Challenges for Japan’s Fiscal Consolidation*

Kazuyuki Sugimoto
Chairman, Japan Fair Trade Commission
Former Professor, Graduate School of Public Policy, The University of Tokyo
Former Administrative Vice-Minister, Ministry of Finance

Junji Ueda
Former Director for Econometric Analysis, Policy Research Institute, Ministry of Finance

Abstract

This paper describes Japan’s past and current fiscal situations and discusses necessary actions for future fiscal consolidation. Since 1990s, the government expenditure has steadily increased due to growing social security benefits along with aging society, but the level of government revenue has little changed. Despite the increase in government debt, actions for fiscal consolidation have been delayed due to lax monetary condition and lack of continuous commitment with public support. Since political support for fiscal policies are asymmetric between “austerity” and “expansion”, it is vital for achieving fiscal consolidation to set up legislative fiscal rules with concrete targets and tractable measures, in addition to basic Public Finance Law.

JEL classification: H6, N45
Keywords: fiscal rule, fiscal consolidation

1. Introduction

The purpose of this paper is to discuss necessary actions for Japan’s fiscal consolidation in the future, considering current fiscal situations and past experiences of setting fiscal rules. First of all, in section 2, we will explain the current fiscal situation in Japan and the reason why it has deteriorated since the 1990s. While the government expenditure has steadily increased due to growing social security benefits since the 1990s along with an aging society, the level of government revenue has little changed and fiscal deficit has increased.

Next, in section 3, we will discuss why fiscal consolidation was delayed in Japan. Since

* This paper builds on the presentation of Kazuyuki Sugimoto at a conference on “Fiscal Rule or Fiscal Crisis? - Challenges to Fiscal Consolidation from a Global Perspective -” hosted by the Asian Development Bank Institute (ADBI) and the Policy Research Institute (PRI) of the Japan’s Ministry of Finance in January 2013. The paper reflects available information at the conference, and the views are solely those of the authors and do not reflect the view of the organizations to which they belong. The author thanks for helpful comments from the participants of the conference.
the 1990s, the yields of Japanese government bonds (JGB) have been lower than before due to increasing domestic savings of the private sector. Despite the increase in government debt, there have been no needs for further loans from other countries owing to increasing savings in the private sector. Therefore, deterioration of fiscal conditions have not caused any visible and critical problems such as an increase in government funding costs due to rising interest rates, depreciation of currency or acceleration of inflation.

In section 4, we move to review a brief history of how the Japanese government has established and enforced “fiscal rules” in order to achieve fiscal consolidation. Japan’s stagnant economy and the changes of ruling parties have made it difficult to keep fiscal discipline, while the government has tried to set up legal framework, such as the Fiscal Structure Reform Act in 1997 and the provision in tax revision law in 2009. In essence, there is significant asymmetry between “austerity” and “expansion” in implementing fiscal policy due to differences in political support, especially dependent upon whether the necessity for fiscal consolidation is widely shared or not.

In section 5, we would like to introduce policy options referring to the results of future projections over the medium-term, and finally conclude that it is necessary to set forth a legislative framework of fiscal rule with explicit targets and measures for the achievement in order to keep fiscal discipline.

2. Japan’s Current Fiscal Situations

In this section, we will briefly explain Japan’s current fiscal situation. Figure 1 shows

Figure 1 Trends in General Account Tax Revenues, Total Expenditures and Government Bond Issues
total expenditures, tax revenues and bond issues of the government’s general account after 1975. Since the gap between total expenditure and tax revenue has been widened since 1990, bond issuance has increased sharply, and has now exceeded tax revenue since 2009. The government restarted to issue special deficit financing bonds in 1994, and they account for a large part of total bond issue in recent years. This figure represents the structural problem of Japanese public finance.

As a result of the continuous bond issues, the outstanding of Japan’s government bonds at the end of FY2012 reached more than 700 trillion yen, which amounts to 17 times that of the tax revenue of general account. The trend of debt to GDP ratio of general government can be compared by using OECD’s Economic Outlook Data. Japan’s debt to GDP ratio was estimated to be 214% at the end of 2012, and its pace of increase has been much faster than in other developed countries, such as the United States, the United Kingdom and France. In contrast, although the high level of debt to GDP ratio in Italy has attracted attention during the European sovereign debt crisis, it has not been increasing for a long time.

As for yearly fiscal positions, Japan has run primary fiscal deficits for 20 years since 1992, due to structural increase of social security benefits. In addition, several temporary and cyclical factors have affected the deterioration of Japan’s recent fiscal position. Following the global financial crisis, primary deficit had increased drastically in 2009 and 2010 due to the decrease in tax revenue in the economic downturn and the increase in expenditure for boosting the short-term demand. After 2011, there have been special expenditures for reconstruction from the great earthquake.

The bar chart in Figure 2 shows the size of primary expenditures, which does not include interest payment and debt redemption. Total primary expenditure consists of social security benefits, capital expenditure, and others. Before 1990, the size of the primary expenditures relative to GDP had been stable around 30%, but it has increased to around 40% toward 2010.

![Figure 2](image-url)
The figure clearly shows that the increase is due to the expansion of social security benefits. On the other hand, the size of primary revenue including tax and social contribution relative to GDP has remained around 30%. It is obvious that sufficient revenue has not been secured in spite of the structural increase of social security benefits after 1990.

It may be worth pointing out that a similar trend has been observed in the central government’s general account budget. Recently, amongst the size of the general expenditures disbursed for public policies except local allocation tax grants, social security related expenditure accounts for more than half. In the 2013 budget, social security related expenditure reaches 29 trillion yen among 54 trillion yen of general expenditures.

Figure 2 shows that the size of social security benefits relative to GDP has almost doubled during the 20 years after 1990. It is worth explaining the reason of this upward trend. Since the main components of Japan’s social security benefits are the ones for elderly people, such as public pension, medical and nursing care, the expenditure automatically increases along with the upsurge of the number of elderly people. In 1990, the number of people over 65 used to be 15 million, but it has doubled and reached 30 million during that 20 years. It is clear that the trend of societal aging, of which pace is much faster than any other developed country, has caused the structural increase of social security benefits.

3. **Why was Fiscal Consolidation Delayed in Japan?**

In this section, we will focus on why fiscal consolidation was delayed in Japan. Although Japan’s fiscal position has severely deteriorated during the past 20 years as shown in the previous section, we have not observed severe fiscal crises, such as interest rate upsurges and currency depreciation. In other words, it has been possible for the Japanese government to defer actions for fiscal consolidation under the situations without pressures from financial markets. It seems that optimistic prospects for economic growth have played another important role for the delay of fiscal consolidation. It is worth looking through these backgrounds, such as circumstances of international financial markets and public support, in order to obtain implications for required actions in the future.

3-1. **International Financial Market**

Due to the increase of private savings all over the world and the enhancement of financial intermediations, the volume of managed assets has drastically increased. Such a worldwide quantitative monetary expansion has led to greedy “search for yields” activities and sometimes causes volatile “surges and stops” of financial flows. It may result in high volatility of asset prices in financial markets.

Figure 3, 4 and 5 shows the recent increasing trend of global money. As illustrated in Figure 3, the volume of bonds and equity has increased 5.5 times during the 20 years since 1990, while world GDP has increased 3.4 times.

Figure 4 shows the increasing trend of the volume of world dollar, especially after the
Lehman shock in 2008 due to the quantitative easing monetary policy by FRB. Figure 5 shows the volume of world monetary supply. The increase of money supply has been observed not only in developed countries such as the United States, Europe and Japan, but in China and other emerging countries after 2000. It deserves attention that the share of China in world money supply has increased from 10% in 2000 to more than 20% in 2012.

It is certain that the worldwide monetary expansion has provided the enhanced capacities for government’s deficit financing in advanced countries. At the same time, however, it should be noted that the monetary expansion has also magnified the propagation of potential shocks due to the loss of confidence for sovereign debt to the whole economy. The recent
European fiscal crisis has been caused by the sudden change of perceived riskiness for sovereign debt due to deterioration of fiscal conditions in some countries.

In addition, low yields of JGB have been caused by increasing domestic savings of the private sectors. **Figure 6**, which illustrates the volume of net lending and borrowing by sectors in Japan, shows the recent characteristics of domestic financial flows in Japan. Household saving has gradually decreased due to aging population, but kept its net lending position. As a result, household financial assets have amounted to 1,500 trillion yen. The most distinct feature is the change of the corporate sector’s financial flow from a net borrowing position to a net lending position after the end of the 1990s. This means that the corporate sector has reduced its debt and increased the holding of financial and foreign assets, instead
of investment on domestic fixed assets. The declining trend of domestic investments has been caused by expectation for lower economic growth, which has been observed in other advanced countries such as Germany.

Under these circumstances, domestic financial institutions, such as banks and insurance companies, have absorbed the increasing domestic household savings and expanded the holding of JGB. Such stable financial flows in Japan have been supported by strong external position. Since Japan’s current account has continuously recorded surplus, domestic sectors have not needed to finance from foreign investors on the net basis. As for the government sector, merely 9% of total JGB is held by foreign investors. To summarize, the large amount of household saving have been invested in government debt and it has enabled the government to raise funds easily, and, therefore, deterioration in fiscal position has not caused any visible problems such as the increase in fund procurement cost, depreciation of currency or acceleration of inflation.

However, several risks should be pointed out under the current situation and in the future. Japan’s trade balance recorded a deficit in 2011 for the first time in the recent 30 years, and the level of deficit reached 7 trillion yen in 2012, due to the increasing import of oil and natural gas. Therefore, the surplus in current account has been decreasing. We should pay enough attention to these changes when we consider the future outlook for financial flows.

In addition, it should be noted that Japan’s domestic financial institutions face risks that the upswing of interest rates may provide large negative impacts on their balance sheets, because they own a large amount of JGB. It is no exaggeration to say that the risk of linkage between deterioration of fiscal position and financial crisis has been accumulated. As mentioned above, monetary expansion has increased capacity for the government’s financial space in advanced countries, but at the same time enhanced the possibility of severe propagation of shocks caused by the loss of confidence for sovereign debt.

3-2. Optimistic Outlook for Economic Growth and Lack of Public Support

In order to implement fiscal consolidation, it is critical for governments and policymakers to obtain wide public support based on good understanding of the necessity for fiscal austerity measures. As for political support, however, there is a considerable asymmetry between “austerity” and “expansion” in implementing fiscal policies. In addition, in Japan, the difficulty in obtaining wide public support for fiscal consolidation seemed to be aggravated by optimistic economic outlook and complexity of the fiscal system.

Firstly, we would like to point out an influence of optimistic prospects for economic growth. When Plaza Accord was concluded in 1985, expansionary fiscal and monetary policies were adopted in Japan for fear of damages by sharp appreciation of yen. These policies resulted in upsurge of asset prices and boosted domestic demand, and high economic growth rate, which was called the “bubble economy.” After the collapse of asset price bubbles, it was continuously emphasized that the government should adopt fiscal expansion in order to cope with the decline of economic growth, while there were little concerns about
deterioration of fiscal conditions. At that time it was widely believed that the economy would return to the former growth path by fiscal stimulus measures which temporarily boost aggregate demand.

In hindsight, however, the Japanese economy has experienced the decline of potential GDP growth since the 1990s due to the decreasing working age population and the end of the catching-up phase of the economy. Under such structural changes, it has been difficult to achieve higher growth rate by only temporary expansions of fiscal deficit. We can conclude that the delay of recognizing structural change in the economy led to the delay of appropriate change in fiscal policy.

Secondly, we would like to point out the complexity of Japan’s public finance system and its effects on difficulty in understanding the necessity of fiscal consolidation. The complexity comes from a large scale of fiscal transfers from the central government to local governments and social security benefits. Figure 7 shows the current transfer system of Japan’s public finance and the size of transfers relative to GDP in FY2011.

This complicated transfer system results in a “wedge” between “benefit” and “burden” as to social security benefits and local government expenditures. Regarding social security benefits, Japan’s system is based on a “social insurance” scheme where the benefits are mainly provided on the records of social contributions payments by each beneficiary. Therefore, the benefits are usually regarded as an “entitlement” of beneficiaries. But a large part of actual benefits are financed not only by social contributions but also by transfers from central and local governments, which amounts to 4.8% and 1.7% relative to GDP respectively in FY2011. As for local government expenditures, of which amount reached 13.9% relative to GDP in FY2011, they are financed not only local tax and other revenues, but also grants and subsidies from the central government.

Figure 7 Overview of Public Finance System in Japan
As a result, amongst expenditures of the central government, only 6.6% were spent for the administration by central government itself, while 11.4% of GDP was spent for transfers. These transfers are financed by central government tax and other revenues, as well as bond issuance, but hardly recognized as disbursement from the central government by the public people who receive the “benefits” provided by local government and social security fund.

Therefore, it has been difficult for the public people to understand that the deterioration in fiscal position, which has mainly taken place in the central government, means the expansion of benefits backed by the burdens of future generations. Increase in bond issuance has been regarded as merely an internal issue in the government, not as problems for each citizen. The claim that the central government should raise tax for covering these expenditures has not been well-understood, and the increase of social security benefits has caused the expansion of fiscal deficit for 20 years.

Moreover, a complicated accounting system with many special accounts and government-affiliated agencies might have distracted the public people from understanding the whole fiscal system and its deterioration. It has been long advocated that there are many things to do before securing the revenue for the structural increase of social security benefits and streamlining the benefit system.

As we mentioned before, there is a significant asymmetry of political support between “austerity” and “expansion.” In order to keep fiscal discipline under this constraint, we would like to stress the necessity of strong legislative fiscal rules with concrete targets and measures. Such rules will help to clearly show the necessity of fiscal consolidation and keep continuous political commitment towards sustainable fiscal policy under the changes of the government and ruling parties.

4. Brief History of Japan’s Fiscal Rules

In this section, we will look back at Japan’s fiscal rules and their roles in the history of fiscal management. Let us start to explain the general rule in “Public Finance Law,” and then move to special rules and frameworks in order to cope with deterioration of fiscal position.

4-1. Public Finance Law and Special Deficit Financing Bonds

The basic rule for Japan’s public finance is the “Public Finance Law” enacted in 1947, and Article 4 stipulates that the government can issue bonds only for financing public works, investments and loans. We understand that this type of restriction on bond issuance is usually referred as a “golden rule” for public debt finance in other countries, such as the U.K. Until 1964, the government kept a balanced budget without issuing any bonds, and after 1965, it started to issue “construction bonds” based on Article 4.

In 1975, the government requested a waiver of this rule by enacting a special law which enables the government to issue “special deficit-financing bonds” during the specific single fiscal year in order to deal with the worldwide recession after the first oil crisis. After 1975,
the government enacted the same special law every year, and introduced rules for fiscal management which stipulated the target year of coming back to no special deficit-financing bonds budget formulation as cabinet decisions.

In order to achieve the target, the government introduced yearly “ceilings” to restrain the expenditures and sold the equities of public corporations such as Nippon Telegraph and Telephone (NTT), and the national railway (JR) to obtain revenues. Owing to the growth in tax revenues due to the sharp rise of asset prices in the second half of the 1980s, the government could stop issuing “special deficit-financing bonds” in 1990.

4-2. Fiscal Structure Reform Act

The government formulated budgets without issuing special deficit-financing bonds between 1990 and 1993, but it was supported by the temporary increase of tax revenues. Due to the collapse of the “bubble economy” and the aging population, fiscal management became unstable in the middle of the 1990s. Under such a situation, it came to be recognized that a legislative framework for fiscal consolidation was indispensable to keep multi-year commitments. In line with this concept, the “Fiscal Structure Reform Act” was enacted in 1997.

The Act specified fiscal consolidation targets as follows:
(1) the ratio of fiscal deficits should be reduced to less than 3% of GDP by 2003,
(2) the issuance of “deficit-financing bonds” should be reduced every year and terminated by 2003,
(3) the ratio of bond issuance to the total budget in 2003 should be reduced compared with that in 1997.

In addition, in order to achieve these targets, a numerical framework for multi-year expenditures was set legislatively for 12 major expenditure categories including social security and public investment.

After the act was enforced in November 1997, however, Japan faced severe economic downturn due to bankruptcies of large financial institutions and the Asian currency crises. The government had changed its fiscal stance toward an expansionary one, and the act was finally suspended in 1998.

4-3. Basic Policies for Economic and Fiscal Management and Structural Reform

Under the government of Prime Minister Koizumi between 2001 and 2006, cabinet decisions on “Basic Policies for Economic and Fiscal Management and Structural Reform” had been yearly rendered in order to attain proper balance between economic growth and fiscal consolidation. These decisions had set a fiscal consolidation target that the primary surplus should be achieved by the early 2010s.

In 2006, the cabinet decision “Basic Policy 2006” stipulated the fiscal consolidation target of primary surplus in 2011 and numerical multi-year expenditure framework. The
framework included the restraining plan for social security related expenditures along with reforms of the systems, nominal reduction rate in public investments, and expenditure ceilings for the other categories.

The controls over expenditures along the framework were applied until the 2008 budget, but after then the targets and the framework were abandoned in order to deal with the economic downturns caused by the global financial crisis. The government formulated an expansionary budget in 2009, and at the same time set a provision in tax revision law in 2009 which stipulated that the government should adopt a statutory measure by 2011 to achieve comprehensive tax reform including consumption tax. The provision was intended to keep a continuous stance for medium term fiscal consolidation.

4-4. Fiscal Management Strategy (2010 - 2012)

After the change of ruling parties in 2009, the “Fiscal Management Strategy” was decided by the cabinet in June 2010. This strategy stipulated fiscal consolidation targets for primary balance of central and local governments and government debt outstanding as shown in Figure 8. As for flow targets, it was stipulated that the government should halve the primary deficit ratio relative to GDP by 2015 from that in 2010 and achieve primary surplus by 2020. As for a stock target, it was stipulated to achieve steady reduction of public debt ratio to GDP after 2021.

In order to achieve these fiscal targets, the strategy contained the “Medium-term Fiscal Framework” for three years and the “Basic Rules on Fiscal Management” as cabinet decisions. The framework was planned to be rolled over year by year, and each yearly budget was formulated along with it in 2011 and 2012. The revised version of “Medium-term Fiscal Framework” in 2012 set the primary expenditure targets of 71 trillion yen for consecutive 3 years. As for the basic rules, the strategy included “Pay-As-You-Go Rule,” “Fiscal Deficit

---

1 The target figure, 71 trillion yen, did not include expenditures related to the “Enhancement of the social security system”, which would be financed by additional revenues, and expenditure and revenue for recovery from the earthquake in 2011, which would be controlled in the special account separately from the general account.
Reduction Rule” and the statement of “Securing Revenue Sources for Structural Expenditures.” The last one was embodied in the “Comprehensive Reform of Social Security and Tax” which will be discussed later.

After the change of ruling parties in December 2012, the new government expresses the same fiscal consolidation targets, and intends to formulate medium-term fiscal consolidation plan for achieving these targets in mid-2013.

4-5. **Comprehensive Reform of Social Security and Tax**

As mentioned before, the third rule in the “Fiscal Management Strategy” stated the government should secure revenue sources for structural expenditures. This rule was embodied in the “Comprehensive Reform of Social Security and Tax” decided in 2012. Figure 9 summarizes the contents of the reform. This reform is based on the consideration that stable financial resources are needed in order to deal with deteriorating structural fiscal balance due to demographic changes, while maintaining and enhancing the social security system.

The reform stipulates that the consumption tax rate will be raised in two stages, from 5% to 8% in April 2014, and from 8% to 10% in October 2015, and the national consumption tax revenue will be legally earmarked to social security expenditures such as pension, medical care, long-term nursing care and childcare. The additional revenues will be used for two parts: equivalent revenue to 4% of consumption tax rate will be used for stabilizing the social security system, and the residual 1% will be used for enhancing the social security system.

Generally speaking, it is feared that earmarking of specific revenues might lead to the loss of discretion in fiscal policy and ineffective appropriation. It can be said that, however, in this reform it was considered critical to attain public support by explaining that the additional burden will be spent for expenditures which are regarded as indispensable by the public people.

Along with the provision in the tax revision law in 2009, the laws for the reform were submitted to the Diet at the end of FY2011. After discussion among the political parties, the
laws were approved by the Diet in August 2012. Since the laws are approved not only by the Democratic Party, the ruling party at that time, but also by the Liberal Democratic Party and New Komeito, the current ruling parties after December 2012, the reform is expected to be implemented even after the recent change of government.

4-6. Legislative Fiscal Rules in Japan and Other Countries

To summarize, Japan has experienced several economic turbulences and changes of ruling parties, which have enhanced difficulties in keeping fiscal discipline and commitment to actions for fiscal consolidation. In order to cope with this problem, the government has introduced legal frameworks such as the Fiscal Structure Reform Act in 1997 and the provision in tax revision law in 2009. As Kumar et al. (2009) points out, fiscal rules laid down in legislation are likely to be more difficult to reverse or abandon, and make the framework more stable, and are particularly important in countries where political change could otherwise undermine the credibility of fiscal policy. It can be concluded that the legislative fiscal rules in Japan mentioned above have been playing an important role to maintain fiscal discipline.

Figure 10 shows other examples of legal framework for fiscal policy in some advanced

| United Kingdom | Budget Responsibility and National Audit Act 2011. The Charter must prepare the Charter for Budget Responsibility, relating to the formulation and implementation of fiscal policy and policy for the management of the National Debt. The Charter stipulates:  
- A forward-looking target to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period  
- A target for public sector net debt as a percentage of GDP to be falling by a fixed date of 2015-16 |
| United States | Expenditure Rule from 2011: Congress enacted discretionary spending cap, saving about $900 billion over the next decade. If Congress does not take legislative action, additional automatic spending cuts (the so-called sequester) are scheduled to take effect from January 2013 to produce savings of 2013 2 trillion over a decade. Pay="A"<strong>"O"</strong> from 2010. The Act stipulates that deficit-raising policies must be financed by other measures over a specified time period. |
| European Union | Other than 3 percent of GDP deficit and 60 percent of GDP debt ceiling, included in the Maastricht Treaty in 1992 and the Stability and Growth Pact (SGP) in 1997, the following rules have been added:  
- National structural budget balance rule requires to adopt in legislation national rules that limit annual structural deficits to a maximum of 0.5 percent of GDP  
- New debt rule at the supranational level requires to continuously reduce the public debt to the GDP ratio to 60 percent of GDP (SGP) threshold. The annual rate of debt reduction should be no less than 1/20th of the distance between the observed level and the target  
- New expenditure benchmark at the supranational level requires that the annual growth of primary expenditure, excluding unemployment benefits and subtracting revenue discretionary increases, should not exceed long-term nominal GDP growth (applies only when a country has an average deficit of less than 3 percent of GDP. |
| Germany | Constitution  
A new structural balance rule was enshrined in the constitution in June 2000. After a transition period, starting in 2011, it will take full effect in 2016 for the Federal government and 2020 for the states.  
The rule calls for a structural deficit of no more than 0.35 percent of GDP for the Federal government and structurally balanced budgets for the Länder.  
For the Federal government the adjustment of the structural deficit to 0.35 percent of GDP in broadly equal steps by 2016 has started in 2011, for the Länder a transition had not yet started in earnest in 2011. |
The Constitution stipulates that programming acts shall determine the objectives of the action and the multi-annual guidelines for public finances.  
The Organic Law transposes the “fiscal c瀑布” signed March 1, 2012, which stipulates the medium-term objective of a structural budget deficit capped at 0.5 percent of GDP.  
The multi-year public finance planning act (LPPF) defines the medium-term structural deficit target and specify the yearly structural deficits to reach it. |
countries. It can be understood that fiscal rules in legislative forms have been widely adopted in many countries, as well as the increasing role of international treaties such as in the European Union in order to achieve fiscal consolidation².

5. Issues to be Tackled in the Future

In this section, we will discuss the issues to be tackled in the future as for Japan’s fiscal policy, mainly on policy options based on future projections and necessity of legislative frameworks.

5-1 Policy Options based on Future Projections

In August 2012, the Cabinet Administration Office (CAO) presented a projection for fiscal balance and government debt under two assumptions about economic conditions: one is a “Growth Strategy Scenario” and the other a “Prudent Scenario.”

As illustrated in Figure 11, the target of primary surplus in 2020 cannot be attained along with the current fiscal policy under both assumptions of economic conditions. Although this projection incorporates the rise of consumption tax rate by 2015, there will remain a gap of 1.4% or 2.8% relative to GDP in 2020 between the estimated figure and the target of primary surplus. According to the CAO’s projection, debt to GDP ratio is expected to show an upward trend under the prudent scenario. Under the growth strategy scenario, the path of debt to GDP ratio looks relatively stable due to the assumption that nominal GDP growth rate stays higher than the effective interest rate for a while, but it is not expected to show a downward trend.

Therefore, in order to restrain the debt growth and achieve the fiscal consolidation target in 2020, it is obvious that further improvement of fiscal balance is indispensable. This projection clearly shows that a large amount of structural deficit and debt outstanding entail a considerable risk over the medium-term. The government has to follow a narrow path in attaining proper balance between fiscal consolidation and stable economic growth.

In order to present an image of necessary policies over the medium-term, we would like to introduce options proposed by International Monetary Fund (IMF) for fiscal adjustment. Figure 12 shows some packages of policies achieving improvement of fiscal balance by 10% of GDP by 2020, with raising consumption tax rate up to 15% or more. It should be noted that these options also assume that the baseline government expenditure relative to GDP should stay at the same level until 2020 in addition to achieving the 10% improvement. In order to achieve it, the government has to contain the increase of social security expenditures due to aging or curtail other discretionary expenditure to offset it.

Moreover, it should be stressed that the impact of the demographic change in the future will also impose a serious risk over the long-term. Due to the increase of the number of elderly people over 75, public expenditures on medical and long-term care will be expected

² Schaechter et al. (2012) introduces recent trends of fiscal rules and legislative framework based on a dataset covering 81 countries from 1985 to end-March 2012.
to soar, because demand for medical treatment and long-term nursing care drastically increases for the aged over 75.

Although the number of elderly people over 65 is estimated to peak out at 39 million in 2042, the decline of the working age population will continue under the current birth rate and erode GDP and tax revenues in the future. In order to manage fiscal policy in accordance with

Figure 11 Economic and Fiscal Projection (Cabinet Office, August 2012)

Figure 12 Options for Fiscal Policy Adjustment Between end-2011 and 2020 (IMF) (Excluding Reconstruction Spending, in % points of GDP)
In order to achieve long-term fiscal sustainability in Japan, it is important to clarify the overall structure of fiscal conditions and show medium- to long-term fiscal projections under prudent assumptions for economic growth, which will help the public to understand the necessity of further fiscal consolidation. Moreover, given the decreasing working age population, it is impossible to keep the current standard of social security benefits. Therefore, the government has to clarify its role and redesign the social security system focusing targets effectively, while securing stable revenues for the necessary benefits.

5-2 Necessity of Legislative Framework

Finally, we would like to emphasize the importance and necessity of legislative framework for fiscal consolidation. As we mentioned before, political support for fiscal policies are asymmetric between “austerity” and “expansion.” It casts a problem how a decision system should be designed in order to achieve sustainable fiscal policy in good times and bad times, or under possibilities for changes of government. In order to keep fiscal discipline and implement credible policies, it is necessary to set forth a legal framework incorporating fiscal rules with explicit targets and concrete measures.

However, as Kumar et al. (2009) indicates, legislative frameworks do not necessarily make the fiscal rule more effective if enforcement mechanisms are weak. Although Article 4 of Public Finance Law prohibits the issuance of deficit-financing bonds, it does not function as an actual fiscal discipline in practice, because every year the government repeats to enact a waiver for it without any sanctions and reputational costs. Legislative framework should incorporate more realistic and practical targets for fiscal consolidation and concrete measures for their achievement, as well as allowing enough flexibility to deal with changing economic situations.

References

(Aug 1997), Ookura Zaimu Kyoukai.


