



# **Fiscal policy in Japan**

**How can we keep fiscal balance  
between expenditures and revenues  
for social spending?**

Round-table discussion on fiscal policy in Asian and the Pacific

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Disclaimer: Views and opinions in this presentation are those of the presenter and do not reflect those of the organization to which he belongs.

## Expenditure

(Allocation of resources to public services)



## Public Finance



## Revenue

(taxation and debt financing)



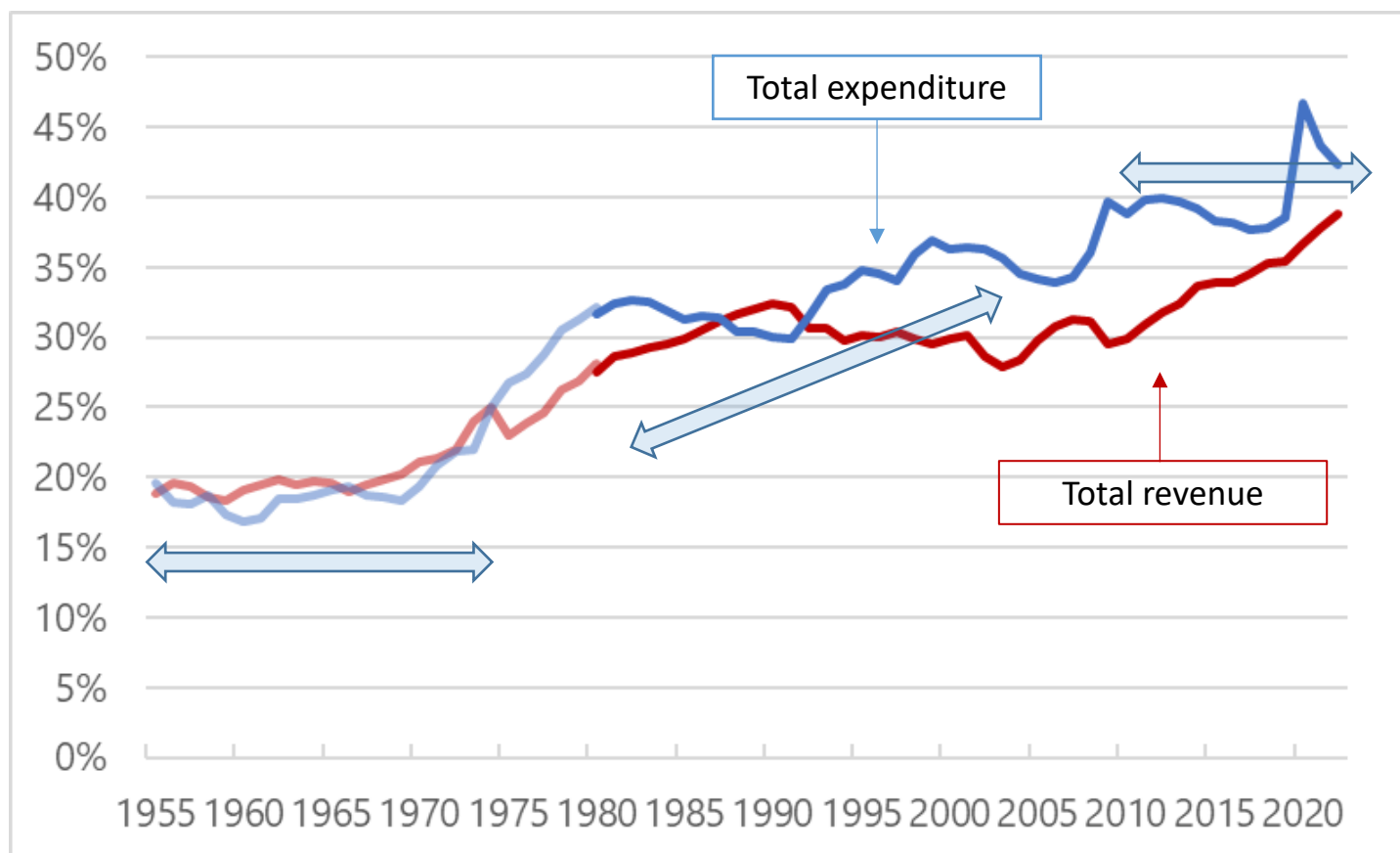
Public finance is to strike the balance between expenditure and revenue.

# Total expenditures and revenues, General Government (% of GDP)

- The level of expenditures and revenues of general government relative to GDP has shifted from 20% (before 1970s) to 40% (after 2010s).

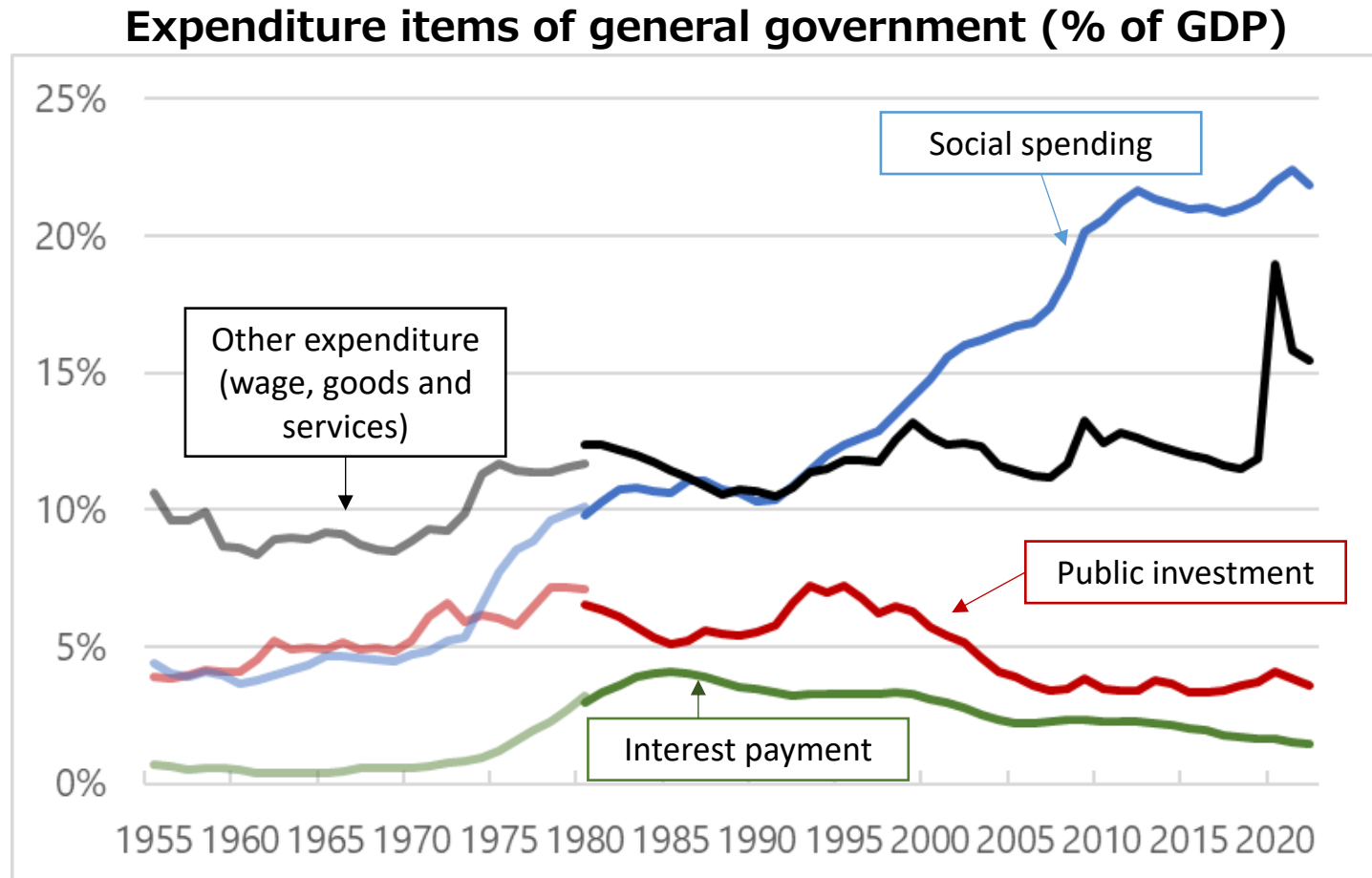
※ “General government” includes central government, local governments and social security funds.

## Expenditure and revenue of general government (% of GDP)



## Expenditures: Japan, General Government (% of GDP)

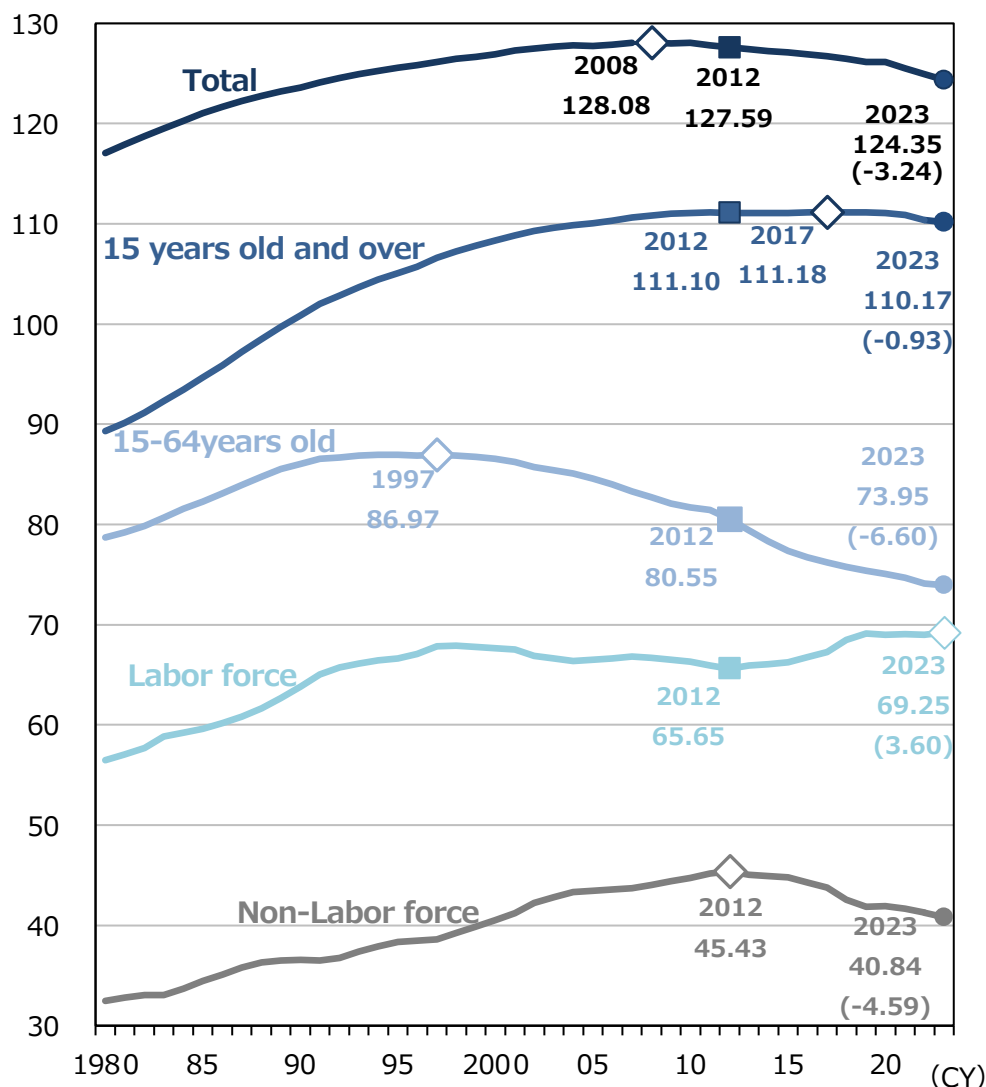
- The level of **social spending** (public pension, healthcare, long-term care) relative to GDP has significantly increased, while other items were in line with GDP growth.



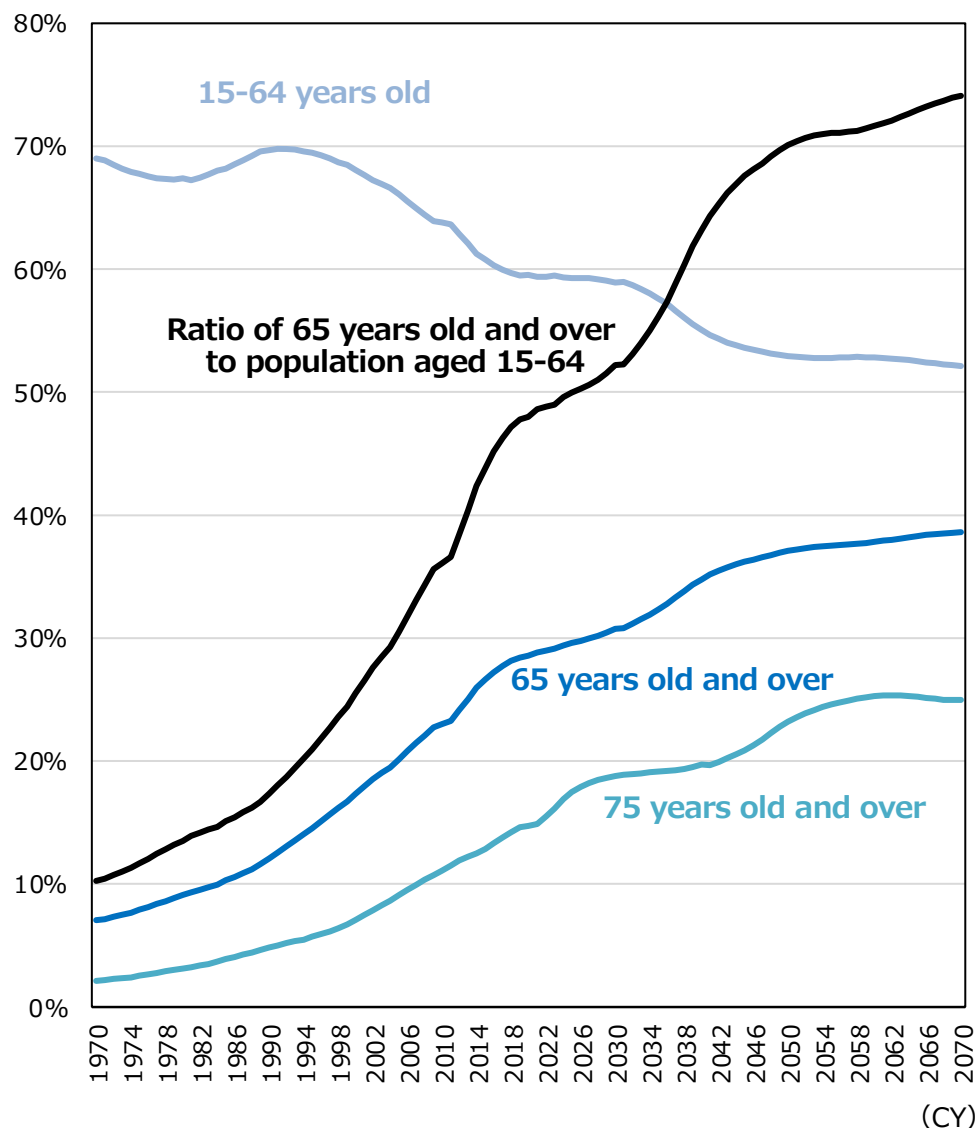
# Demographic changes in Japan

## Total population and labor force

(million people)



## Ratio of elderly people



(Note) ( ) represents changes from 2012.

(Source) Ministry of Internal Affairs and Communications, Ministry of Internal Affairs and Communications, National Institute of Population and Social Security Research

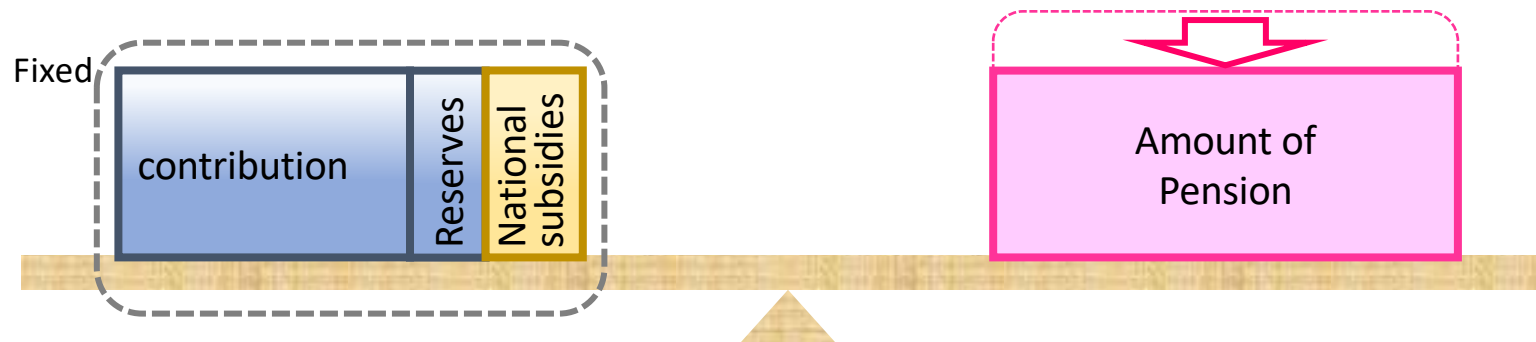
## Impacts of demographic changes on fiscal policies in Japan

- Demographic changes have caused sustainability problems on the social spending under pay-as-you-go system, which is based on transfers from current young generations to old generations.
  - They have caused increasing social spending relative to GDP and decline of the relative size of total revenue to spending.
- 
- **Pay as you go system** for Public pension, Healthcare, and long-term care needs systematic adjustments by:
    - **Control benefit level**  
(higher eligibility age or higher efficiency of service provision)
    - **Increase fiscal resources**  
(higher contribution rate of young generations)
    - keep reserves  
(to maintain equity across generations)

## Measures to fill the gap between expenditures and revenues

- In addition to curb the social expenditures in the annual budgeting procedure, the government used several institutional measures to increase revenues and curb spendings.
- **Macroeconomic indexation of pension benefits**  
(automatic reduction of pension benefits in real term)
- **Increasing social contribution**  
(automatic rate increases corresponding to the increasing healthcare and long-term care spending)
- **Earmarking consumption tax revenue to social spending**

## Automatic balancing mechanism (ABM) introduced in 2004



### 1. Fixing future contribution rates

- Gradually increasing the EPI contribution rate on wages from 13.58% (2004) to 18.3% (2017)

### 2. Automatic adjustment for benefit level

- Introducing a modified indexation rule reflecting demographic factors  
→ To assure fiscal sustainability, the rule will be automatically applied for necessary periods, which will be described in regular 5-year actuarial valuations.

### 3. Increasing subsidies to basic pension (NP)

- Using additional revenue from consumption tax raised in 2014

# Macroeconomic indexation of public pension benefits

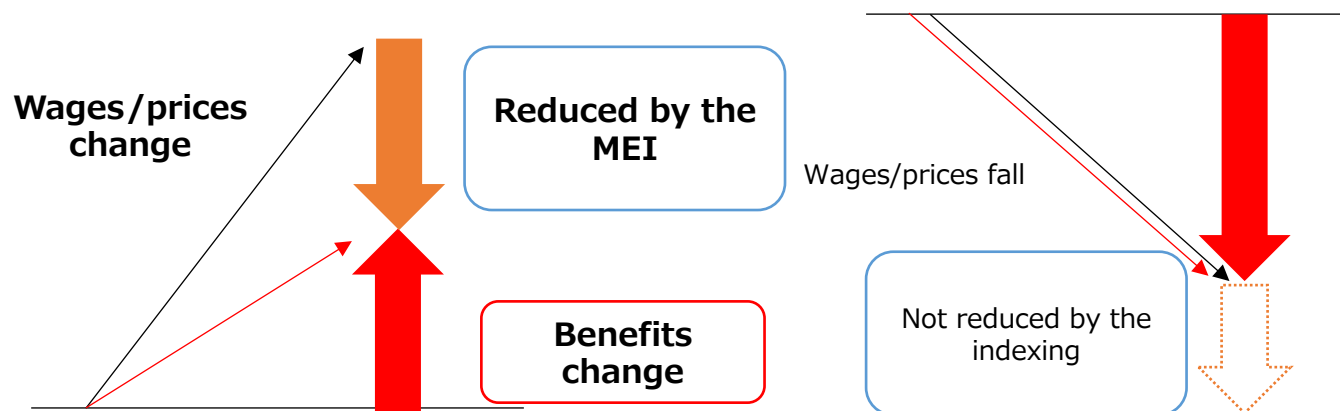
|      | Price | Wage  | MEI            | Benefit revision |              |
|------|-------|-------|----------------|------------------|--------------|
|      |       |       |                | 67 and younger   | 68 and older |
| 2024 | 3.2%  | 3.1%  | <b>-0.4%</b>   | 2.7%             | 2.7%         |
| 2023 | 2.5%  | 2.8%  | <b>-0.6%</b>   | 2.2%             | 1.9%         |
| 2022 | -0.2% | -0.4% | <b>(-0.3%)</b> | -0.4%            | -0.4%        |
| 2021 | 0.0%  | -0.1% | <b>(-0.1%)</b> | -0.1%            | -0.1%        |

(note1) Macro-economic indexing (MEI) rates in parentheses are postponed due to negative wage/price growth.

(note2) Pension revision for 67 and younger is calculated according to wage growth and MEI, and that for 68 and older is to price increase and MEI, not exceeding that for 67 and younger.

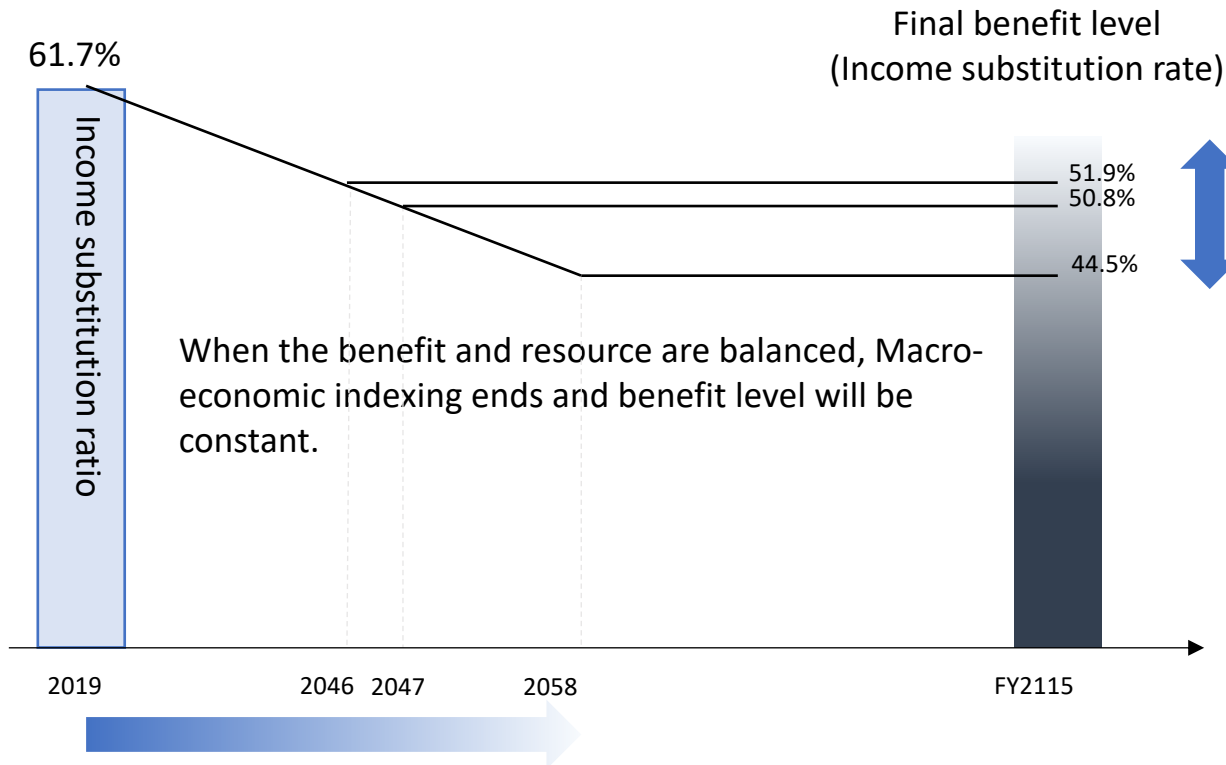
## Macro-economic indexing (MEI)

To balance the benefits and resources, a certain percentage of the benefit amount is reduced when wages and prices rise. This can stabilize the benefit amount in the future.



# Macroeconomic indexation of public pension benefits: Actuarial valuation

- Every 5 years, the government implement “actuarial valuation” (checking how the intertemporal budget constraints are satisfied)
- The results show projections for the future pension benefit level under different economic and social parameters.

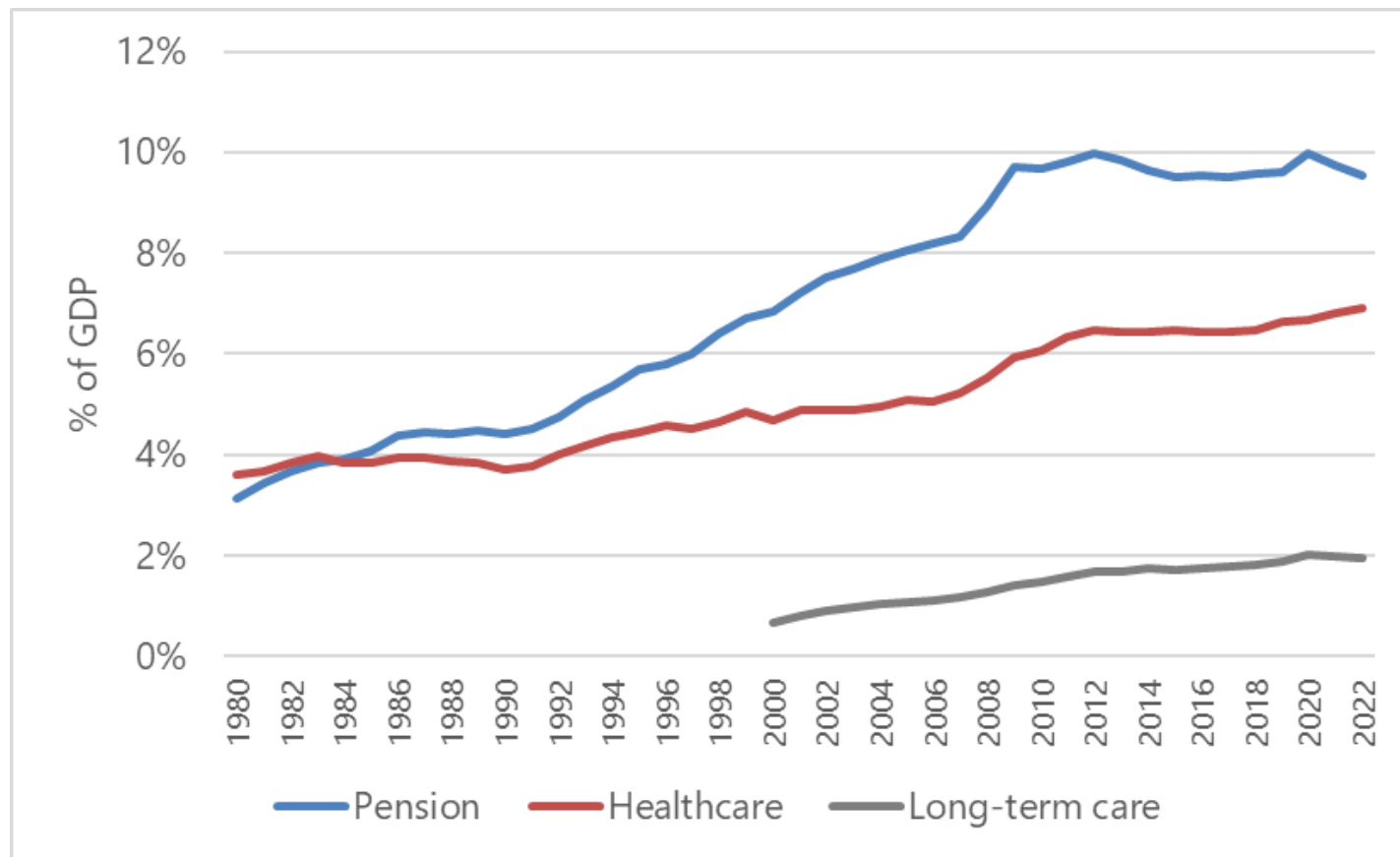


- The higher the economic growth is (or the more the population is), the higher the benefit level by the shorter benefit reduction by macro-economic indexation.

## Social spending: historical trend of expenditure items

- Public pension benefits have been in line with GDP growth after 2010s, while the healthcare and long-term care spending grew at more than GDP growth rate.
- To contain the spending increases of social spending, a “spending guideline” was applied every year to control the growth below the increases due to “aging effects”.

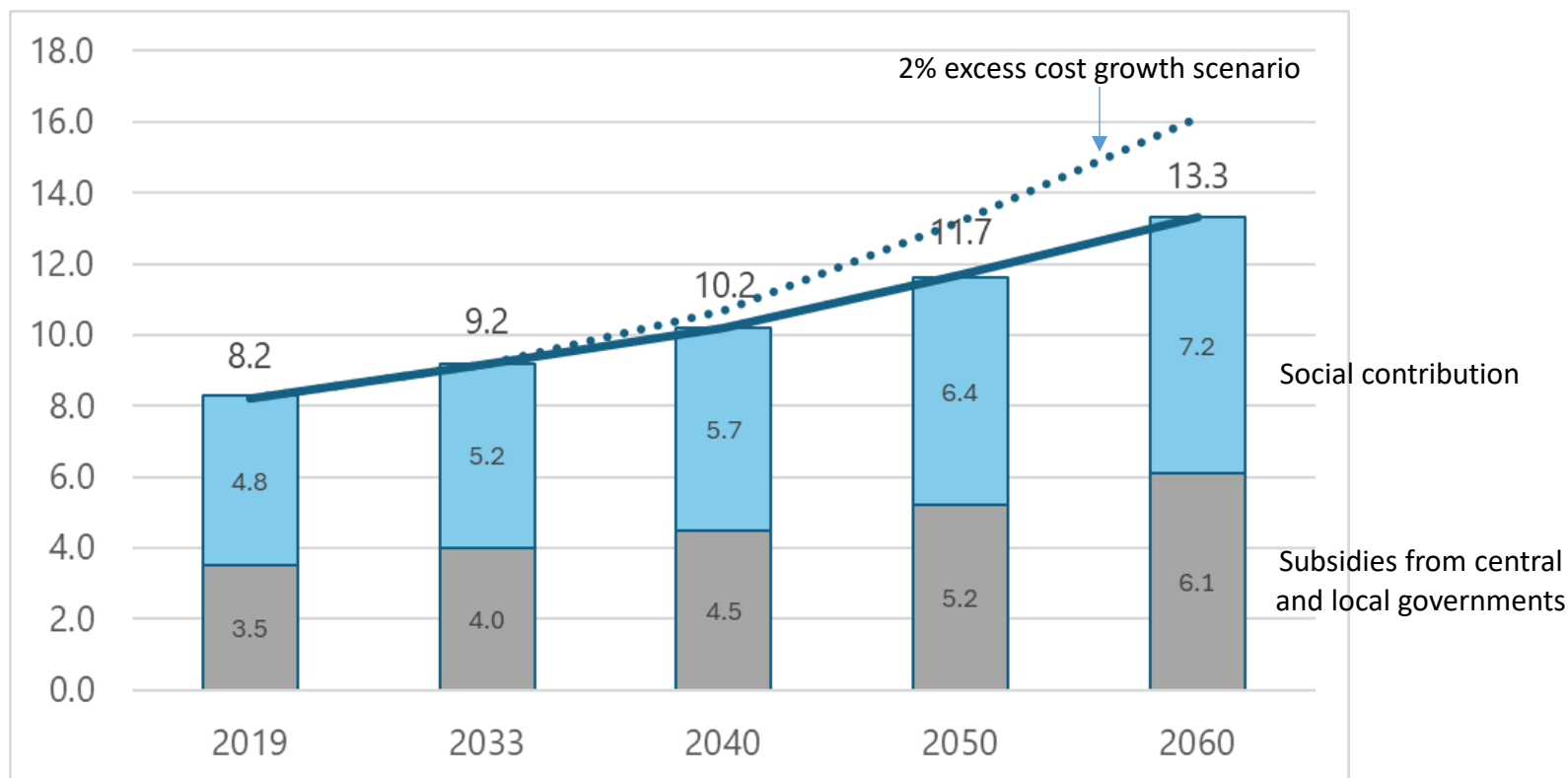
### Expenditure items of social spending (% of GDP)



## Social spending: projections for expenditure items

- Healthcare and long-term care spending is expected to grow more than GDP growth.
- Growth in healthcare spending will be attributable to the excess cost growth (ECG) including a shift to higher-priced medical care.
- Long-term care spending is expected to grow due to increasing number of beneficiaries.

### Projections for healthcare and long-term care spending (% of GDP)

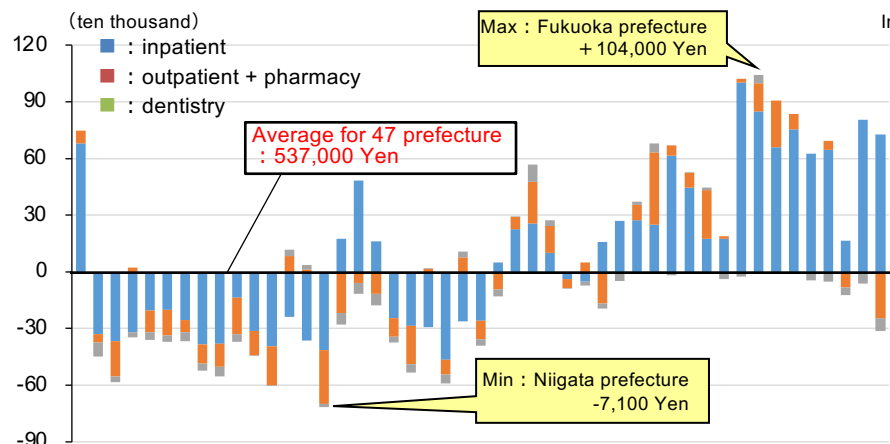


\*These projections incorporate future demographic changes, cost growth (price and wage), and 1% excess cost growth for healthcare.

# Increasing social contribution: role of local governments

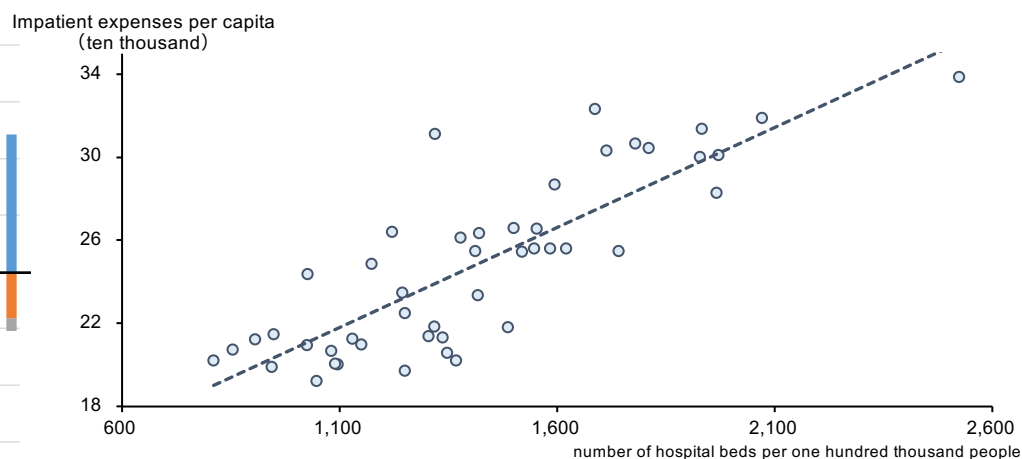
## ■ Diversified outcomes and demand / supply across different regions (prefectures)

### ◆ Regional difference of medical care expenditure per capita (47 prefectures)



(Source) MHLW

### ◆ Relationship between inpatient expenses and number of hospital beds (47 prefectures)



## Need to strengthen the fiscal role of local governments

### • Enhance fiscal responsibility of local governments

→ Establishing a **clear linkage between benefit and burden** at local government level, while being supported by national subsidies

Long-term care system : municipalities

Medical care system : prefectures

→ Institutionalizing **mandatory supply plans** made by local governments

→ **Visualizing different outcomes and effectiveness** to motivate reforms

## Increasing social contribution: role of local governments

- The share of social contribution is fixed to the total benefit.
- Social contribution rates are set every 3 years by local governments, reflecting the increasing benefit for past 3 years.

Total cost for long-term care service provision (2.0% of GDP)



Co-payment

Total benefit disbursed to the service providers

50%



50%



Social contribution

23%

(Population share)

27%

Contribution by  
aged 65 and over

Contribution by  
aged 40-64

Subsidies from central and local  
governments

25%

12.5%

12.5%

Central  
government

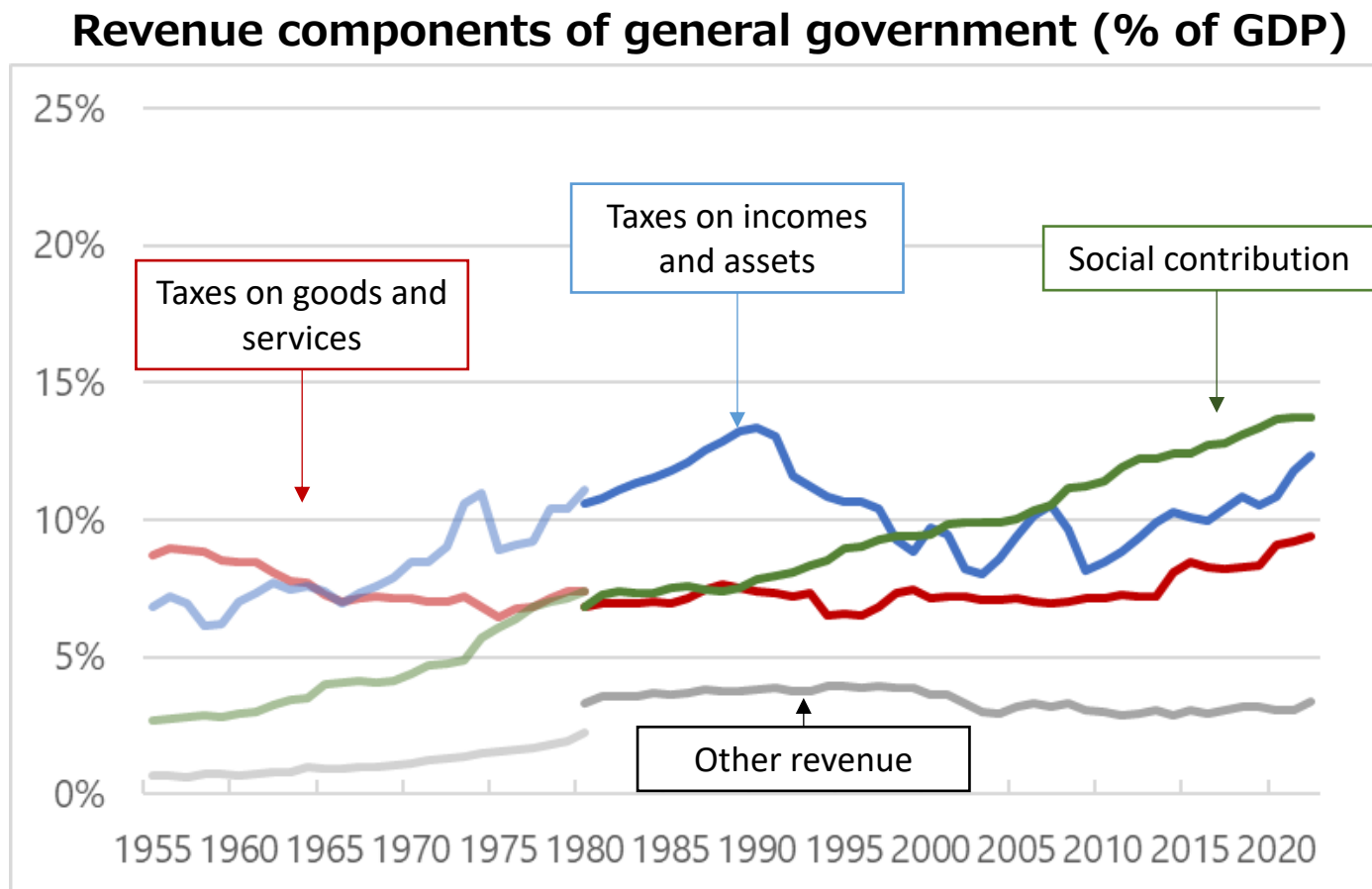
Prefecture

Municipality

(financed by tax)

## Revenues: Japan, General Government (% of GDP)

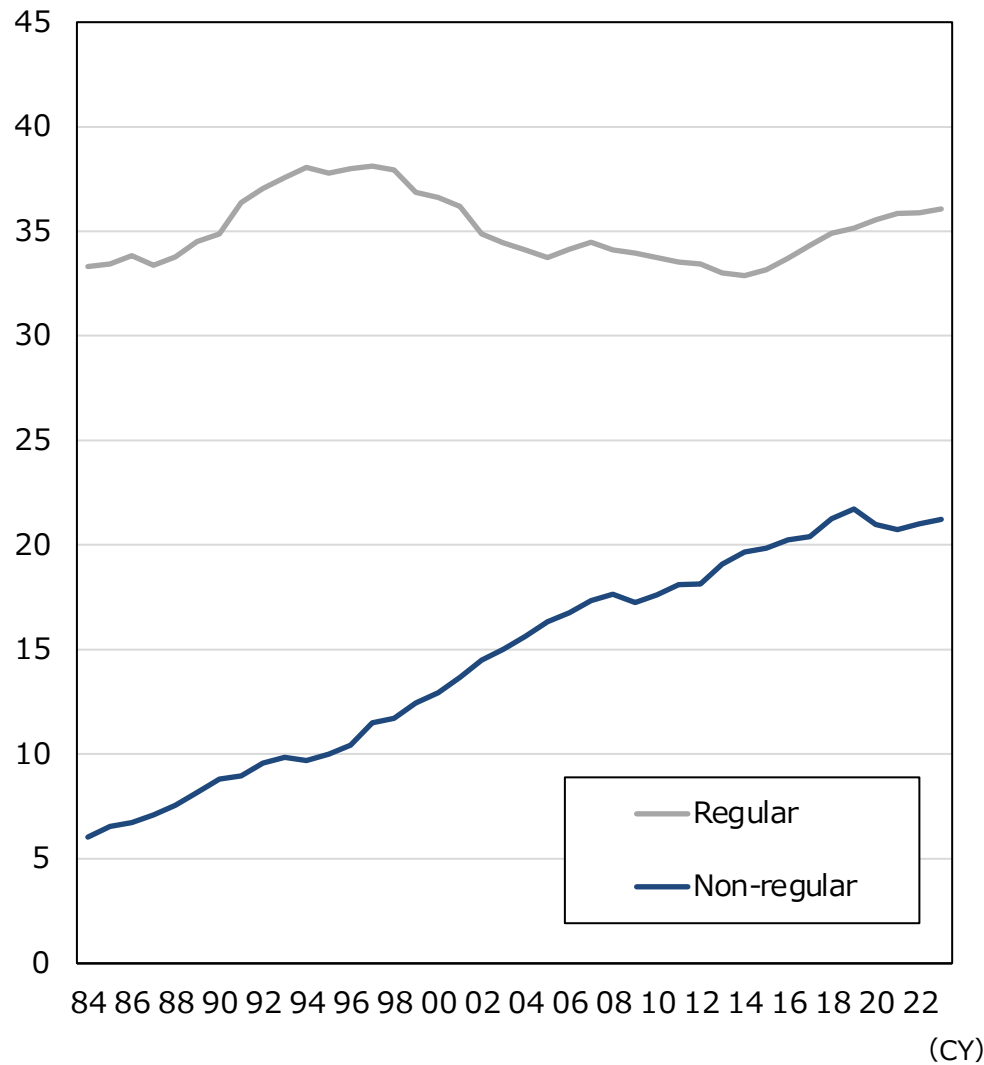
- The level of **social contribution** levied on wages and salaries of workers has significantly increased relative to GDP.



# Employment and Wages

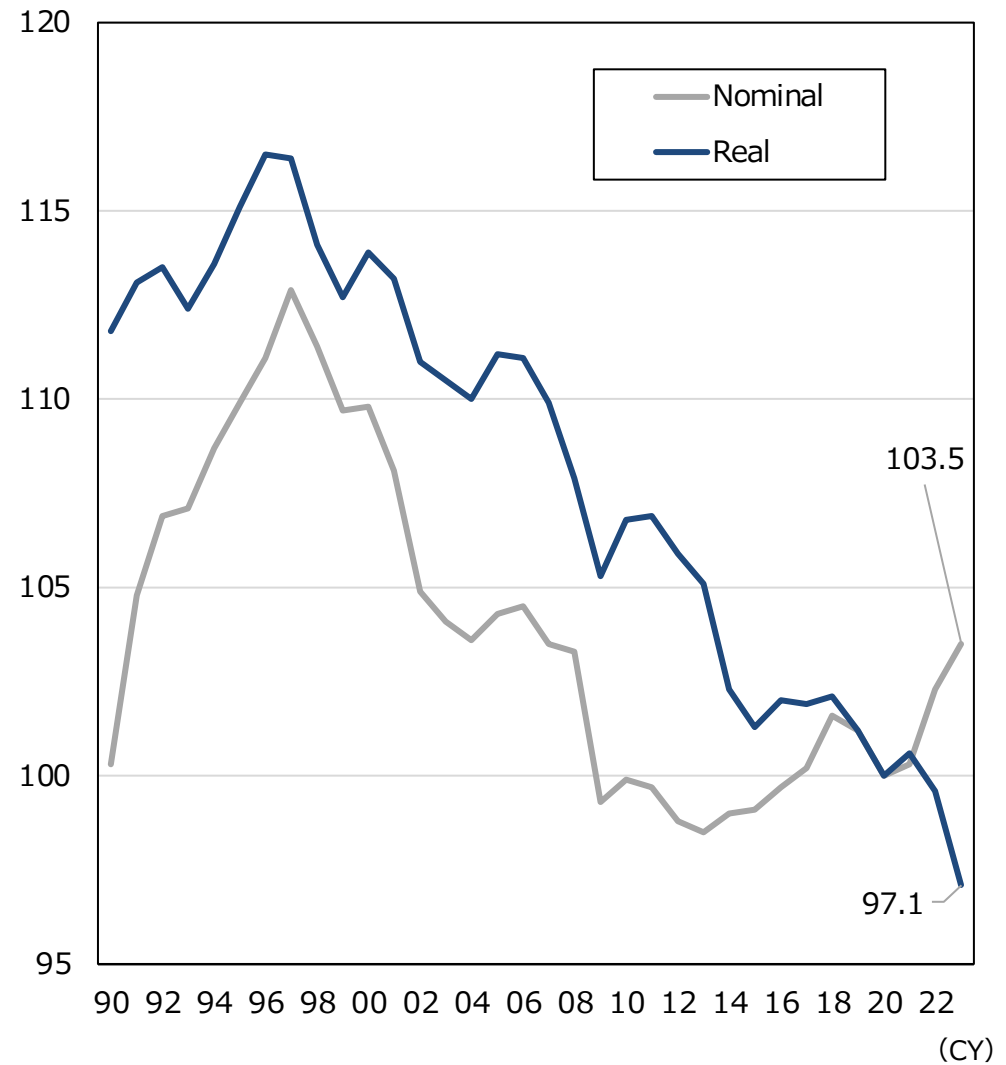
## Number of employees

(million people)



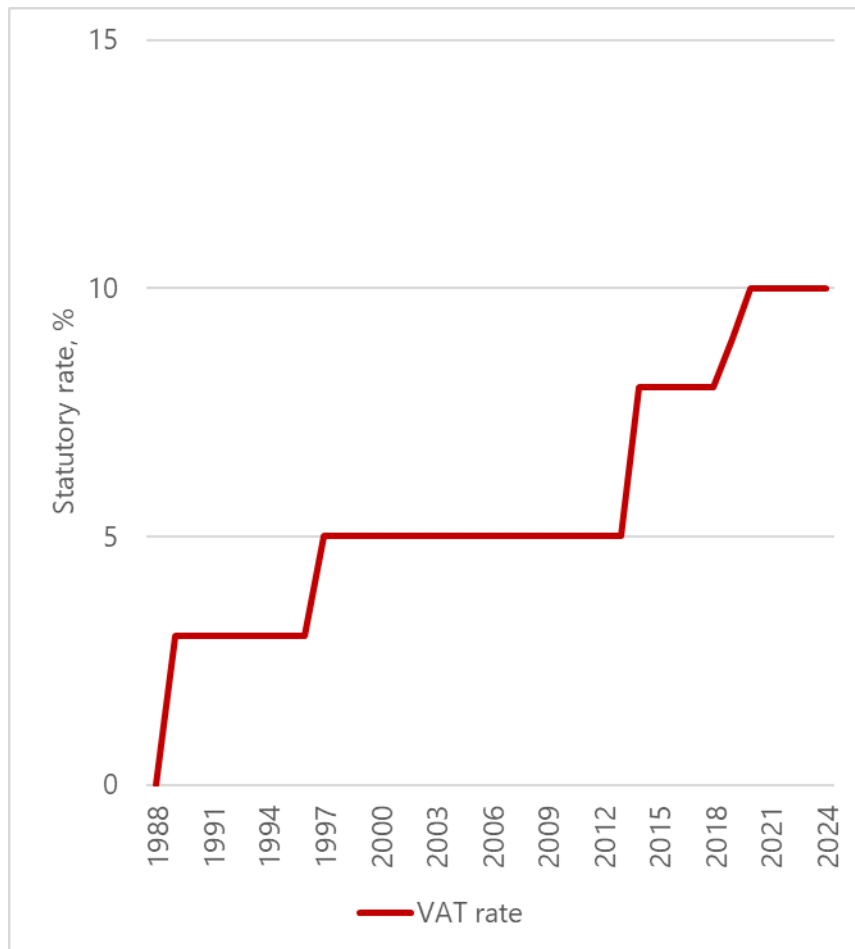
## Wages

(CY2020=100)



# Tax reform: consumption tax

- Consumption tax (Value-Added Tax) was first introduced in 1989 with 3% rate, and the rate was raised to 5% in 1997, 8% in 2014, and 10% in October 2019.
- Consumption tax revenue has been earmarked to social spending since 2000.



## Value added tax (VAT) fits better to economic globalization and aging

- VAT does not accumulate at the production stages, assuring the production efficiency
- VAT does not undermine international competitiveness
- ✓ In contrast, CIT (corporate income tax) and SSC (social security contribution) distorts both (i) production efficiency and (ii) international competitiveness.

*Sato (2019), 'The impact of demography on financing social expenditure', presented at G20 Symposium, January 2019.*

## For sustainable pension and healthcare systems

- **Installing flexible and automatic adjustments for benefit parameters and revenues**  
→ need to cope with realization of uncertainties without renegotiation / political decisions.
- **Effective control of demand and supply of services by fiscally responsible institutions**  
→ need to focus on and incentivize for better outcomes and efficiency.
- **Avoiding commitments based on optimistic assumptions and projections**  
✓ Ex. free healthcare provision to people aged 70 and more adopted in Japan from 1973 to 83

## Need to assure sustainable growth under demographic changes

- **'Output is central'** for assuring real benefit of social security system at national level  
→ need to carefully consider impacts of social security system on **labor supply** (elderly and female).  
→ need to effectively use **retirement savings** for long-term economic growth.  
→ need to avoid significant economic distortions by further revenue mobilization.