Mizuho Economic Outlook & Analysis

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Outlook and comments on the review of Japan's fiscal consolidation plan

Some proposals for achieving a primary balance surplus

< Summary >

◆ In April 2018, the Japanese government's Council on Economic and Fiscal Policy begins a full-fledged revision of its fiscal consolidation plan drafted in 2015. The most important focus of this revision is how the government will set a new goal of achieving a primary balance (PB) surplus, replacing the FY2020 goal that was abandoned in the fall of 2017.

◆ It is crucial for the government to turn the PB deficit into a surplus by at least FY2025, when Japan's post-war baby boomers will reach 75 years of age or older. In this case, based on a conservative growth projection, the government needs to reduce the PB deficit by 1.4 trillion yen each year in FY2019 and beyond.

◆ In the coming years, expenditure reforms for restoring the nation's fiscal health initiated by the Abe administration are expected to produce a positive impact. The new plan scheduled to be revised in June 2018 should provide a more detailed roadmap for achieving a PB surplus by, for example, the establishment of numerical targets.

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1. Fiscal consolidation efforts delayed by sluggish tax revenues and supplementary budgets

On March 29, one day after passing the general-account budget for FY2018 totaling a record 97.7 trillion yen, the Japanese government's Council on Economic and Fiscal Policy held a meeting. At the meeting, the council conducted an interim assessment of Prime Minister Shinzo Abe administration's integrated economic and fiscal reforms in line with its fiscal consolidation plan (formally the "Plan to Advance Economic and Fiscal Revitalization") formulated in 2015 and agreed on the direction of discussions to revise the plan in June 2018.

In the current plan, the government provided an interim indicator of -1% for the primary balance (PB)-to-GDP ratio in FY2018 to attain its target of achieving a PB surplus by FY2020. But the actual projection for FY2018 is far from the target, estimated at -2.9%. The interim assessment identified the following factors behind this discrepancy: (1) more efficient government spending (around +0.7%); (2) the effects of issuing supplementary budgets (roughly -0.4%); (3) sluggish tax revenues due to the country's economic growth being lower than originally projected (about -0.8%); and (4) the effects of postponing the consumption tax rate hike from 8 to 10% (around -0.7%) (**Chart**). Meanwhile, for the new plan, the council agreed to steadily restore Japan's fiscal health while paying due regard to avoid a negative impact upon the economy, and to develop a framework to ensure a PB surplus by resetting the target fiscal year.

2. PB surplus attained by at least FY2025

In subsequent meetings, the Council on Economic and Fiscal Policy will enter into in-depth discussions on a new policy blueprint for improving the government's fiscal health. With the most important issue focusing on the timing for achieving a PB surplus, FY2025 will most likely be the target year, because improving the country's finances by this time – the year when Japan's post-war baby boomers will reach 75 years of age or older – will be crucial in preparing to meet further ballooning social security costs. More specifically, it should be announced that the PB surplus goal will be attained by at least FY2025, with a view to achieving this goal even earlier.

Supposing that the PB surplus goal is set for FY2025, based on the government's fiscal outlook stemming from a cautious outlook on economic growth, it will be necessary to reduce the revenue-expenditure gap by an average of 1.4 trillion yen each year in FY2019 and beyond. To narrow this gap, the new plan must provide full details of the expenditure restraint policies.

3. Further restraints upon the growth of social security costs could be an option

First, to deal with rising social security costs, it is indispensable to maintain the conventional approaches to restraining cost increases from the previous fiscal year to the 500 billion-yen level. On top of this, with the government's recent efforts to reduce regional differences in medical and nursing care costs by half expected to produce a positive impact, it is worthwhile to set even stricter targets, such as holding social security spending growth down to the 400 billion-yen level.

4. Expenditure reductions desired for public policies other than social security

In policy areas other than social security, the government has persistently curtailed increases in the country's initial budget from the previous fiscal year (growth of around 30 billion yen). In the coming years, the government should scale down its budget in consideration of the positive outcomes expected through expenditure reforms, such as visualizing regional differences in administrative services and promoting progressive practices nationwide. Pursuing a budget ceiling (upper limit on the budget requested by each ministry) is also worthy of consideration in terms of cutbacks. According to the budget request guidelines formulated every summer, the Abe administration has demanded a yearly ten-percent budget reduction in policy expenditures, excluding social security, while accepting roughly three times the reduction amount for budget requests in the special category established to promote the administration's key policies. Imposing an even stricter ceiling, for example, demanding 15 to 20% cuts in the budget requested for policy expenditures from the previous fiscal year, could further urge each ministry to advance its scrap-and-build policy and expenditure reforms on its own initiative.

5. More effective controls on supplementary budgets and local government finances

So far, this paper has basically discussed suggestions to strengthen control of the country's initial budget. The government's new fiscal consolidation plan should also introduce controls on its supplementary budgets, such as imposing multi-year spending caps (e.g., five trillion yen over three years). Meanwhile, the Abe administration has initiated various efforts to improve the administrative and fiscal health of local governments, including information transparency in public services and administrative cost reductions through information technology. The new plan should present as well specific details on how these efforts can contribute to restraining expenditures.

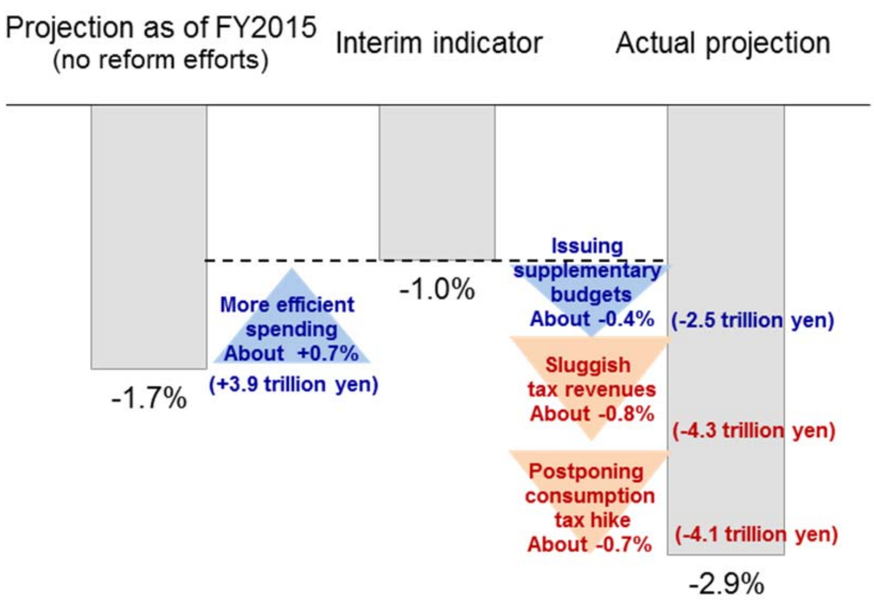
6. Detailed roadmap for restoring fiscal health

All in all, work on comprehensively revising its fiscal consolidation plan will require the government to set specific targets for a wide range of expenditure reforms. Ideally these targets would be drawn together to present methods of reducing the amount of the revenue-expenditure gap required each year.

Furthermore, the government should also clarify the PDCA (plan-do-check-act) cycle based on the progress of the new plan. For example, in cases where approaches focusing solely on expenditure reforms deviate significantly from the PB surplus roadmap, the new plan could provide an outline of fundamental tax reforms that include a further consumption tax hike.

Given the Bank of Japan's (BOJ) quantitative and qualitative monetary easing (QQE) for the past five years, the country's finances have enjoyed the benefits of low interest rates. However, to prepare for the BOJ's exit policy from QQE, the government needs to strengthen its resilience to rising interest rates. In the near future, it will be essential to implement policy measures to prevent a sharp decline in the economy after the introduction of the consumption tax hike planned in October 2019. In the meantime, it is extremely important to draw up a detailed roadmap for restoring fiscal health from a long-term perspective. For the fiscal consolidation plan scheduled to be revised in June 2018, it is desirable that the government formulate a new plan that will be fully supported both domestically and internationally.

Chart : Gap between the initial FY2018 PB projection and the actual projection



Note: The percentages represented in the chart are the ratio of primary balance (PB) to GDP.
Source: Made by MHRI based on the Committee for Promoting the Integrated Economic and Fiscal Reforms, the Council on Economic and Fiscal Policy, *Interim Assessment of Integrated Economic and Fiscal Reforms* (March 2018).