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Policy Proposals for Fiscal Consolidation

— With the return to "a world with interest rates," the formulation and execution of a long-term plan cannot wait —

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<Summary>

- Japan's fiscal situation has deteriorated significantly since the COVID pandemic. Going forward, with the return to "a world with interest rates," an increase in public debt service expenditures is inevitable for Japan, whose outstanding long-term debt (central + local) is more than double the country's GDP, so fiscal restructuring cannot wait.

- Given this situation, Japan should take the following measures for fiscal restructuring:

(1) Determine targets for fiscal consolidation
The current fiscal consolidation targets, which are to achieve a primary-balance surplus and "at the same time, to aim for steady reduction of the public debt-to-GDP ratio," need to be maintained. But it is also essential to formulate a long-term plan that includes numerical targets and defines the period for reform.

(2) Set targets for expenditures
The government should continue to declare clear "expenditure targets." It will also be important to review methods of local-government financing with a view to getting local governments to operate primary-balance surpluses, and to set guideline numerical targets.

(3) Strengthen functions for assessing and monitoring fiscal discipline
It is vital to establish functions for objectively making macroeconomic and fiscal forecasts and describing the long-term outlook, monitoring the content of and adherence to fiscal plans and rules, and performing objective or critical assessments. Consideration should also be given to the possibility of introducing highly independent monitoring mechanisms of the like seen in many other countries.

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(4) Determine rules for supplementary budgets and reserve funds

It is necessary to break away from the current situation where large-scale supplementary budgets and reserve funds have become the norm. Rules or regulations should be introduced to facilitate a return to the restrained spending that in fact ought to be the norm.

(5) Secure financial resources in the initial budget and allocate them to growth areas in a prioritized and focused fashion.

Effective fiscal policy will require a bold review of current resource allocation, and it will be crucial to make greater use of evidence-based policymaking (EBPM) and prioritize and target the allocation of financial resources to growth areas.

(6) Review people' cost burden and benefits

Regarding the cost burden on the public, it is important to spread the burden as fairly as possible among the people, focusing on the three core taxes of consumption tax, income tax, and corporation tax.

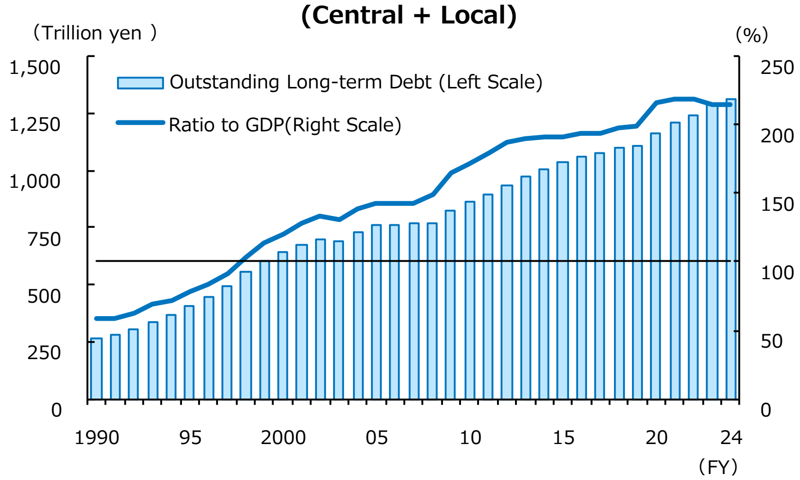
◆ In documents such as its Basic Policy, the government should clearly present specific targets and execution structures for fiscal restructuring, and establish a framework that will allow steady progress toward fiscal consolidation to be made.

- **This is a English version of "財政健全化に向けた提言ー「金利のある世界」に復帰で、長期計画の作成・履行待ったなしー" in JRI Viewpoint (The original version is available at https://www.jri.co.jp/MediaLibrary/file/report/viewpoint/pdf/15017.pdf)**

1. Fiscal management requires a greater level of discipline

Japan's fiscal situation has deteriorated significantly since the COVID pandemic. Outstanding long-term debt (central + local) has continued to increase, and has recently reached a level of more than twice that of nominal GDP (Figure 1). Massive fiscal deficits are run every year, and even though the government is aiming to achieve an aggregate (central + local) primary-balance surplus, in FY2024 the balance is expected to register a deficit of -18.6 trillion yen (-3.0% of nominal GDP)[1]. A look at the government's general account budget for FY2024 reveals that tax revenues are only 69.6 trillion yen against total expenditures of 112.6 trillion yen, so the situation where more than 30% of total expenditures are financed by debt (public debt revenues) is continuing[2].

Figure 1. Outstanding Longterm Debt (Central + Local)



Source: Prepared by JRI based on data from the Ministry of Finance

Despite the fact that fiscal demand is expected to increase further in the future, progress toward securing additional financial resources has been slow. First, with regard to the issue of financial resources for social security expenses, which has been unresolved for many years in spite of such expenses increasing due to the aging of the population, there have hardly been any discussions on how to pay for social security expenditures since the consumption tax was hiked to 10%. It is not clear about what the future tax burden will be and how the costs will be shared among them (meaning they face a high degree of uncertainty about the future). There is also the issue of financial resources for new policy initiatives such as decarbonization, bolstering defense capabilities, and strengthening measures to address the declining birthrate. The government declared that it would raise the burden on the public in the form of higher taxes, in addition to freeing up revenue through a review of current expenditures, but it has not actually increased the burden yet, preferring to postpone it to the future. So for the time being, the extra revenue needed will be procured through the issuance of new government bonds.

While increases in these sorts of policy expenses will be unavoidable. rising public debt service expenditures will also become a severe problem in the future due to the scrapping of negative interest rates and the return to

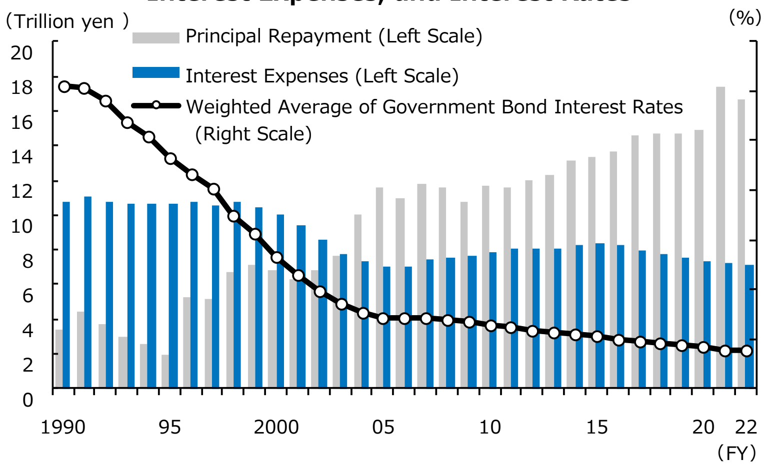
[1] Estimate based on the Cabinet Office's "Economic and Fiscal Projections for Medium to Long Term Analysis" (submitted to the Council on Economic and Fiscal Policy on January 22, 2024)" and the FY2024 budget. Excludes expenditures and financial resources for recovery and reconstruction measures and GX (green transformation) measures.

[2] The public debt dependence ratio (i.e., the proportion of expenditures financed through bond issuance) in the FY2024 budget was 31.5%. The public debt dependence ratio has remained above 30% since it reached 38.6% in the revised budget for FY1998.

"a world with interest rates." Dividing the national debt service expenditure in the government's general account into principal repayment and interest expenses (Figure 2), we find that principal repayment has been on an upward trend since the latter half of the 1990s, reflecting the accumulation of outstanding government bonds under the 60-year maturity rule for government bonds. In contrast, interest expenses have reflected the situation with market interest rates. They fell sharply in the first half of the 2000s, remained steady for a time, but have declined gradually since the mid-2010s. This downward trend has helped to curb the rise in total national debt service expenditure. Therefore, if interest rate rises become sustained in the future, interest expenses will start rising significantly, and public debt service expenditures are certain to soar as a result. In fact, the Ministry of Finance estimates that a 1% rise in interest rates would almost double interest expenses in less than a decade.

Given these circumstances, it can be said that the government finds itself at a critical juncture, where it must re-accelerate its efforts to achieve fiscal consolidation by shifting to a far more disciplined approach to fiscal management.

Figure 2. Trends with National Principal Repayment, Interest Expenses, and Interest Rates



Source: Prepared by JRI based on data from the Ministry of Finance

2. "Fiscal consolidation targets" and "expenditure targets"

In Japan, efforts to achieve fiscal consolidation have been made for many years. Various reforms aimed at delivering economic growth and fiscal consolidation have been instituted, and these have had set time frames and accompanying roadmaps. At the same time, medium-term fiscal consolidation targets and future outlooks have been presented.

Currently, there are two medium-term fiscal consolidation targets[3]: 1) "Aim for the primary surplus of the central and local governments by FY2025 by implementing economic revitalization and fiscal consolidation steadily" and 2) "At the same time, firmly maintain the aim of reducing the public debt-to-GDP ratio steadily." In addition, "expenditure targets" are presented as "structures for linking the fiscal consolidation targets to the budgets formulated in each fiscal year," and for the three years from FY2022 to FY2024[4], " the Government will compile a budget in accordance with the benchmarks," such as those shown in Table 1.

[3] "Basic Policy on Economic and Fiscal Management and Reform 2018" (June 15, 2018 Cabinet Decision).
[4] "Basic Policy on Economic and Fiscal Management and Reform 2021" (June 18, 2021 Cabinet Decision). The content of the "Basic Policy on

Table 1. "Expenditure targets" from FY2022 to FY2024

With regard to social security expenditures, the policy is to aim to keep the essential increase within the levels equivalent to the expected increase due to population aging during the foundation-reinforcement period, and the policy will be continued based on the future economic situation and price movements and the like.
With regard to general expenditures other than social security expenditures, the Government will continue existing efforts to improve government expenditures, with consideration of the future economic situation and price movements and other such factors.
With regard to the level of local government expenditures, while keeping in line with the efforts of the national government's general expenditures, the Government will ensure that the total amount of general revenue sources necessary for stable fiscal management of local governments, including those receiving local allocation tax grants, shall be maintained substantially at the same level as that of the FY2021 Fiscal Plan of Local Governments, and not below.

Source:Cabinet Office "Basic Policy on Economic and Fiscal Management and Reform 2021" (June 18, 2021 Cabinet Decision)

According to estimates from the Cabinet Office, if Japan's economy grows steadily and the nominal growth rate stays at around 3% (growth scenario), the primary balance of the central and local governments will be surplus in FY2026. Therefore, if this is achieved, a new medium-term framework will be needed to achieve the second fiscal consolidation target, which is to steadily reduce the public debt-to-GDP ratio[5]. In addition, since the current "expenditure targets" are set to expire in FY2024, it will be necessary to present new targets that are consistent with a steady reduction in the debt-to-GDP ratio.

3. Concern about weakening commitment

Even though Japan needs to move quickly in fiscal restructuring, there is a risk that commitment to fiscal consolidation will weaken in the future due to the following factors:

(1) Normalization of large-scale supplementary budgets and reserve funds

In spite of long-standing efforts for fiscal consolidation, the target of achieving a primary surplus for the central and local governments combined, the first step toward achieving this goal, has still not been accomplished.

Unfortunately, an examination of the trend with the primary balance of the central and local governments reveals that the deficit has widened significantly due to unforeseen circumstances such as the global financial crisis in the late 2000s, the Great East Japan Earthquake in the early 2010s, and the COVID pandemic in the early 2020s. However, even though the deficit narrowed during the economic expansions of the mid-2000s and mid-2010s, it did not move into surplus.

As background factors to this, it can be pointed out that on the revenue side, the increase in tax revenues may not have been sufficient due to prices and wages remaining flat even during the period of economic expansion, while on the expenditure side, supplementary budgets have increased in size and have become the norm because

Economic and Fiscal Management and Reform 2018" was largely repeated, with alterations to the periods covered.

[5] The "Basic Policy on Economic and Fiscal Management and Reform 2023" (June 16, 2023 Cabinet Decision) states that the government will "consider frameworks for achieving both economic revival and fiscal consolidation."

of the frequent use of so-called "15-month budgets." With regard to supplementary budgets, the Public Finance Act states that they can be prepared for 1) obligatory expenses prescribed by law etc. and 2) in special cases of "urgency" due to reasons that have arisen after the main budget was prepared. In reality, though, even during normal periods of economic expansion, considerable discretionary expenditures for such purposes as public investment have been added, and supplementary budgets have become a de facto loophole for bypassing the ceilings set in the initial budgets.

In addition, something that stands out recently is the swelling of reserve funds. The Constitution and the Public Finance Act provide for the establishment of a reserve fund "to provide for unforeseen deficiencies in the budget[6]." In the case of reserve funds, the Diet deliberates on the budget without deciding in advance how the money will be used, so from the perspective of fiscal democracy, restraint is called for when including expenditures in the budget. However, taking the FY2024 budget as an example, one trillion yen has been allocated as a "Contingency Fund for the Measures to Address Soaring Crude Oil and Commodity Prices and to Set up the Environment for Promoting Wage Increases." These constitute reserve funds for specific purposes, and it is doubtful whether they were truly unforeseeable. And besides that, the regular reserve fund has been doubled to one trillion yen[7].

(2) "Illusionary fiscal consolidation" due to time lag in rising interest expenses

Interest expenses are expected to increase in the future as interest rates rise. However, depending on the situation, it is possible that the adverse impact on the fiscal balance of higher expenses will be mitigated by if the increase in interest expenses is exceeded by an increase in tax revenues. For example, according to the Ministry of Finance's "Estimation of Impact on Expenditures and Revenues in the FY2024 Budget" (3.0% economic growth scenario), interest expenses will increase by 1.4 trillion yen in FY2025 compared to the previous year, while tax revenues will rise by 6.2 trillion yen, so the fiscal balance will improve by 3.0 trillion yen even though primary-balance expenditures such as social security-related expenses are expected to increase by 0.9 trillion yen.

A recent figure for the average remaining maturity of ordinary government bonds is nine years and two months (bonds outstanding as of the end of March 2023), and even if rising interest rates do not immediately push up interest payments, the government will be forced to refinance most of its debt at higher interest rates over time. To prepare for the anticipated steep rise in interest expenses after refinancing, it will be crucial to firmly establish a path toward fiscal consolidation within the next decade. In the meantime, if inflation accelerates and tax revenues increase substantially, there is a danger of commitment to fiscal consolidation weakening. However, it needs to be borne in mind that such a rise in tax revenues is by no means guaranteed, and even if it does occur, it will only be temporary. To gain the confidence of the market, it is extremely important for the government to maintain a sincere commitment to fiscal consolidation even if tax revenues increase, and to exercise restraint in its annual spending. And to demonstrate this resoluteness and unwavering

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6 Article 87 of the Constitution states: "In order to provide for unforeseen deficiencies in the budget, a reserve fund may be authorized by the Diet to be expended upon the responsibility of the Cabinet."

7 The regular reserve fund, which was 350 billion yen during the Heisei era (1989-2019) was increased to 500 billion yen after the start of the Reiwa era (2019).

commitment both at home and abroad, the government needs to determine new fiscal consolidation targets, establish fiscal discipline, and steadily take action to meet these targets and exercise that discipline.

4. How fiscal consolidation should be pursued

However, under the current framework, it is unlikely that the government's currently relaxed stance on fiscal restructuring, will strengthen naturally. The development of a system for steadily advancing fiscal restructuring is therefore a pressing task, which can be broken down into the following six specific subtasks:

(1) Determine targets for fiscal consolidation

The current fiscal consolidation targets, which are to achieve a primary-balance surplus and "at the same time, to aim for steady reduction of the public debt-to-GDP ratio," need to be maintained. As to the sustainable level of outstanding long-term debt, i.e., the level that can be tolerated in the long run given the size of Japan's economy, frankly, no one knows what it is. Therefore, these targets should be regarded as the minimum necessary to control risk.

If targets that go one step further were to be set, one approach would be to declare a specific long-term time frame and numerical target, such as restoring the long-term debt-to-GDP ratio of the central and local governments to the level it was at the beginning of this century (about 130%[8]) over a period of 25-30 years[9]. Then, a medium-term target (KPI target) for the same ratio, which would be set to minimize the impact on the economy, could be announced every three or five years. It will be important to ensure, by pursuing it as a long-term project, that fiscal consolidation neither imposes an excessive burden on nor adversely affects financial markets, and at the same time, to continuously gain market trust by successively announcing and then achieving KPI milestone targets. If the ratio of outstanding long-term debt to GDP of the central and local governments is lowered over 30 years from the current level (214% in the FY2024 budget) to the level it was at the beginning of this century, it is estimated that the primary-balance surplus would be 2.8% of GDP (interest rate = nominal growth rate scenario) (Table 2). This is just an example based on a simple premise, but in actual policymaking, the target figures are likely to vary significantly depending on economic conditions and the remaining maturities of government bonds. Furthermore, there are numerous different opinions concerning the level of tolerance of the pain that fiscal restructuring will cause. So, it will be

Table 2. Primary-balance Surplus-to-GDP Ratio Required to Reduce the Long-term Debt-to-GDP Ratio to 130%

(%)

Period	Primary-balance Surplus-to-GDP Ratio		
	Interest Rates > Growth Rate	Interest Rates = Growth Rate	Interest Rates < Growth Rate
25 years	5.1	3.4	1.7
30 years	4.5	2.8	1.1

Source: Prepared by JRI
Note: Calculated the annual primary -balance surplus that would be needed to reduce the long -term debt -to -GDP ratio from 214% (FY2024 budget) to 130% over 25 or 30 years.

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8 The long-term debt-to-GDP ratio of the central and local governments was 128% FY2001 and 133% in FY2002.

9 This is a case that after the government achieves a primary-balance surplus in FY2025 as per its target, the cumulative increase in the long-term debt-to-GDP ratio that has occurred over a period of about 25 years will take a similar number of years to be reversed.

necessary to make estimates based on various scenarios, initiate a national conversation, and determine appropriate time frames and numerical targets.

(2) Set targets for expenditures

The government should continue to specify "expenditure targets" to support the compilation of annual budgets based on fiscal consolidation targets.

This will also need to involve a review of methods of financing local governments. Recently, while the primary balance for the central and local governments combined remains in the red, the primary balance of local governments as a whole is in surplus, and their cash reserves are increasing. Although this is partly due to the results of local governments' efforts to improve operational efficiency, there is also a need to examine whether tax allocations to local governments, which are designed to cover shortfalls in their own financial resources, are excessive. Local government tax revenues vary greatly among local governments, so these imbalances must be corrected. It will also be necessary to reduce local allocation tax through a review of the inclusion of administrative expenses in the figures for local governments' fiscal requirements that are used as the basis for determining amounts of allocation tax grants. Furthermore, changes in the supply of and demand for administrative services are expected, as reviews of the nature and methods of provision of administration services, particularly in depopulated areas, will be required as the population declines in the future. Given this, the current "expenditure targets," which are aimed at ensuring that the total amount of general financial resources of local governments is "substantially the same level" so that it does not fall below the level of the current local fiscal plan, needs to be reviewed.

In addition, the "expenditure targets" as a whole ought to be made more detailed, such as by including specific targets. In the 2000s, for example, the Basic Policy for Economic and Fiscal Management and Structural Reform 2006 (July 7, 2006 Cabinet Decision) provided specific details of expenditure reforms to be undertaken over a five-year period in defined areas such as "social security," "local government finance," and "public works-related expenditures," and for some of these areas, the text contained concrete information about how expenditures would be curtailed and how fast reductions would occur. This kind of concreteness can be said to be essential for advancing reforms.

(3) Strengthen functions for assessing and monitoring fiscal discipline

Fiscal rules such as the "fiscal consolidation targets" and the "expenditure targets" are indispensable for fiscal consolidation, but they will not necessarily lead to fiscal consolidation by themselves. For example, if the government presents a forecast for the future long-term debt-to-GDP ratio based on an optimistic economic projection, and envisions that the fiscal consolidation targets will be met even with lax fiscal rules, fiscal consolidation will not be achieved if actual economic growth is lower than the government's forecast. This has already happened in the past.

To avert such a situation, it will be essential to determine macroeconomic and fiscal forecasts and the long-term outlook objectively, monitor the content of and adherence to fiscal plans and rules, and perform objective or critical assessments. In many Western countries, "independent fiscal institutions" (IFIs) have been established as public bodies that are responsible for such functions, such as the Congressional Budget Office (CBO, established in 1974) in the U.S. and the Office of Budget Responsibility (OBR, established in 2010) in the U.K. Functions for assessing and monitoring adherence to fiscal discipline should be strengthened with reference to such initiatives.

(4) Determine rules for supplementary budgets and reserve funds

To break away from the current situation where large-scale supplementary budgets and reserve funds have become the norm, which will be an essential task in the process of fiscal consolidation, rules such as the following should be introduced to facilitate restrained spending and reduce debt.

1) Limit additional expenditures to those that are mandatory and those that are intended to deal with truly unforeseeable events (such as sudden economic crises or large-scale disasters). When securing additional financial resources, minimize the issuance of new government bonds in connection with supplementary budgets by thoroughly reviewing existing expenditures.

2) During periods of economic expansion, the tendency is for tax revenues to be higher than initially expected, but limit additional spending via supplementary budgets to mandatory expenditures such as local allocation tax grants. Use the remainder of the tax revenue increase not for short-term discretionary expenditures, such as "15-month budgets," but instead to pay off government debt.

3) Limit reserve funds to a regular reserve fund of 500 billion yen, and do not include expenditures for specific purposes in reserve funds.

(5) Secure financial resources in the initial budget and allocate them to growth areas in a prioritized and focused fashion.

To ensure that use of supplementary budgets is restrained, it will be essential to include discretionary expenditures that have hitherto been financed via supplementary budgets in the initial budget. Even if tax revenues increase significantly due to economic growth or inflation, it will be important not to allocate the extra money to policy expenses, but instead to use it to improve the primary balance and reduce public debt (new borrowing).

To secure the minimum necessary financial resources while keeping a lid on expenditures, a bold review of the current allocation of financial resources will be required. This review of the allocation of financial resources will need to involve greater use of evidence-based policymaking (EBPM) so that the effectiveness of policies is measured and the most effective policies are prioritized for resource allocation.

Furthermore, to reduce the long-term debt-to-GDP ratio in a stable manner, it is important that the nominal economic growth rate exceeds interest rates, making it essential to prioritize and target the injection of funds in areas that promote Japan's growth. To maintain and strengthen the growth potential of Japan's economy even as the country's population declines in the future, it will be important to take measures with economic/social transformation and innovation in mind, not only in the realm of "investment," such as science and technology, industrial promotion, and education, but also in the realm of "social capital development," such as infrastructure and defense.

(6) Review people' cost burden and benefits

If fiscal consolidation targets are still not achieved even after maximizing efficiency in the use of expenditures, it will become necessary to review the burden on the public, which could involve raising the tax burden. In such a case, however, it will be imperative to eliminate public uncertainty about future disposable income, such as the risk of tax hikes. And it will be essential to inform the public in advance how much the burden on them is expected to increase by in the future. For example, the aforementioned Basic Policy for Economic and Fiscal Management and Structural Reform 2006 presented specific figures highlighting the need for revenue reform and the scale of the increase in the tax burden. These were based on estimates in the Appendix of the amounts of expenditure reduction that expenditure reform would deliver over five years in each spending category and comparisons of those figures with the financial resources required to achieve a primary-balance surplus[10]. So one idea would be to revive this approach.

When raising the burden on the public, rather than just focusing only on specific tax items, it will be important to share the burden among people and taxpayers as fairly as possible, while also considering the overall cost burden and tax burden, centered on the three core taxes of consumption tax, income tax, and corporation tax (tax mix).

Regarding the fairness of the burden, although the social insurance premium burden is basically a fixed rate of burden relative to income, there is an upper limit on the monthly remuneration used as the basis for computing the rate, so for those with high incomes, who are able to benefit from this cap, the burden percentage decreases as their incomes rise. The burden is therefore regressive, which is unfair. To ensure that the burden of social insurance premiums is based on ability to pay, it will be necessary for high-income groups, which currently benefit from the upper limit, to pay a fixed rate, just as those with lower levels of income do. In short, the cap on the monthly remuneration basis should be quickly scrapped.

And as for the pressing issue of securing financial resources for tackling the declining birthrate, there should be no need to rely on social insurance premiums, which basically constitute a fixed-rate burden. Instead, it will be crucial to clearly advocate the philosophy that "the next generation should be nurtured by society as a whole." This perspective entails exploring the possibility of redistributing the income and assets of the more affluent elderly generation to the next generation, not only within families but also across society, through increased taxation on financial income, inheritance, and gifts. Naturally, if such a path is taken, it will be necessary to carefully determine the tax rates, the timing of introduction, and the duration of the measures in such a way as to prevent the economy once again slipping into a deflationary spiral due, for example, to a plunge in asset prices as owners rush to sell to avoid the new taxes.

On the other hand, when it comes to social security benefits for the public, some hold the view that inadequate systems have led to sloppiness in the selection of recipients, with people receiving handouts even though they

[10] The "Basic Policy for Economic and Fiscal Management and Structural Reform 2006" set a target of achieving a primary-balance surplus in FY2011.

do not really need them[11]. This view stems from what happened during the recent COVID pandemic, though admittedly, the government needed to act quickly at that time. To ensure that essential benefits reach only those who truly need them in a targeted manner during times of emergency, a system for that purpose needs to be established in normal times.

5. Conclusion

The Basic Policy on Economic and Fiscal Management and Reform, which is formulated in June every year, is nicknamed the "Big-Boned Policy," but in recent years, it has tended to avoid in-depth discussion of fiscal restructuring, though there has been an increase in the number of statements of expanding expenditures. Given these circumstances, it is impossible for momentum for fiscal restructuring to emerge in the first place. As pointed out in this paper, given that commitment to fiscal consolidation could weaken, it is important to formulate concrete consolidation measures and clearly state them as the government's policy.

This year is the first fiscal year of "a world with positive interest rates," and the hope is that this fiscal year's "Big-Boned Policy" will present not small steps, but a truly big-boned reform plan that positions this as the first year for fiscal restructuring.

[11] The "Special Cash Payments" (COVID-related fixed-amount cash benefits) made in 2020 saw all individuals registered with the Basic Resident Registration System as of April 27,2020 receive a cash handout of 100,000 yen. In addition, although the "Temporary Special Benefit for Households Exempt from Resident Tax" was intended to target low-income households who are struggling to make ends meet, the total amount of income used to determine households exempt from resident tax did not include income such as interest income and dividend income subject to separate withholding taxation. Asset holdings were also ignored. It is therefore possible that pensioners who own land, a home, and large amounts of financial assets were able to receive the benefit.