

FISCAL CONSOLIDATION STRATEGY IN JAPAN: THE ROLE OF EXPENDITURE CONTROL

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Introduction

In order to achieve fiscal consolidation, each country sets a target using an index such as fiscal deficit, primary balance or debt to GDP ratio. In many cases, governments do not clarify concrete measures on how to attain the target when they set it. They do not state which tax to increase or which expenditure to reduce. Japan was no exception when it decided the fiscal target in 2001: a primary balance surplus for the central and local governments combined by the early 2010s. However, Japan took a step forward last year. The government decided that it would cut expenditures by approximately ¥11.4 to ¥14.3 trillion in fiscal 2011 in order to achieve the fiscal consolidation target. Moreover, the government specified the breakdown of the cuts for each expenditure item in the decision.

In this paper, I will briefly explain the development of fiscal consolidation in Japan and show the recent change in the components of expenditures: a decrease in government investment and an increase in social expenditure. Then, I will introduce two ideal types of expenditure, namely, project-type and program-type, and discuss expenditure control with respect to both types of expenditure.

1 Fiscal consolidation in Japan

1.1 Japanese fiscal target

In 2001, Japan set a target for fiscal consolidation in Basic Policies 2001: Japan will achieve a primary balance surplus for the central and local governments combined by the early 2010s. The primary balance as a percentage of GDP recorded its worst level of -6.0 per cent in 1999. However, the primary balance has improved as the government has made its utmost efforts and the economy recovered to restore tax revenues. The government has controlled expenditure through structural and fiscal reforms. The primary balance was -1.7 per cent of GDP in 2006 and will be -0.6 per cent in 2007. Now we are very close to the original fiscal target, but we have just achieved the first stage of fiscal consolidation. Japan's fiscal situation is still one of the worst among the advanced countries: debt is 148 per cent of GDP¹ and fiscal deficit is -3.6 per cent of GDP in 2007.

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¹ Long-term debt outstanding of central and local governments.

Table 1

Roadmap and Targets for Fiscal Consolidation

Phase	Term	Target
1	Fiscal 2001 - Fiscal 2006	-
2	Fiscal 2007 - early 2010s	Achieve a surplus in the primary balance for the central and local governments combined by Fiscal 2011 as a first step toward fiscal consolidation
3	Early 2010s - Mid 2010s	Reduce the debt-to-GDP ratio

Table 2

Targets for Expenditure Cuts
(trillion yen)

	Fiscal 2006	Fiscal 2011		Reduction (=a-b)
		Baseline (a)	Target (b)	
Social Security	31.1	39.9	38.3	-1.6
Personnel Expense	30.1	35.0	32.4	-2.6
Public Investment	18.8	21.7	16.1 to 17.8	-5.6 to -3.9
Other Expenditures	27.3	31.6	27.1 to 28.3	-4.5 to -3.3
Total	107.3	128.2	113.9 to 116.8	-14.3 to -11.4
Fiscal Gap to be filled				-16.5

Figures are the total for the central and local governments combined based on SNA.

Last year, a Cabinet Decision (July 7, 2006, Basic Policies 2006) elaborated on the original fiscal target mentioned above.

First, the government defined the following three phases to show a roadmap of medium-term fiscal consolidation.

Second, the government made clear the amount and the breakdown of expenditure cuts in order to achieve a primary surplus in its Basic Policies 2006. It identified a fiscal gap of ¥16.5 trillion in achieving the target in 2011. In order to fill the gap, the expenditure cut will be ¥11.4 to ¥14.3 trillion. The cut in social security spending is about ¥1.6 trillion and the cut in public investment is ¥5.6 to ¥3.9 from the respective base lines.

1.2 Fiscal projection

In January 2007, the Cabinet Office presented a fiscal projection² up to 2011. According to the projection, Japan can achieve a primary surplus in 2011 only if Japan meets the following conditions:

- a) Expenditures are cut to the maximum level, ¥14.3 trillion in 2011, the upper bound of the target in Basic Policies 2006.
- b) High productivity growth supported by proper policies leads to a high potential growth in GDP. Deflation ends and the CPI picks up toward 2 per cent. As a result, the economy moves onto a growth path so that the nominal GDP increases toward 3.5 per cent or more over the coming five years.

This projection shows that the most stringent expenditure control together with high economic growth is necessary for fiscal consolidation.

2 Change in the components of expenditure

2.1 Japanese trends

The expenditure components have changed and are expected to keep changing in Japan. As the population is aging and social welfare programs develop, social expenditure has increased drastically. In Fiscal 1965, social security related expenditure by the central government was only 1.6 per cent of GDP, whereas it amounts to 4.1 per cent in fiscal 2007. On the other hand, expenditure on public works has been diminishing. It was 2.2 per cent of GDP in fiscal 1965 but it is only 1.3 per cent in fiscal 2007. These trends will continue in the coming years, as Japan makes its utmost efforts in line with the expenditure targets mentioned above.

2.2 Trends in other advanced economies

Table 3 shows recent trends in social expenditure and government investment (Ig) in the major economies. We can observe a rapid increase in social expenditures also in all other advanced economies. As a result, social expenditure consists of a very large portion of total government expenditure nowadays (see Table 4). Government investment tends to be on the decrease especially in Germany and Japan.

² "Course and Strategy for the Japanese Economy: Reference Estimate by the Cabinet Office", January 18, 2007.

Table 3

Trends in Expenditures
(percent of GDP)

	Social Expenditure (Public)				Government Investment (Ig)			
	1990	1995	2000	2003	1990	1995	2000	2004
Japan	11.2	13.9	16.1	17.7	4.8	6.4	5.1	3.7
U.S.	13.4	15.4	14.6	16.2	2.4	2.3	2.5	2.5
Germany	22.5	26.6	26.3	27.3	2.2	2.2	1.8	1.4
U.K.	17.2	20.4	19.1	20.6	2.6	2.2	1.3	1.8
France	25.3	28.3	27.6	28.7	3.4	3.2	3.1	3.1
Italy	19.9	19.8	23.2	24.2	3.2	2.1	2.3	2.4

Source: Social Expenditure Database (OECD), National Account (OECD).

Table 4

Ratio of Social Expenditure to the Total Government Expenditure (2003)
(percent)

	Japan	U.S.	Germany	U.K.	France	Italy
Ratio	46.9	43.6	56.3	48.4	53.5	50.1

Source: Social Expenditure Database (OECD).

3 Expenditure control

3.1 Project-type expenditure and program-type expenditure

There exist many types of expenditure even though social expenditure weighs most in many advanced economies. Each expenditure has its own character. Control strategies are different for each type of expenditure. The economic effect and political implications differ in accordance with the type of expenditure. For the sake of simplicity, we can think of two ideal type expenditures and analyze the differences between the two. They are “project-type” expenditure and “program-type” expenditure.

“Project-type” expenditure is usually direct investment or consumption by the government in order to implement projects. Public works, such as construction of highways, airport or railways is a typical project-type expenditure. The government has a choice of which project to adopt in the budgeting process.

“Program-type” expenditure is a disbursement by the government to certain programs. The government has to accept the requirements of expenditure as long as they are based on an effective program. Program design is crucial in the budgeting process. Social security related expenditure such as medical care is typical of a program-type expenditure.

This typology is, in a sense, a simplification of the discussion. Many actual expenditures may not categorize into either of the two types. However, an analysis of the idealized expenditure type can help to understand the real budgeting process.

3.2 Implications and effects of expenditure control

3.2.1 Expenditure control process

The process of controlling expenditure is different for the two types of expenditure. Since the upper limit of disbursement can be set in the budgeting process for project-type expenditures, capping seems more effective. If you need to cut project-type expenditure, you can do so by slowing down the project or cutting the number of projects; for example, construct nine bridges instead of ten. On the other hand, if you wish to control program-type expenditures, you have to engage in program design. For example, you have to cut the level of medical support to a patient from 80 to 70 per cent. Once the program comes into effect, you cannot limit the number of people who are applicable to the program or you cannot cut the level of support to each recipient of the subsidy. If the program does not have a sunset clause, the expenditure will disburse automatically as the program proceeds year by year. Since the budget for program-type expenditure is just an estimation of the disbursement, we can only find out the actual expenditure after the disbursement is settled. In the budgeting process, we discuss control over program-type expenditure only on an estimated basis.

3.2.2 Economic effect

The economic effects are different for both types of expenditures. A reduction in public works decreases the aggregate demand of the economy directly and indirectly through the multiplier effect. This negative effect could be offset by the increase in private demand if the reduction crowd in the private investment. Table 5 shows the recent change in public and private investments in Japan. According to these figures, the decrease in public investment was compensated by the increase in private investment after FY2003. Although Japan is implementing considerable cuts in public works, the economy has been on the track of recovery. The increase in private investment is not necessarily the effect of the crowd-in, since the interest rate stayed at a very low level throughout this process. We are often tempted to employ project-type expenditures as a tool to stimulate the economy, since we can control the amount of expenditure more directly than program-type expenditures. In late 1990s, Japan expanded public works spending to overcome the recession unsuccessfully and piled up the huge debt.

Table 5

Public Investment and Private Investment in Japan
(percentage of change from the previous year)

	Fiscal 2001	Fiscal 2002	Fiscal 2003	Fiscal 2004	Fiscal 2005
Public Investment	-4.7	-5.4	-9.5	-12.7	-1.4
Private Non-residential Investment	-2.4	-2.9	6.1	6.3	5.7
GDP	-0.8	1.1	2.1	2.0	2.4

Source: National Accounts.

A reduction in program-type expenditure has more complicated effects on the economy than that in project-type. In April 2003, the government implemented the medical care system reform. The public support to medical expense for each member of the employees' medical plan was reduced from 80 to 70 per cent. In other words, the actual payment for each patient increased from 20 to 30 per cent just like a rise in price. Medical expense per capita decreased by 4.2 per cent in 2003 for those who belong to the reformed plan. The price signal which enhanced by the reform diminished the demand for medical services. The reform seemed to have the substitute effect in addition to the income effect. Despite the reform the national medical expense is still growing rapidly as the aging of the society proceeds. Therefore, Japan needs to implement further medical system reforms. Some programs, such as the unemployment insurance, function as a typical built-in stabilizer of the economy. It is difficult to employ program-type expenditures as a tool for discretionary fiscal policy.

3.2.3 Distributional effect

The effect of project-type expenditure is direct but limited regionally. The economies of some regions in Japan are more dependent on public investment. Cuts in project-type expenditures induce distributional effects among regions. In Hokkaido and Tohoku (northern rural area), the public investment to the area GDP is 7.3 per cent, while in Kanto (where Tokyo is) the rate is only 2.6 per cent. Cuts in public works weaken the income redistribution among the regions.

The effect of program type expenditure is nationwide, since any people in the nation are usually eligible for government programs. Programs, especially social programs, have income redistribution effect. Therefore, for example, a cut in pension program diminishes redistribution of income among the generations and a cut in social aid reduces that among income groups.

Table 6**Project-type Expenditure and Program-type Expenditure (Summary)**

	Project-type Expenditure	Program-type Expenditure
Character	Investment to a Project by the Government	Disbursement based on a Program
Examples	Public Works	Social Security
Economic Policy	Discretionary Fiscal Policy	Built-in-stabilizer
Distribution Effect	Distribution among Regions	Income Distribution among Groups
Control Method	Capping in the Budgeting Process	Engage in the Program Design Process
How to Cut	Cut the Number of Projects Slow down the Project	Cut the Level or the Coverage of Assistance

3.2.4 Political implications

Aspects of political support are different for these two types of expenditure. For project-type expenditure, political pressure is strong at the stage of picking up the project. Requests come from the constituency where the project may be implemented. We can observe assembly members of both the ruling party and opposing party supporting the same projects in the same constituencies, even though the stance on nationwide public works are different between both parties.

On the other hand, requests for program-type expenditure come from the group of people who can benefit from the program. For example, an occupational group, an income class or a generation can be the originators of the request. Therefore, program design tends to lead the political debate among parties.

4 Conclusions

Expenditure control is essential in the fiscal consolidation process. Japan has made its utmost efforts to cut expenditures and the primary balance has improved since 2003. Japan will continue these efforts in coming years in order to achieve primary surplus by 2011. Control strategies are different for each type of expenditure. The economic effect and political implications differ in accordance with the type of expenditure. We have to pay attention to the nature of the each expenditure in implementing expenditure cuts. For the simplicity, I presented two ideal types of expenditure, project-type and program-type, and discuss the differences between the two in some aspects. For project-type expenditures, the expenditure cut can be implemented by slowing down the project or cutting the

number of projects. Capping in the budget is effective to control this type of expenditure. In general, beneficiaries of a project is limited regionally, therefore, political support and economic effects of a project is strong but limited to the region. On the other hand, we need to engage in the program design to cut program-type expenditures. Social programs often have redistribution effect among groups of people and the cut in the expenditure tend to cause political debate among parties. A cut in budgeting process is just an estimated difference between the baseline and the reviewed for the program-type. Social programs sometimes function as a built-in stabilizer and the actual expense depends on the economic situation. As the economic effect and political implications differ in accordance with the type of expenditure, we have to plan the suitable strategy to control each of expenditure.

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