

Debt Sustainability in Japan¹

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1. Introduction

Japan has a strict legislation against debt accumulation by the Government. The Public Finance Law of 1947 allows only “construction bonds” which are issued in order to finance expenditures that lead to accumulation of assets, *inter alia*, public infrastructure investments². Government bonds issued for financing government consumption or loss of revenues, those which are called “deficit-financing bonds,” are prohibited.

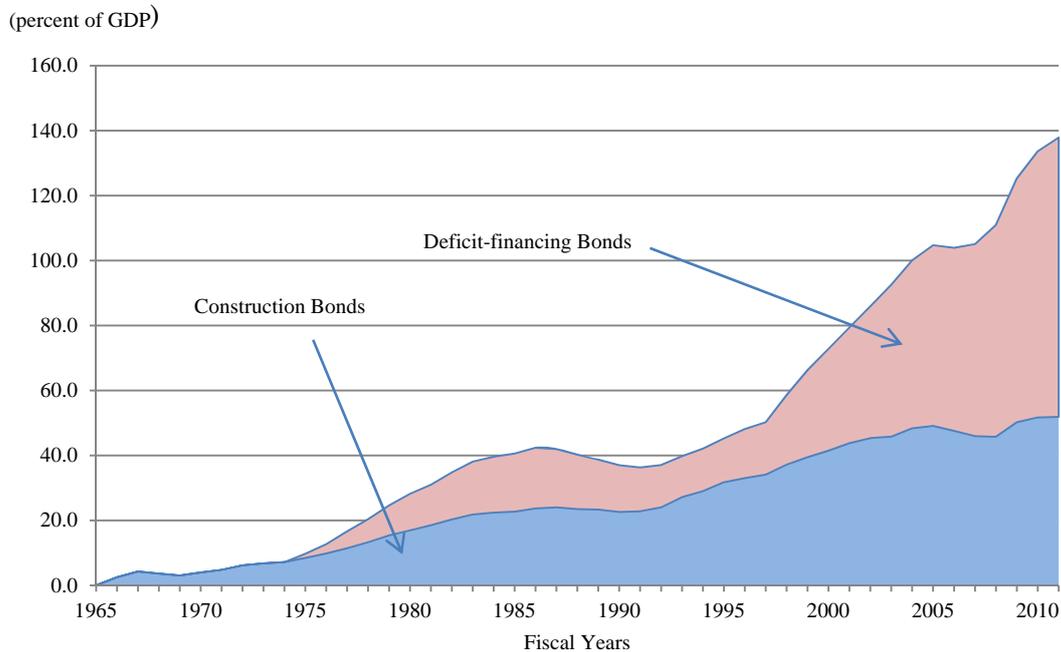
The stance of the government in early years was more cautious than the requirement of the legislation. No government bonds, not even “construction bonds,” were issued before FY1965. It was only after the outbreak of the serious recession that took place in 1965, dubbed “Structural Recession,” when the Government initiated the issuance of government bonds. After issuing “deficit-financing bond” briefly in FY1965 as an emergency measure, “construction bonds” became an essential source of financing after FY1966. However, the amount of government bond issuance was still very limited, and restriction on “deficit-financing bonds” was strictly observed.

The situation changed in the aftermath of the first oil crisis, which forced the Japanese economy to experience her first negative growth since just after the World War II. The need to stimulate demand and pull the world economy out from the global recession as a “locomotive,” which was the outcome of the London Summit in 1977, resulted in a rapid build-up of outstanding stock of government bonds. The impact was apparent in both categories of government bonds (Figure1).

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² Article 4 of the Public Finance Law reads as follows: “National expenditures shall be compensated by the revenue excluding those from public bonds or borrowing. However, for the source of public works expenses, disbursements and loans, it shall be permissible to issue public bonds or make loans not exceeding the amount approved by the Diet.”

Figure 1
Central Government Bonds



First, in order to maintain government consumption and transfers in face of fall in revenues, issuance of “deficit-financing bonds” became a usual practice. After FY1975, Government had to have a special legislation approved by the Diet each year in order to authorize the bond issuance which is prohibited by the Public Finance Law. Second, public infrastructure investment were expanded in order to stimulate the economy. Accordingly, issuance of “construction bonds” also increased at a rapid pace.

In the subsequent recovery phase, the government introduced a restraint on expenditures (i.e. “zero ceiling” or “minus ceiling” on initial budget requests) to reverse the deterioration of the fiscal situation. In spite of the efforts, however, increase in government expenditures was not completely reversed so that outstanding government bonds continued to increase in a ratchet-like manner. The situation was briefly masked by the steady growth in the first half of the 1980s, and by the “bubble economy” in the second half. Improvement in the fiscal situation was also supported by the relatively low interest rate realized by the interest rate regulation and the low interest rate policy by the Bank of Japan (especially during the latter half of 1980s). The magnitude of outstanding stock of central government bonds relative to nominal GDP were stable, and even declined towards the end of the 1980s. For a brief period, even the new issuance of “deficit-financing bonds” was brought to zero.

The situation, however, worsened in the next decade. The deterioration of fiscal

situation rapidly became apparent with the burst of the bubble in the early 1990s.

First, a series of economic stimulus packages were implemented³. Since March 1992, total of 16 packages were introduced with majority accompanying supplementary budgets. The measures taken in the period included increase in public investment expenditures as well as tax cuts. The measures, however, proved to be unsuccessful in bringing-about the expected outcomes. It was partly because the increase in public investment of the central government was often offset by the decline in public investment of the local governments who were facing severe budget constraint. But it was also because the transmission mechanism of fiscal policy was discontinued by the excess debt situation of the corporate sector and by the non-performing loans problem in the banking sector⁴.

Second, decline of population and its aging has started to exert pressure on public finance. It led to a rapid increase in benefit payments to the elderly by the social security system. Since the working population started to shrink in 1996, and economic conditions remained stagnant throughout 1990s, increase in premium receipts was limited. As a consequence transfers from the government to social security system, which is necessary to fill the balance, expanded.

Third, the deregulation on the financial sector that took place in the 1980s allowed interest rates to reflect the market conditions more flexibly. The long-term interest rates often exceeded the growth rates which were low, and even became negative. Interest rate payments also became a burden.

Some successes in fiscal consolidation were achieved in the 2000s.⁵ It was made possible by the accommodative environment which was provided by the longest expansionary phase in the post-war period (between January 2002 and February 2008). However, the achievements were quickly overturned by the severe recession following the outbreak of the sub-prime mortgage problem in the U.S. (between February 2008 and March 2009) and by the tragic earthquake and tsunami disaster in Eastern Japan (March 2011).

As a result, the fiscal situation at present is among the worst in the world. According to OECD (2011), which supplies data for the general government, the ratio of financial balance to GDP in Japan for 2010 is among the worst in the OECD members with deficit of 8 percent, which is only slightly better than those in countries which have

³ Keynesian discretionary fiscal policy has been popular in Japan even in the 1990s, which is in contrast with the situation in the U.S. and the European countries. It implies that there was no need of a “return of the master Keynes” after the Lehman Brothers shock in Japan.

⁴ The change in the business cycle in the 1990s is discussed in Saito (1997).

⁵ For a discussion of the fiscal and other economic policies in the 2000s, see Saito (2006).

recently received financial assistance from the international community. The seriousness becomes more apparent when we compare the ratio of gross government debt to GDP. Japan has the highest ratio of 199.7 percent, only to be followed by a group of countries which has ratios around 120%.

Having seen the data, it is natural to be anxious about the sustainability of the Japanese fiscal situation. In the following, current state of public finance will be analyzed, and its sustainability examined. They will form the basis for the subsequent discussion on the measures of fiscal consolidation. To conclude, issues for further consideration are noted.

2. Current Situation of Public Finance

2-1 Choice of Fiscal Indicator

Before examining the current situation of public finance, it would be worthwhile to clarify the definition of the fiscal indicator we employ.

Fiscal situation is often discussed by looking at the general account of the central government. It is where most of the allocation of budgetary resources to policy objectives is made, and it is also most visible to those outside the government. However, it is not an appropriate indicator of fiscal situation in two respects. First, there are many special accounts outside the general account that make financial transactions with the general account as well as with agents outside the government. Second, there are also local governments which also make disbursements from resources raised by taxes and local government bonds as well as transfers from the central government.

In view of the above, the concept of the government typically employed for analytical purposes is that of the System of National Accounts, i.e. “general government” which includes social security fund as well as central and local governments. General government is an appropriate concept when, for example, an international comparison is necessary because it will not be affected by the difference in social security system, i.e. whether it is a part of the central government or is managed by social security funds. However, when Japanese financial situation is to be assessed, general government concept may be misleading. That is because the primary balance of social security fund in Japan has been in surplus until 1997 so that accumulated assets can be drawn down in the future for financing benefits receivable by the aged⁶. Deficit of the fund in

⁶ Current Japanese social security system was established in 1961 when national pension insurance system was introduced for the self-employed. The system covers the whole population and is managed as a modified pay-as-you-go system, in which the benefits for the elderly are financed by premiums paid by the insured, augmented in part by accumulated assets and transfers from the government.

subsequent years shows that it is exactly what is taking place at present. Thus combining social security fund with central and local governments may make fiscal situation look different from what it actually is.

The discussion naturally brings us to the issue of the choice between gross-term and net-term debt and financial balance. Net-term figures are much lower than the gross-term ones (according to the OECD, net financial liabilities of the general government in Japan in 2010 is 116.3 percent of GDP). There are proponents of the view that fiscal situation is not as bad as the argument based on gross-term figures suggests⁷.

To obtain debt figures in net-term, government assets need to be subtracted from the gross debt figures. One group of assets that is significant in magnitude is foreign reserves, whose total magnitude is one of the largest in the world. If this is subtracted, it may make a large difference. But since foreign reserves are accumulated by paying Japanese Yen which were, in turn, purchased by issuing short-term government debt, it does not make much difference in net-terms, other than accrued interest from the foreign assets held, if both foreign assets and backing short-term debt is covered: they would simply cancel-out. Another group of assets is those accumulated in the social security fund. The problem does not arise if social security fund is excluded from the definition of the government as we have argued for earlier. But even if it is included, assets in the social security fund reflect liability to pay benefits in the future. It implies that these assets are unqualified to be used for repayments of government bonds, so that it is also unqualified to be subtracted from government debt. Finally, there are also group of assets other than financial ones⁸. There are property held for roads, rivers, ports, and other public purposes. Even though they are assets, they cannot be presumed that they be sold. There are also group of property that are unused or inefficiently used. They would be eligible for selling by the government to raise funds to repay government debt. The problem is the valuation of those assets.

In consideration of the above, the following discussion will be based on the gross long-term debt figures of the central and local governments combined (referred to as “government debt” hereafter unless stated otherwise). It excludes social security funds as well as short-term government debt⁹.

⁷ Such an argument was made by Broda and Weinstein (2004).

⁸ According to the System of National Accounts, non-financial asset of the general government amounts to 469.4 trillion Yen at end-2009.

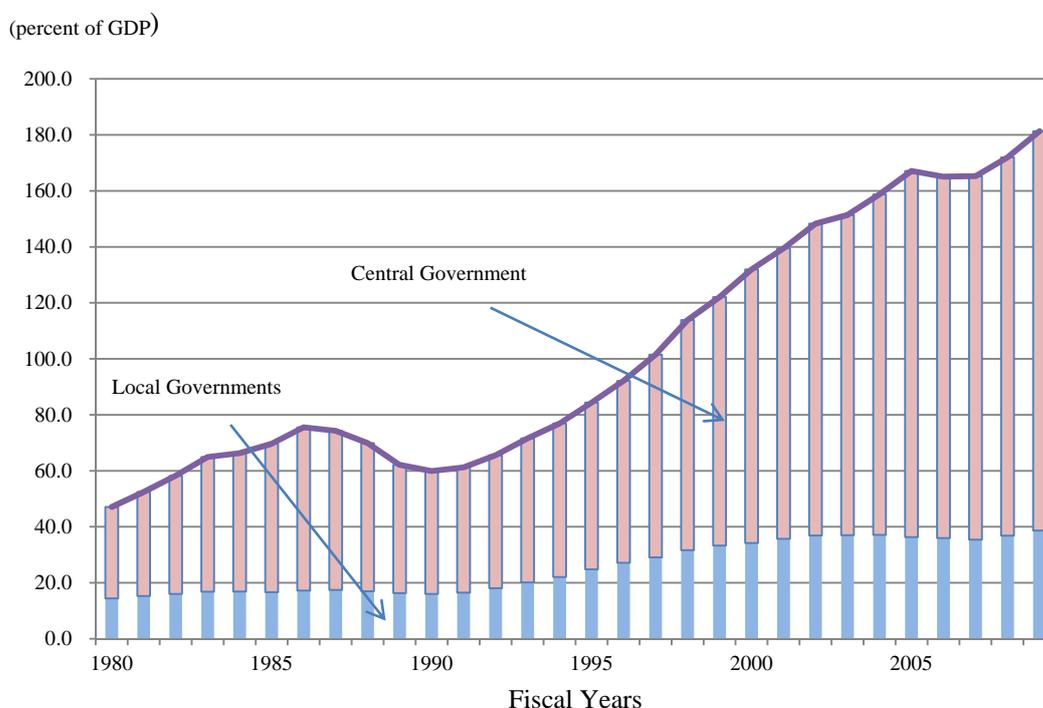
⁹ The concept is basically same as that of CAO (2010b and 2011a), except that the coverage of the latter is slightly more narrow, and that they make adjustments for one-time transfers of assets to the central government etc.

2-2 Steep Rise in Government Debt

Government debt to GDP ratio, employing the above concept, shows that the ratio which was about 60 percent at end-FY1990 rose rapidly in the 1990s to above 100 percent by end-FY1997 (Figure 2). It showed slower increase in 2000s and even fell after reaching more than 167 percent in FY2005. But it started to rise again in FY2008, and by end-FY2009 it reached 181 percent.

Though bonds issued by both the central and local governments increased, the bulk of the increase was due to the former which alone amounted to more than 142 percent of GDP.

Figure 2
Central and Local Government Debt



2-3 Deterioration of Financial Balance

The developments in the public debt to GDP ratio reflects the changes in the financial balance of the central and local government combined. It shows that during the 1990s, financial deficit widened to reach about 8 percent of GDP in FY1999. In the 2000s, it showed a gradual improvement, becoming less than 3 percent of GDP between FY2006 and FY2008. It reflected the fiscal consolidation efforts during the period as well as the prolonged economic recovery phase (from January 2002 to February 2008) which turned out to be the longest in the post-war period. However, the impact of the

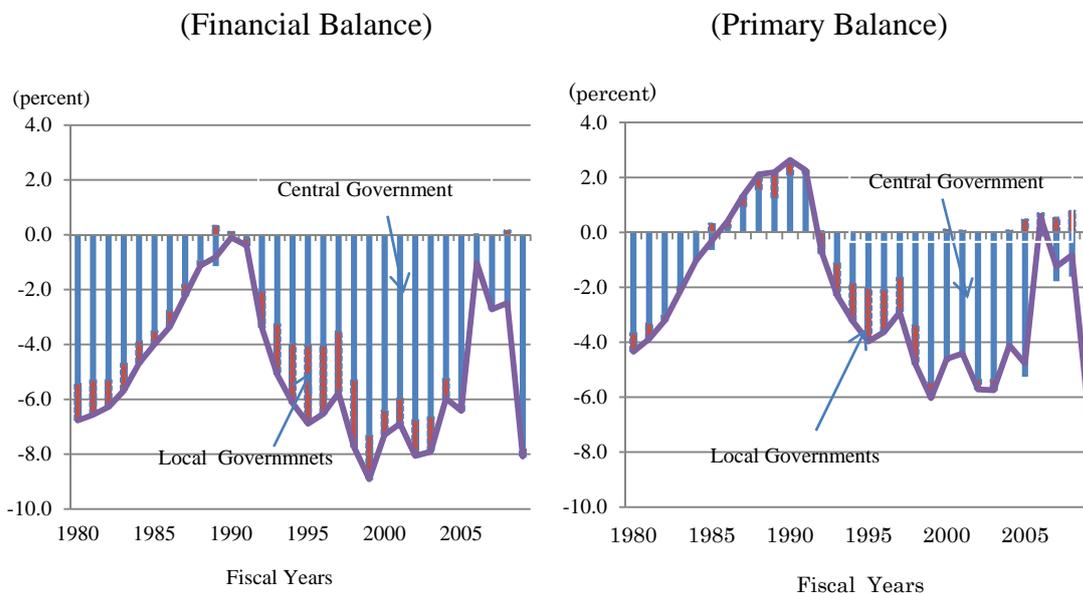
great recession in 2008 and 2009 widened the deficit to almost 8 percent in FY2009.

Breaking-down the balance between central and local governments shows that increase in deficit was due mainly to the worsening balance of the central government, while the local governments gradually reduced their deficit.

Profile of the primary balance is almost the same as the financial balance except that the level is about 2 percentage points lower than the latter (corresponding of course to the interest payment on debt). A point worth noting is that the pace of the improvement in the balance in the first half of the 2000s. The primary balance has not improved as much as the financial balance during the period, implying that the latter benefited from the decline in interest payment due to the monetary easing that took place during the period.

Deterioration of the financial balance could be a result of worsening of either structural or cyclical deficit, or both. Of the two factors that that led to the deterioration, widening of structural deficit is estimated to have overwhelmed widening of cyclical deficit. According to CAO (2011b), the latter is estimated to have been only 2 percent in FY2009. It confirms the smallness of the built-in-stabilizer in the system, and provides the background for the traditional reliance in Japan on the discretionary fiscal policy.

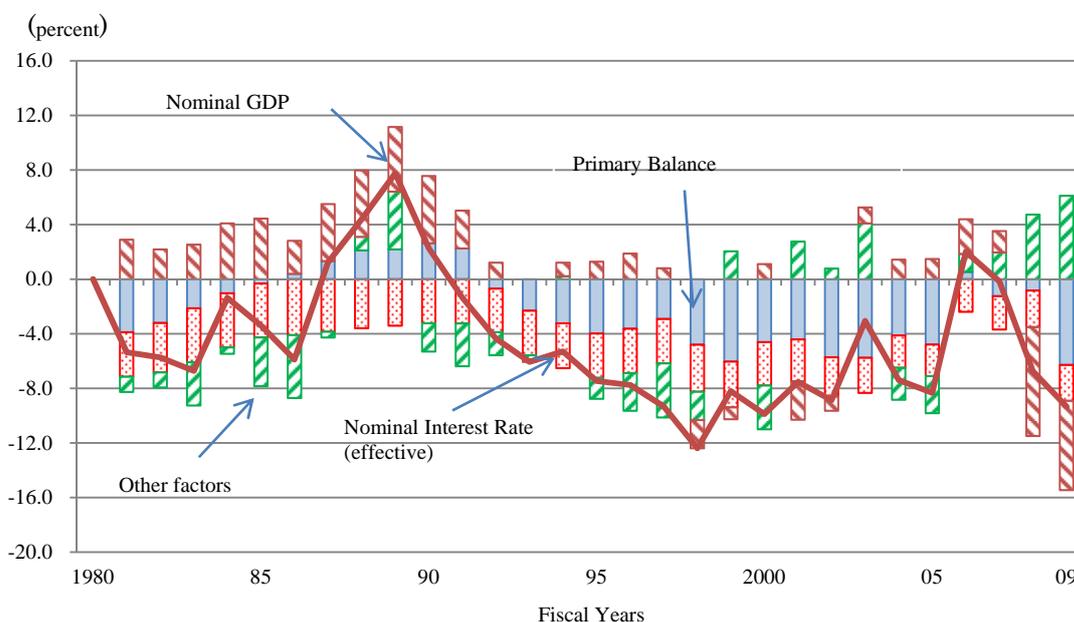
Figure 3
Fiscal Balance



3. Factors Affecting the Changes in Government Debt to GDP Ratio

The changes in government debt to GDP ratio can be attributable to the changes in the primary balance, nominal effective interest rate, and nominal GDP growth rate (Figure 4). We will see them in turn.

Figure 4
Factors Affecting Changes in Government Debt to GDP ratio



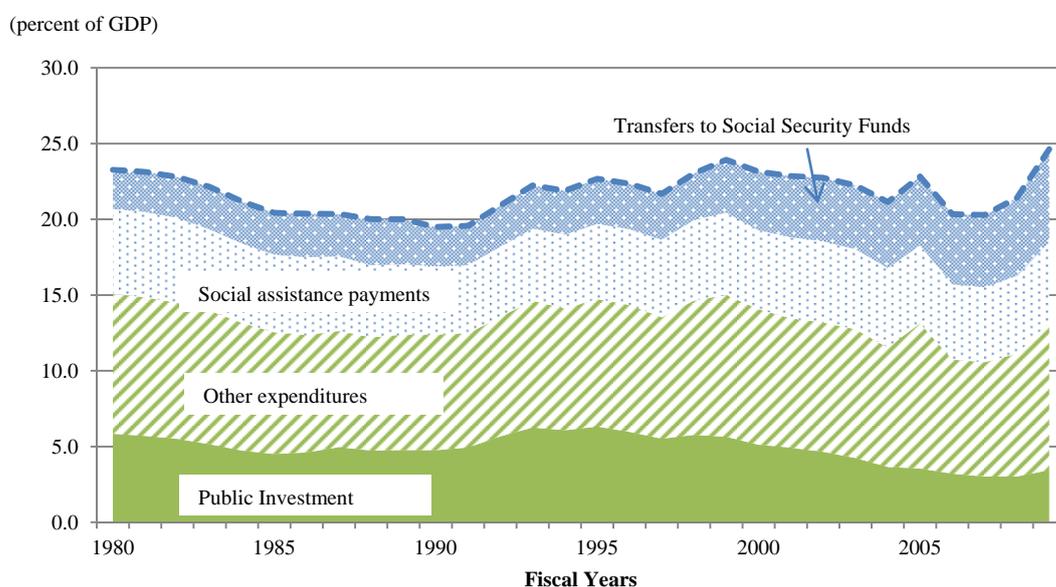
3-1 Primary Balance

Primary balance improved in the second half of the 2000s. At its recent peak, the primary balance showed a surplus in FY2006 and a deficit of less than 2 percent in FY2007 and FY2008. While they were partly attributable to the receipts of one-time transfers of assets from a number of special accounts outside the central government, they also reflected fiscal consolidation efforts made in the first half of 2000s. If the trend was sustained, primary balance could have reached a surplus on a sustained basis by FY2011, which was the target year for the fiscal consolidation at that time. The trend was reversed when the impact of the subprime loans problem brought an end to the prolonged recovery phase in the early 2008. The Lehman Brothers shock was a further blow to the economy. Decline in tax revenue due to the recession and increase in government expenditures aimed to support the economy under strong downward pressure worsened the primary balance.

Breakdown of primary balance to government expenditure and revenues provides explanations for the changes in the primary balance (Figure 5).

On the expenditure side, public investment has often been blamed for the worsening of the fiscal situation. Certainly it was a significant factor in the first half on the 1990s. However, since mid-1990s, it has been on a declining trend until it was reversed in the most recent recession. What has offset the decline in public investment was the steady increase in transfers to the social security funds that cover pensions, medical care, and long-term care.

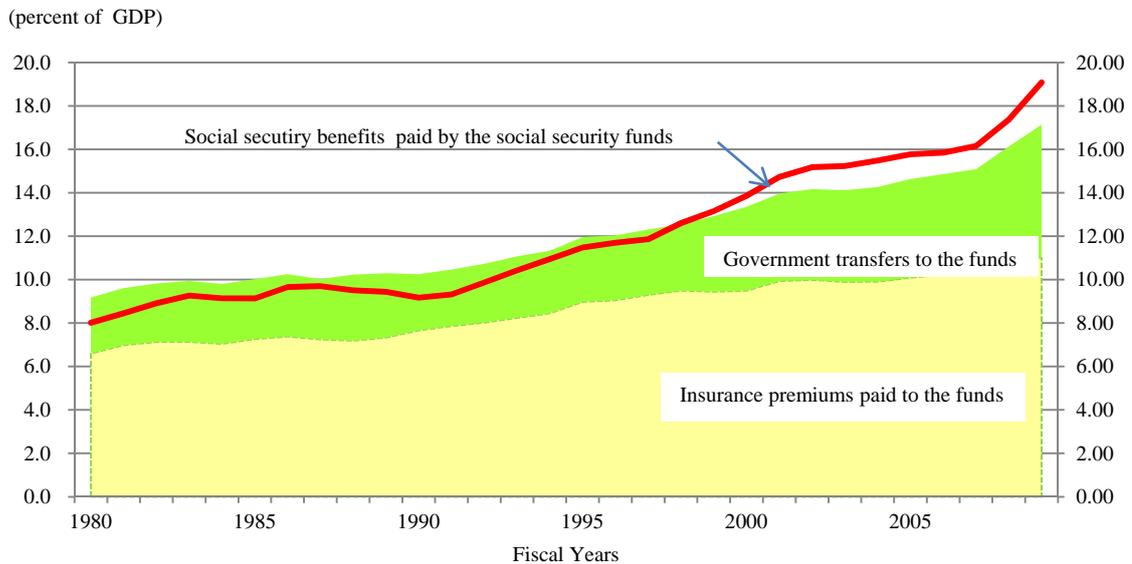
Figure 5
Breakdown of Government Expenditures



As is well known, Japan is in midst of a rapid aging progress within a shrinking population. The share of those aged 65 or more in the total population has risen above 23 percent in 2010, and is expected to exceed 25 percent in 2013. At the same time, total population has started to shrink since 2004 when a peak of 128 million people was reached, and is expected to become less than 120 million in 2025.

Against this backdrop, social security benefit payment is increasing rapidly (Figure 6). The benefit paid by the social security funds for pension, medical care, and long-term care together were about 10 percent of GDP in FY1993 and increased to almost 20 percent in FY2009. The social security contribution, on the other hand, has risen only by a slower pace. It was about 8 percent of GDP in FY2000, but risen only to 11 percent by FY2009. The resulting gap was left to the government, as well as running down assets, to fill.

Figure 6
Balance of Social Security Fund



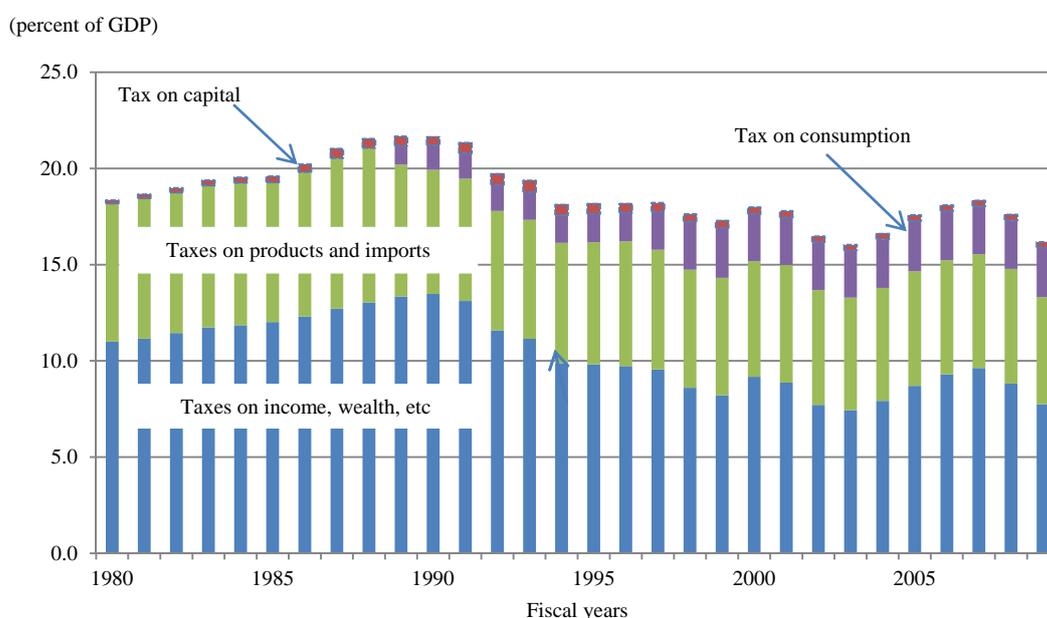
Efforts have been made in order to limit the growth in benefit payments. Pension, in particular, when the system was reviewed in 2004, introduced what is called a “macroeconomic slide” whereby benefits are cut by the rate of decline in working age population as well as the extension of life expectancy. Together, it is estimated to lead to an annual cut by 0.9 percent. If this clause is implemented fully it is expected that it would be almost enough to stabilize the pension payments in terms of its ratio to GDP. The problem is that its introduction is sustained until sometime after prices have started to increase¹⁰. Since Japan is still in deflation, it could be well into the future. More vital problem is that, for medical care and long-term care, there are still no mechanisms introduced to the system which could limit benefit payments which already has started to increase at a significant pace, albeit from a lower level than that of the pension,.

On the revenue side, tax revenue to GDP ratio has shown a gradual decline since FY1980, even though consumption tax (the Japanese VAT) was introduced in 1989, and was raised in 1997. The decline is due partly to cyclical changes but due also to changes in tax system, mainly reflecting tax cuts that took place in advance of the introduction

¹⁰ To be precise, the arrangement is that macroeconomic slide will only be introduced after the suspension of pension cuts, which should have taken place even when prices fell, is made up for by the suspension of pension increases, which should take place once prices start to rise.

and increase of consumption tax as well those that formed a part of stimulus packages. If tax revenues are adjusted for the changes, the ratio averaged over the medium-term would almost be flat. It implies that long-term GDP elasticity of tax revenue is about unity. Looking at individual tax categories, personal income tax has a progressive tax rate so that GDP elasticity is over unity. Corporate tax has a flat rate, but since lower tax rate applies to small and medium sized enterprises, its elasticity also exceeds unity. On the other hand, property tax, for instance, do not necessarily increase along with GDP. Grouping different taxes together should provide elasticity with respect to GDP as mentioned above.

Figure 7
Breakdown of Tax Revenues



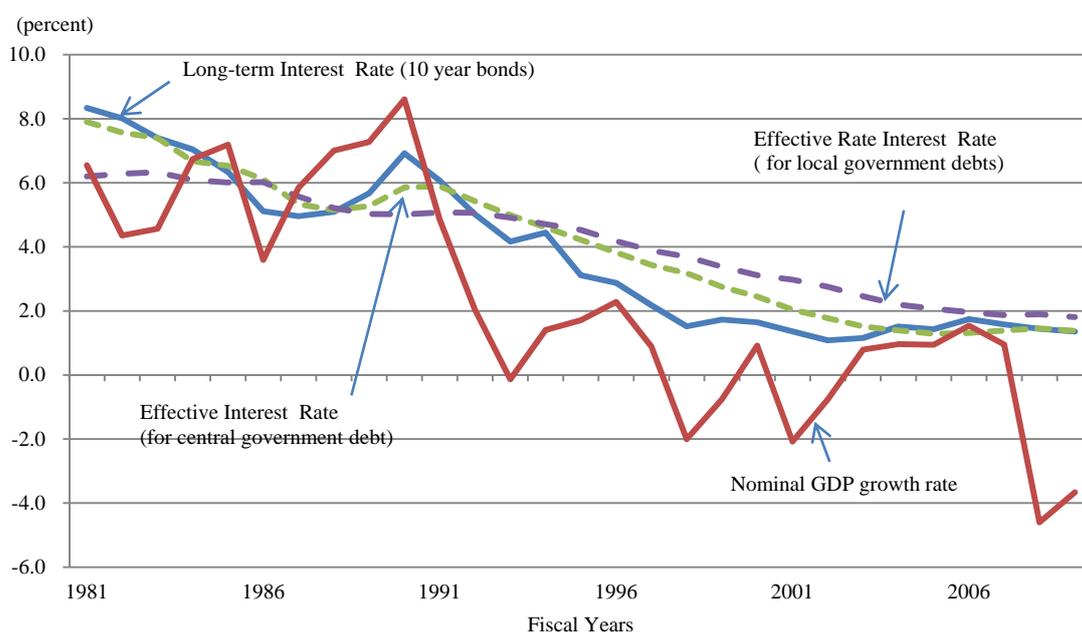
3-2 Long –term interest rate and nominal GDP growth rate

With respect to the difference between the effective interest rate on debt and the nominal GDP growth rate, it differs by period¹¹. In 1980s, which included the bubble period, nominal GDP growth rate was higher than the interest rate contributing to exert a downside pressure on debt to GDP ratio. However, the situation reversed in the 1990s, when the bubble burst and non-performing loans problem dragged the economy down so that it was only able to achieve very low growth rate, if not a negative one. During

¹¹ Note that the comparison made is between the “effective rate of interest paid on debt” and nominal growth rate. Since long-term interest rate only applies to new debts, “effective rate” tracks the long-term rate with a lag.

the prolonged recovery period of early 2000s, the growth rate revived once again to the level close to the interest rate which was under the influence of the quantitative easing policy. The Lehman Brothers shock in 2008, however, brought another period of interest rate exceeding the growth rate. Although the relationship differs from period to period, nominal long-term interest rate on average has tended to exceed nominal GDP growth rate on average over the period of 1980s to 2000s.

Figure 8
Interest Rates and Nominal GDP Growth Rate



4. Sustainability of the fiscal situation

4-1 Analysis of debt sustainability

Sustainability of the fiscal situation in Japan has been examined by a number of different approaches¹². They include; (a) examination of whether the no-Ponzi game condition is satisfied in the debt dynamics; and (b) examination of whether government debt is a stationary series or cointegrates with other fiscal variables. They tend to suggest that debt sustainability has been lost during the fiscal management of the 1990s. It matches the intuition provided by the observation of data.

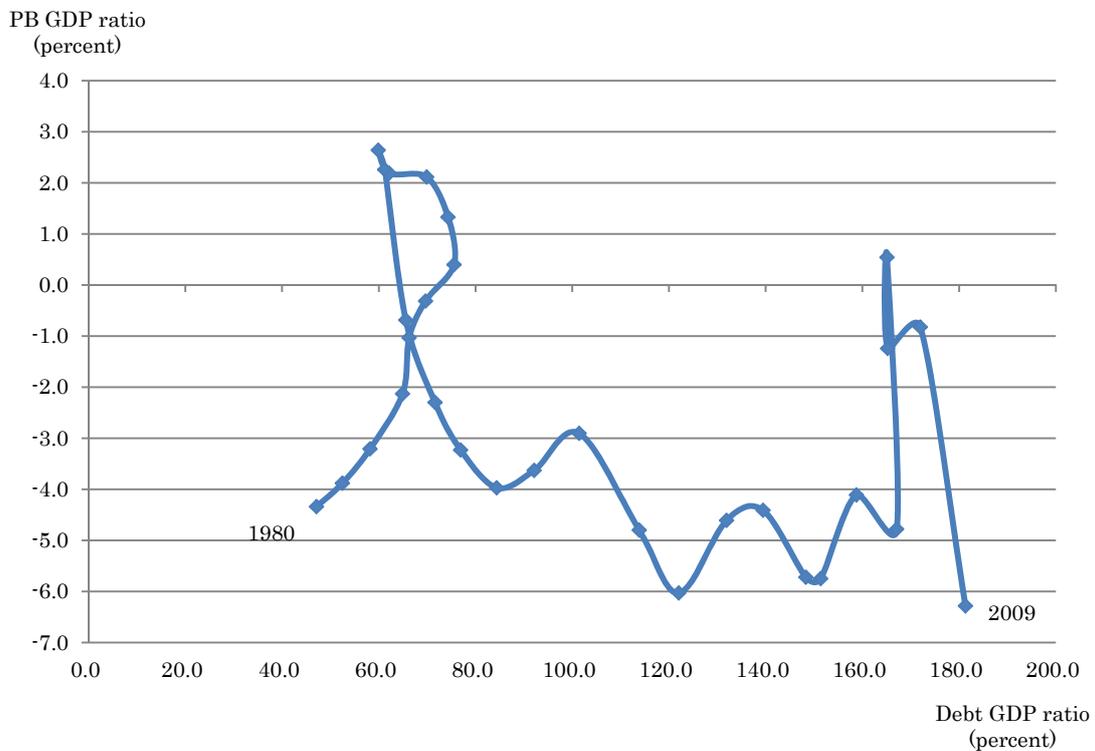
Although they provide an assessment of the fiscal management of the past, it may not apply to current and future fiscal management. For that purpose, some additional

¹² A survey of research made on the debt sustainability in Japan is provided in Kato (2010).

analyses are warranted.

One way to examine the sustainability of the Japanese fiscal situation is to look at the relationship of debt to GDP ratio and primary balance, as suggested by Bohn (1998). According to this view, increase in debt to GDP ratio should encourage efforts to alter the fiscal situation and lead to an improvement in primary balance, implying a positive correlation between debt to GDP ratio and primary balance. Positive correlation does show up during the first half of 2000s. However, it has been disturbed by the Lehman Brothers shock which more than reversed the improvement in the primary balance.

Figure 8
Bohn's Condition



Another way to check the sustainability of the fiscal situation is to simulate the future trend by a macroeconomic model which incorporates fiscal and social security sectors. Cabinet Office undertakes a semi-annual exercise which provides simulations on real as well as fiscal sectors. For instance, CAO (2010) shows that without additional fiscal coordination efforts, even though primary balance is expected to show a modest improvement, deficit in the financial balance is expected to widen continuously in the 2020s and, as a result, debt to GDP ratio is also expected to rise. The simulation is done for two scenarios that distinguish each other by the medium-term growth rates, but the

difference in growth rates only affects the pace of deterioration of the financial deficits and the rise in debt to GDP ratio, but not the trend.

Finally, generational accounting provides further insights on the sustainability of the fiscal situation. The deterioration in the fiscal situation means that current generation is enjoying benefits in their lifetime while passing-on the burden to the future generation. Studies extending the approach to include past benefits and contribution as well as future ones show that, among the current generation, the older generation will receive benefits in excess of contributions while the younger pay more than they receive. However, bulk of the financing of current fiscal and social security programs is left to the future generation to bear¹³. It suggests that, in social aspect as well, the situation is not sustainable.

4-2 Insensitivity of Japanese long-term interest rates

Notwithstanding the difference in method, examination of the fiscal situation all suggests that the Japanese fiscal situation is unsustainable. Although it agrees with intuition, it seems inconsistent with the low long-term interest rate in Japan. Surely, if the market is aware of the unsustainability of the fiscal situation, it would ask for a higher risk premium. One popular view is that interest rate was low (“dog didn’t bark”) because market participants did not fully reflect fiscal fundamentals. But once current account balance turns deficit or government debt exceeds gross household financial asset, proponents of the view asserts, it would lead to a higher interest rate¹⁴. In order to understand the situation, it is worth noting a number of points.

First, whether the long-term interest rate has incorporated a fiscal risk premium should not be judged by an absolute level of the interest rate but rather by comparing it to an equilibrium rate. An equilibrium nominal long-term interest rate can be considered to be determined by short-term interest rate, real potential growth rate, and expected inflation rate. Since potential real growth rate in Japan, which is facing decline in population, is as low as 1/2 percent, and that inflationary expectation is in the negative field, equilibrium nominal interest rate should be quite low, far less than the apparent low nominal long-term interest rate in Japan. The difference between the two should include, among others, fiscal risk premium. In fact, CAO (2010a) has found that the variables mentioned above, as well as government debt, were significant in determining long-term interest rate. While it confirms the incorporation of fiscal risk premium in the long-term interest rate, it is also true that the fiscal risk premium is small compared to

¹³ See, for example, Masujima et al (2009).

¹⁴ See, for instance, IMF (2011), Berkmen (2011), and Tokuoka (2010).

the largeness of the debt to GDP ratio. It relates to the following point.

Second, Japanese current account position, which is in surplus, seems to have limited the magnitude of the fiscal risk premium. Large current account surplus implies that newly issued government debt can be purchased by domestic investors, and do not have to ask foreign investors to absorb them. In fact, government bonds, even though the amount outstanding is almost 200 percent of GDP, are mostly held by domestic investors (more than 90 percent). CAO (2010b) has found that, among the OECD countries, the size of fiscal risk premium is inversely related to current account surplus.¹⁵

Third, there is a strong incentive for banks to hold government bonds. Deposits are still a major source of savings in Japan so that banks have ample resources for lending and investment. Since firms are less eager to make business investment, and even when they do, they can either use their retained profits or tap securities market, banks are inclined to purchase government bonds. After all, banks can enjoy capital gains by holding government bonds, at a time as at present, when the Bank of Japan commits to low interest rate policy for a considerable period. The incentive to purchase government bonds are strengthened by the bank regulation that treats government bonds as having zero risk-weight.

5. Measures for Fiscal Consolidation

A necessary condition for a sustainable fiscal situation is for the government debt to GDP ratio to stabilize in the medium-term. Useful starting point is the Domar's condition,

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{D_{t-1}(i - g)}{Y_t} - \frac{(G_t - T_t)}{Y_t}$$

where D denotes government debt, Y gross domestic product, i nominal effective interest rate, g nominal GDP growth rate, G government expenditures, and T tax revenues.

It suggests that, on order to stabilize government debt to GDP ratio, one of the following situations should be met; (a) when interest rate is equal to growth rate,

¹⁵ . The size of fiscal risk premium, however, was found not to be affected by the share of foreign investors. It implies that it is not so much the ownership of the bonds than the abundance of savings that is important.

primary balance should be in equilibrium, (b) when interest rate exceeds growth rate, primary balance should be in a surplus, and (c) when interest rate falls below growth rate, primary balance could stay in deficit. However, historical record shows that nominal effective interest rate tends to exceed nominal GDP growth rate in recent years. Higher interest rate relative to growth rate is also expected to realize in the medium-term, as the simulations such as CAO (2010b, 2011a) show. Therefore, in order to achieve fiscal consolidation, it is safe to assume that primary balance is necessary to be zero or in surplus. In what follows, alternative measures for this end will be discussed.

First, nominal growth rate could be raised. Higher growth rate is considered to contribute in increasing tax revenue. During the business cycle, it is true that increase in growth rate leads to rapid increase in tax revenues because more firms become profitable and start to pay taxes. But when growth rate declines, just the opposite happens so that tax revenues drop more than proportionately. Therefore, in the medium-term, GDP elasticity is unity. In other words, tax revenues increase with the growth in GDP so that ratio of tax revenues to GDP stays almost at the same level in the medium-term. If the primary balance is to improve relative to GDP it has to come from other means.

Second, government expenditures could be cut. In view of the efficiencies in government expenditures in many respects it is an area of great potential. In this respect, priorities could be given to cut in discretionary expenditures. However, progress has already been made in this area, and as we have already seen, it is the social security expenditure that is exerting upward pressures on expenditures. Therefore, capping and reducing expenditures for social security benefits is the key area to make progress.

In order to reduce transfers to the social security system, the balance between benefits and contributions has to be improved. As for the pension system, a schedule to raise the premium rate until 2017 is already in place. On the other hand, review of benefits is still under consideration. Measures discussed include reduction of pension benefits for high-income earners, and change of eligible age for pension receipts from the current target of 65¹⁶ to 68-70. Discussion is also made to eliminate the extra benefit provided as a result of the suspension of price indexation in deflationary times. As for the medical care and long-term care, measures under consideration are; shortening of average length of hospital stay; introduction of fixed payment on medical consultation; promotion of use of generic medicines; and prioritization of long-term care facilities and

¹⁶ It would be fully applied from those born after 1961. For those born before 1961, the eligible age for pension receipt is shifted gradually from 60 to 65.

increase in-home care.

Third, tax rates could be raised. Compared to other industrial countries, the ratio of tax and social security contributions is low, which shows that there is room to raise the revenue of the government.

Among the major tax items, revenue from personal income tax has declined in the recent years since minimum taxable income was not adjusted along with deflation. However, due to the difference in tractability of incomes, lack of social security number tends to shift the larger burden of taxes to employed workers rather than to the self-employed. Furthermore, it implies that current working generation is going to bear most of the burden. Therefore, personal income tax cannot be the main source of tax revenue. As for the corporate tax, the effective tax rate at 40.69 percent is already high from international standards, and in order to maintain enough incentive for firms to stay within Japan, it should be lowered rather than raised. Thus, a natural choice is to raise the consumption tax rate.

Consumption tax rate is very low compared to other OECD countries. The average tax rate in European countries, for instance, is about 20 percent, and so there is a room for raising the rate¹⁷. Surveys show that as long as the revenues are used for meaningful purposes, social security purposes in particular, people are ready to accept the raise. Also, it is preferable from the point of view of intergenerational equality because higher tax rate would apply not only to the current working generation but also to aged retired generation.

6. Current Program in Place

6-1 Medium-term fiscal consolidation program

In face of the increased tension surrounding sovereign risk, it has become all the more important to show the commitment to fiscal consolidation. The current program which is being pursued by the Japanese Government is; (a) for the central and local government combined, to halve the primary deficit that existed in FY2010 by FY2015, and achieve surplus by FY2020; and (b) to achieve a steady decline of the debt to GDP ratio after FY2020¹⁸. Central government is also to achieve a similar goal as (a).

In order to meet the objectives, the Government intends to contain expenditure of the general account of the central government other than debt service in FY2012 and

¹⁷ IMF (2011b) suggests that consumption is preferable to other taxes because it is (a) less distortionary, (b) relative easy to administer, (c) stable source of revenue, and (d) fairer than other taxes in helping offset the imbalance in the distribution of lifetime pension benefits across generations.

¹⁸ Fiscal Management Strategy (June 2010).

FY2013 so that they do not exceed the level of those in the initial budget for FY2011. It also intends to ensure that the amount of government bond newly issued in FY2012 does not exceed the amount issued in the initial budget for FY2011.

In the medium-term, the Government is committed to raise the consumption tax rate in stages to 10 percent by mid-2010s¹⁹. The additional revenue raised by the increase in consumption tax rate is planned to be used for maintaining and strengthening the social security system. In order to make clear that the revenues are actually being used for the social security system, it will be managed by a separate account. The necessary legislation is going to be proposed to the Diet early next year as required by the law²⁰.

6-2 The impact of the Great East Japan Earthquake

The impact of the tragic Great East Japan Earthquake should be mentioned. The disaster required the government to allocate large sum of resources in order to restore those areas that were affected by the earthquake. The expenditures are going to be spent mainly in the “concentrated restoration period,” five years starting from FY2011. The total amount is going to reach 19 trillion yen, and is to be financed by a special government bond called “restoration bonds” as well as non-tax revenues and savings of other expenditures. “Restoration bonds” amounting to 11.5 trillion yen will be financed by temporary increase in tax rate of personal income and inhabitant taxes as well as corporate tax, and is planned to be repaid in 25 years.

These arrangements are designed so that the fiscal impact will not add to the long-term burden on the future generation. To make that transparent, issuance and repayment will be managed separately from other bonds.

7. Conclusion

As we have seen, the fiscal situation is rapidly deteriorating in the recent years, and is becoming unsustainable. Efforts to rectify the situation are clearly warranted. The difficulty is that the underlying forces of the deterioration come from the demographic changes that have made the current social security system unsustainable. The necessary reforms require changes in the structure of benefits and contribution which has generational implications as well.

In addition, there are a number of issues that needs further consideration. Let us note

¹⁹ Definite Plans for the Comprehensive Reform of the Social Security and Tax (**2011)

²⁰ Article 104, paragraph 1, of the supplementary provisions of the Tax Reform Act 2009 requires that “the government shall take the necessary legislative measures by FY2011.”

them before concluding.

First, the timing and the pace of the implementation of fiscal consolidation measures needs to be well designed²¹. While there are suggestions that fiscal consolidation will bring-about positive non-Keynesian effect on the economy, the evidence is still not solid enough to totally rely on the effect. It is therefore important to take into account the negative impact that will be exerted on the economic condition by the fiscal consolidation measures²². If the economic condition is firm enough to withstand the negative influence, the problem will only be of implementation. But if the economic condition is too fragile to endure the downside pressure, it will reduce tax revenue, and fiscal consolidation measures may not be able to achieve the initial goal. Since measures that requires authorization by legislation has to be prepared well in advance of implementation, the conditions for implementation has to be well defined and at time of emergency, some kind of an escape clause needs to be included²³.

Second, even though the timing and pace of fiscal consolidation seemed appropriate it is usually conditional on an economic forecast, not only of its own economy but also of other economies as well. In such case, the impact of the fiscal consolidation that is going to be implemented in other economies could easily make the forecast diverge from the ones employed. Simultaneous fiscal consolidation by major economies could bring about a worsening of the global economy which could, in turn, worsen the fiscal conditions of those countries in need of consolidation. In order to avoid such a situation from becoming a reality, international coordination could be considered.

All the anxiety on the demand side mentioned above could be, at least, partly offset by the structural reform to raise potential growth. Importance of raising growth potential should be emphasized not only from the point of view of increasing tax revenues but also from the point of view of creating a favorable environment for fiscal consolidation. The problem is that structural reform measures usually take lengthy time to implement and to witness observable impact. Rapid effort is warranted in this area as well.

Finally, while it is preferable that fiscal consolidation be undertaken at the best timing and pace, the market may not be as patient, and may ask for an immediate action

²¹ Among the recommendations by IMF (2011b) of “four Ss,” “Sooner rather than later,” and “Sustained” are included. Other two are “Stepwise” and “Simple.”

²² The simulation result in IMF (2011b) shows that positive impact can be expected. They would come from (a) reduction in precautionary savings, (b) limiting increases in the risk premium, (c) switch to less distortionary corporate taxes (which they assume together with the increase in consumption tax rate), and (d) confidence effects. But these positive effects only become apparent in the medium-term. During the earlier years, negative impact overwhelms.

²³ The condition for raising the consumption tax rate as stated in the Tax Reform Act 2009 is for the “concentrated measures aiming for economic recovery within three years including 2008 will improve the economic situation.”

regardless of the economic condition. That could prove to be a devastating situation, where a recession and a worsening of fiscal situation could go into a vicious cycle²⁴. The only plausible solution to this kind of a situation is to have a credible medium-term fiscal consolidation plan in place well in advance so that getting into this kind of situation can be avoided. For this end, efforts toward fiscal consolidation need to be made even in an adverse economic environment.

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²⁴ Current account surplus should provide some room as we have seen earlier. But the decline in the savings rate due to aging of the population is expected to reduce the surplus. There are also views that the ongoing change in the energy structure in Japan may force the current account to fall and turn into deficit earlier than expected.

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