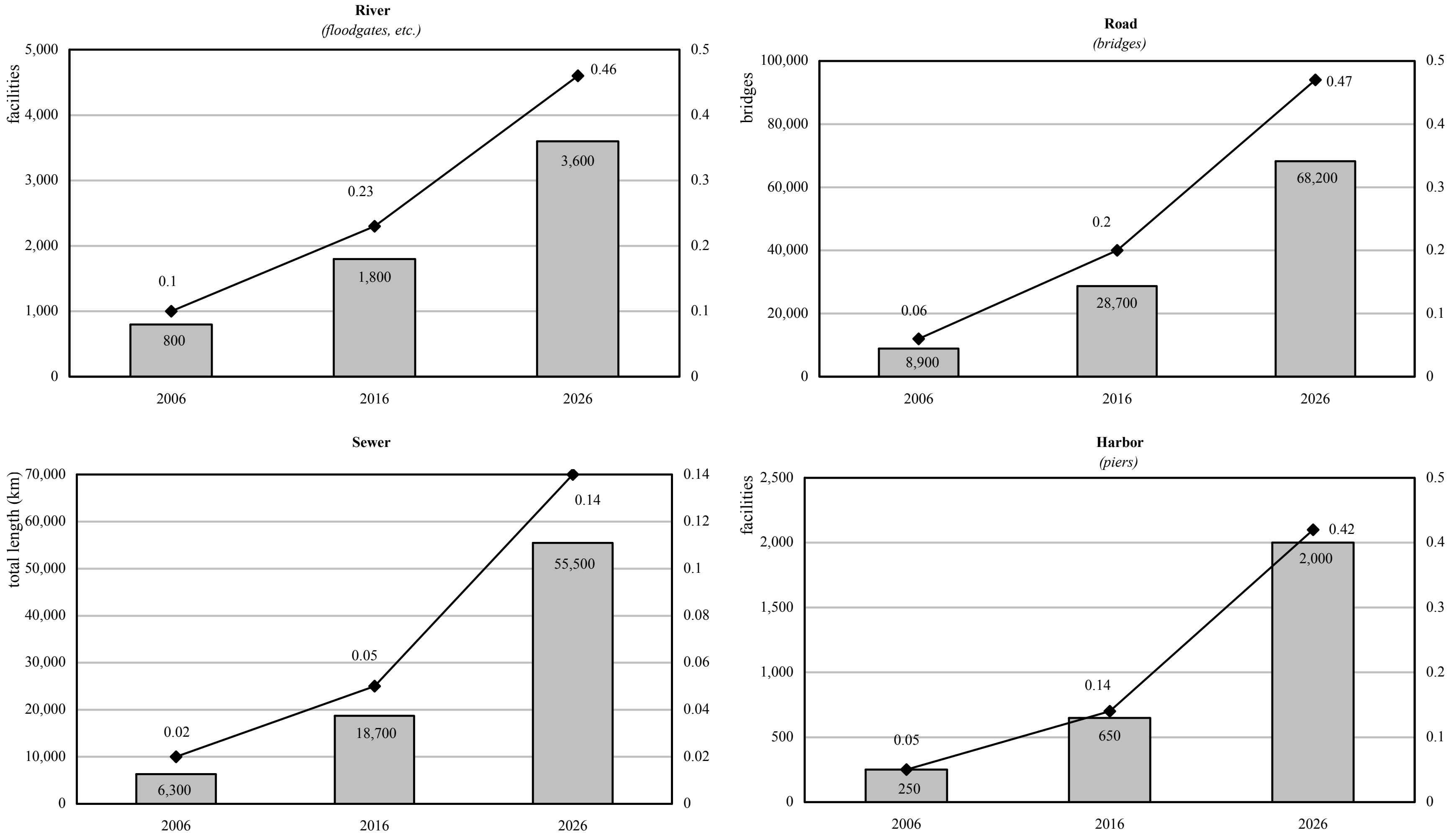
Taking into consideration the observations presented in this paper, some implications for coming Japanese fiscal consolidation can be drawn.

- Relatively low level of tax burden implies the possibility of revenue reform.
- Room for expenditure cut seems rather limited. But reduction of so-called "wasteful expenditures" is still necessary to gain people's wider support for tax increase.[2]
- Exit from deflation is indispensable precondition for successful fiscal consolidation.
- Because of rapid population ageing, expected Japan's economic growth in future would remain moderate. Adequate speed for Japan's fiscal consolidation might be slower than in other advanced economies. Hasty implementation of fiscal tightening could be harmful.

[2] There are many literatures suggesting that fiscal consolidation would be more successful through expenditure cut, but Japan's situation should be seen as rather unique because of its small government size.

Figure 8

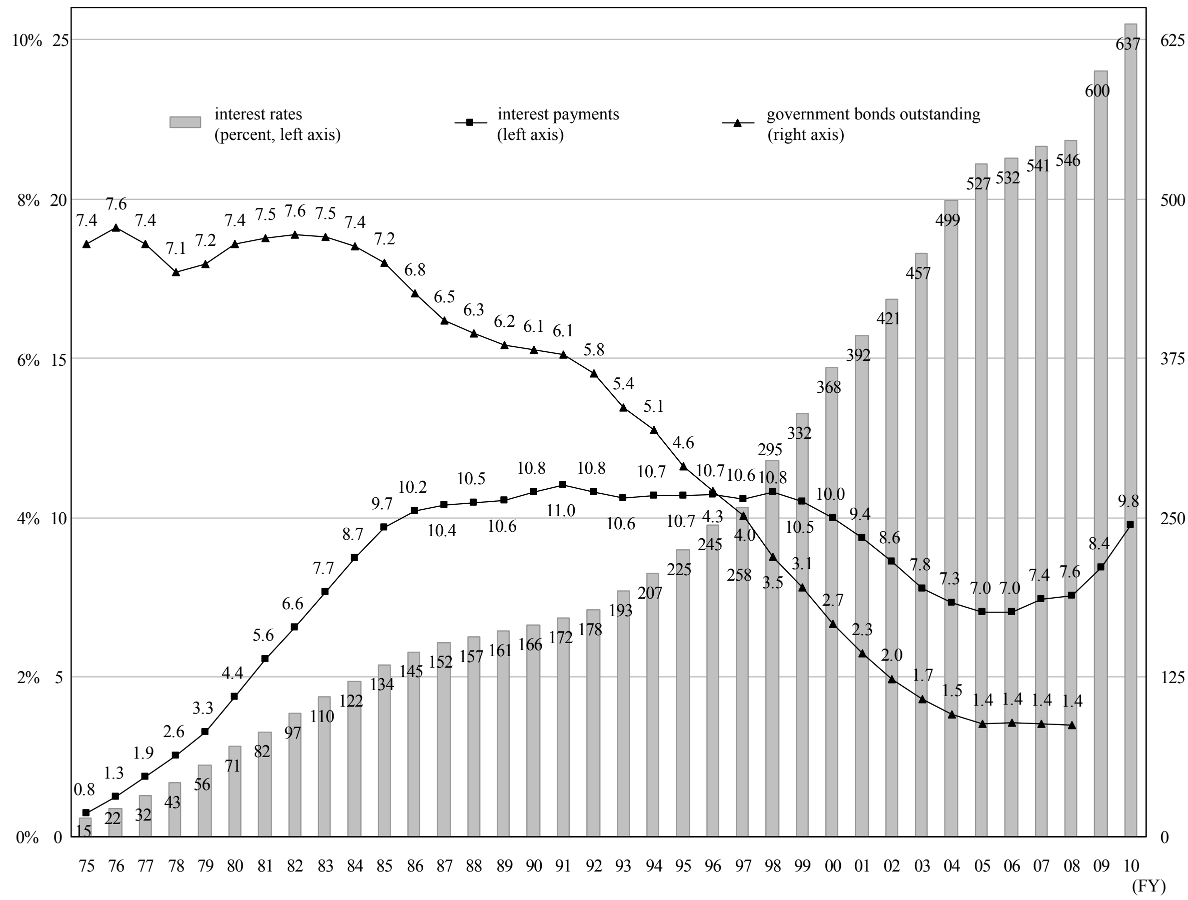
Ratio of Old Infrastructures



Bar graph: number of the facilities constructed over 50 years ago (Left scale). Line graph: ratio of the facilities constructed over 50 years ago (Right scale).

Figure 9

Trends in Interest Payments and Average Interest Rate
(trillion yen)



Notes: Interest Payments for FY1975-2008: *Settlement*; FY2009: *Second Revised Budget*; FY2010: *Initial Budget*.
Government bonds outstanding for FY1975-2008: Actual; FY2009: *Second Revised Budget*; FY2010: *Initial Budget*.

On 22 June, Japanese Government took a Cabinet Decision on a Fiscal Management Strategy. The Strategy reflects the ideas described above and sets new fiscal consolidation targets in both aspects of flow and stock.[3]

Flow targets:

- By FY2015 at latest, halve primary balance deficit relative to GDP from the level in FY2010.
- By FY2020 at latest, achieve primary balance surplus.
- Continue fiscal consolidation efforts in and after FY2021.

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[3] The pace of fiscal consolidation set in these targets is a bit slower than in other advanced countries. The G-20 Toronto Summit Declaration describes that "advanced economies have committed to fiscal plans that will at least halve deficits by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016. Recognizing the circumstances of Japan, we welcome the Japanese government's fiscal consolidation plan announced recently with their growth strategy".

Figure 10

Major Tax Reforms

	Drastic tax reform (1988, 1989)	Tax reform (1994)	Permanent tax reduction, etc. (1998, 1999)	2003 ~
Taxation on consumption	·Introducing consumption tax (+5.4 tri. yen) 1989 ~ ·Streamlining the individual indirect taxes (–3.4 tri. yen) 1989 ~	·Raising the consumption tax rate ·Introducing local consumption tax (+5.1 tri. yen) 1997 ~		·Reducing the tax exempt threshold for small- and medium-size corporations, etc. (+0.6 tri. yen) 2004 ~
Taxation on individual incomes	·Institutional reduction (Mitigation of progressive tax rate structure, increase in the personal exemption, application of the special exemption for dependents, etc.) (–5.5 tri. yen) 1987, 1988 ~	·Institutional reduction (Mitigation of progressive tax rate structure, Increase in the personal exemption, Broadening the income bracket for employment income deduction, etc.) (–3.5 tri. yen) 1995 ~ ·Special tax reduction 1994 (–5.5 tri. yen); 1995 (–2.0 tri. yen); 1996 (–2.0 tri. yen)	·Reduction in the highest marginal tax rate (–0.5 tri. yen) 1999 ~ ·Permanent tax reduction (–3.5 tri. yen) 1999 ~ 2006 ·Special tax reduction 1998 (twice) (–4.0 tri. yen)	·Review of various deductions (Special deduction for spouses, Public pension deduction, etc.) (+1.1 tri. yen) 2004, 2005 ~ ·Transfer of tax revenue sources 2004 ~ [central → local: 3.1 tri. yen]
Taxation on corporation	·Lowering the basic tax rate, etc. (–0.6 tri. yen) 1987 ~ (–1.8 tri. yen) 1989, 1990 ~		· Lowering the basic tax, rates, broadening the tax base (–0.4 tri. yen) 1998 ~ · Lowering the basic tax rates (–2.5 tri. yen) 1999 ~	·Tax reduction for R&D and investment in plant and equipment, etc. (–1.7 tri. yen) 2003 ~ 2006 : Abolition of the IT investment tax incentives +0.8 tri. yen) ·Review of Depreciation system (–0.7 tri. yen) 2007 ~
Taxation on others	·Reducing inheritance tax (Mitigation of progressive tax rate structure, Increase in the basic exemptions, etc.) (–0.7 tri. yen) 1988 ~ ·Taxation, in principle, at capital gains from stock transfers, etc. (+1.2 tri. yen) 1989 ~	· Reducing inheritance tax (Mitigation of progressive tax rate structure, Increase in basic exemptions, etc.) (–0.3 tri. yen) 1994 ~		·Reduction of inheritance tax reduction in the highest marginal tax rate etc. (–0.2 tri. yen) 2003 ~

Note: Figures in parentheses represent the sum of the estimation of increase and decrease of national taxes and local taxes (fiscal year).

Stock target: Achieve stable reduction in the amount of public debt relative to GDP from FY 2021.

The Strategy also describes the following points:

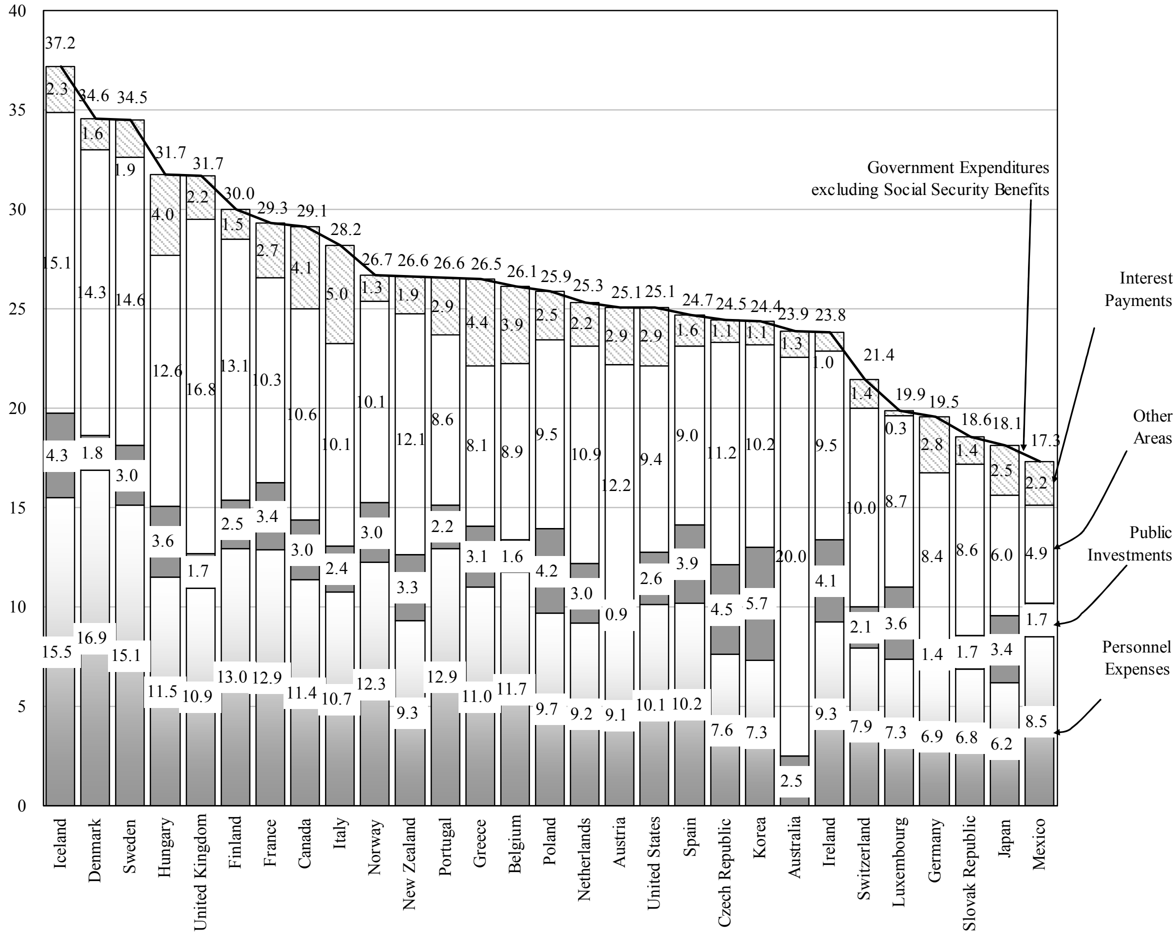
- The government should make every effort, in cooperation with the Bank of Japan, to bring deflation to an end. By implementing the New Growth Strategy in conjunction with the Fiscal Management Strategy, the government aims at achieving over 3 per cent of nominal growth rate and over 2 per cent of real growth rate on average until FY2020.
- Basic rules on fiscal management as “Pay-as-you-go” rule.
- As measures on the revenue side; the government will soon determine the details of the comprehensive reform of taxes including personal income tax, corporate tax, consumption tax and tax on assets, so that necessary revenue will be secured towards achievement of fiscal consolidation targets.
- As the Medium-term Fiscal Framework; “Overall Expenditure Limit” for General Account is set during FY2011 ~ 2013.

The Japanese Government will pursue to restore fiscal soundness along the Strategy.

Figure 11

General Government Expenditures excluding Social Security Benefits

(percent of GDP)



Notes: Australia doesn't include Personnel Expenses because of lack of data.

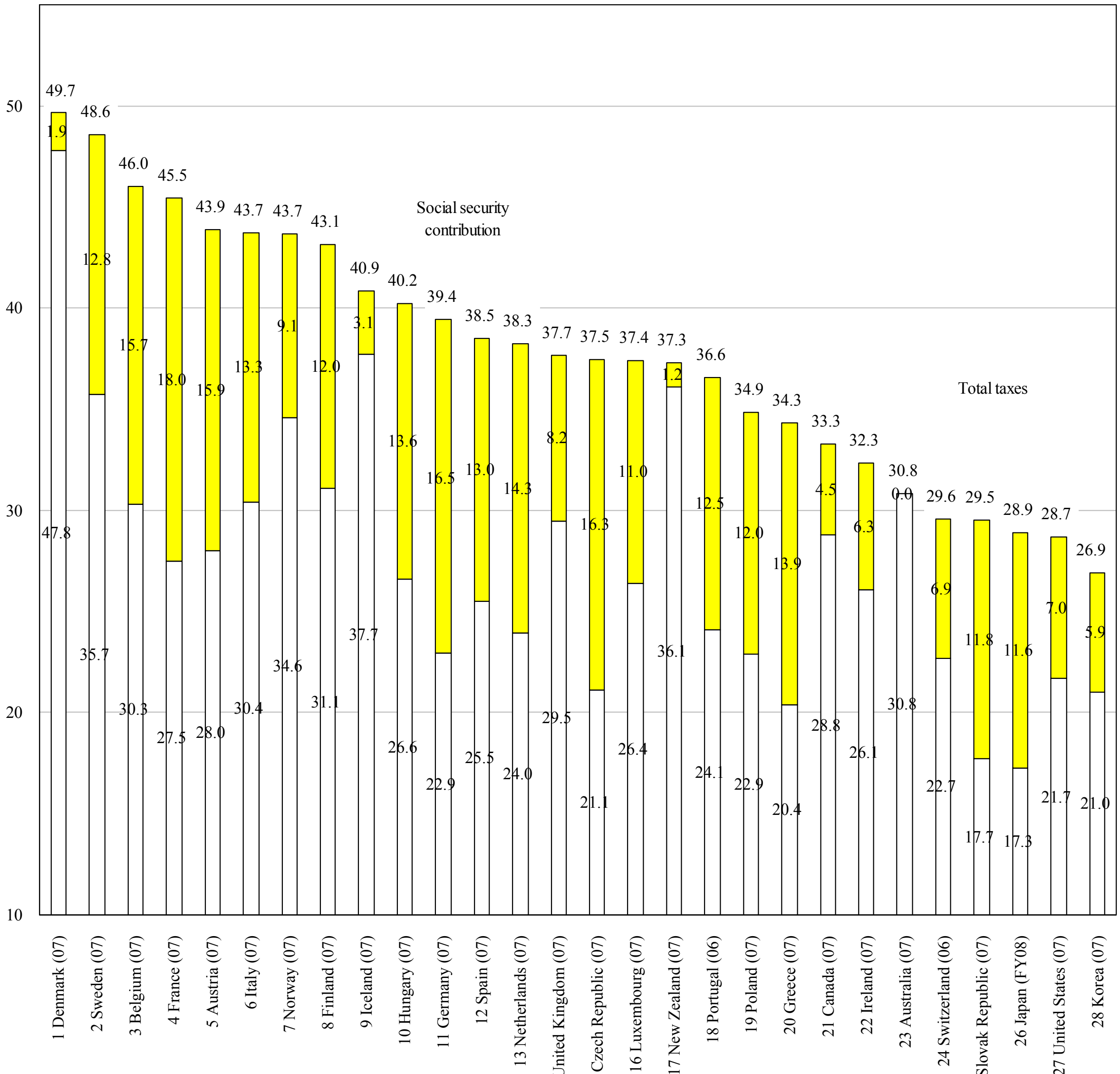
Japan: FY2007, Other countries: CY2007 (Korea, Switzerland: CY2006, New Zealand: CY2005, Mexico: CY2004).

Source: OECD.

Figure 12

International Comparison of National Burden Ratio

(percent of GDP)



Notes: 28 countries of 30 OECD members' actual figures. The other 2 countries (Turkey and Mexico) do not appear above because of lack of data.
Source: For Japan: Cabinet Office's *National Accounts*, etc. For other countries: OECD, *National Accounts 2009* and OECD, *Revenue Statistics*.