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# Mizuho Economic Outlook & Analysis

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# *Japan's fiscal consolidation plan revised*

## *Need to strengthen expenditure reform to achieve a primary balance surplus in FY2025*

< Summary >

◆ According to the new fiscal consolidation plan stipulated in the Basic Policy on Economic and Fiscal Management and Reform 2018, which was approved by the Cabinet on June 15, the target of achieving a primary balance ("PB") surplus was pushed back five years to FY2025 from FY2020.

◆ Given that the target is based upon an optimistic scenario for the economy, there is the possibility that the target may not be achieved if Japan's actual economic conditions remain unchanged.

◆ In the new reform time schedule to be formulated by the end of this year, Japan's government will be required to come up with a more specific, in-depth reform plan based upon the qualitative improvement of fiscal conditions which has thus far been pursued by the Abe administration.

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On June 15, the Japanese government approved the Basic Policy on Economic and Fiscal Management and Reform 2018 (hereinafter the "Basic Policy"). This marks the sixth annual establishment of such a policy under the second Abe administration.

The structure of the Basic Policy this time is depicted in **Charts 1** and **2.** On the economic policy front, it is noteworthy that measures related to priority policy themes, such as human resources development revolution and supply system innovation, have been organized systematically and that establishment of a new status of residence to accept more foreign workers has been included.

### Chart 1: Outline of the Basic Policy on Economic and Fiscal Management and Reform 2018

- Prioritize the human resources development revolution and the supply system innovation to raise the potential growth rate.
- Curb demand fluctuations accompanying the consumption tax hike scheduled in October 2019 to a maximum extent.
- Formulated the New Plan to Advance Economic and Fiscal Revitalization that aims to achieve a PB surplus in FY2025.

**Economic policy: Major actions for realizing strong economic growth**

Human resources development revolution

- ◆ Free early childhood education (Free education for all 3-5-year-old children and 0-2-year-old children who belong to households exempt from the Inhabitant Tax. Unlicensed nurseries will also be eligible for the same level of financial assistance as licensed nurseries. (37,000 yen per month for 3-5-year-old children))
- ◆ Free higher education (Financial assistance will be divided into three stages and provided to households with annual income under 3.8 million yen)
- ◆ Recurrent education (Expansion of educational training benefits and program development by industry-academia collaboration)
- ◆ University reform (Appointment of external governors, collaboration and unification of universities)
- ◆ Employment of the elderly (Preparation of environment for raising the continuous employment age limit to over 65 years old and trial hiring of the elderly)

Supply system innovation

- ◆ Selection and promotion of Flagship Projects (FP2020 that realizes early results, FP2025 that accompanies full-fledged social change)
- ◆ Creating a foundation for economic innovation (data utilization infrastructure, regulatory sandbox)

Work-style reform

- ◆ Correction of long working hours, equal pay for equal work, Sophisticated Professional System, minimum wage increase

Acceptance of new human resources from overseas

- ◆ Creation of a new status of residence in areas truly needed, separate from immigration policy

Others

- ◆ Use of area-limited sandboxes in the National Strategic Special Zones
- ◆ Expansion of the good renting of private houses and rooms
- ◆ Development and promotion of IR (Integrated Resort)

**Fiscal policy: Promotion of "integrated economic and fiscal reforms" and formulation of FY2019 budget**

Consumption tax hike in October 2019 and curbing of demand fluctuations

- ◆ Examine measures to ensure free price setting by business owners
- ◆ Examine purchase assistance measures for consumer durables (automobiles, houses, etc.)

New Plan to Advance Economic and Fiscal Revitalization (so-called fiscal consolidation plan)

- ◆ Aim at realizing a PB surplus in FY2025 for central and national governments, etc.

(⇒See **Chart 2** for details of the plan.)

Guiding principles in budget formulation for FY2019

- ◆ Take temporary special measures to curb demand fluctuations accompanying the consumption tax hike in the initial budgets of FY2019 and FY2020
- ◆ Formulate the budget in line with the policy to maintain the existing expenditure reform on social security expenses, etc.

Source: Made by MHRI based on *Basic Policy on Economic and Fiscal Management and Reform 2018* (approved by the Cabinet on June 15, 2018).

## Chart 2: Overview of the new fiscal consolidation plan

### Outline

- Tackle fiscal consolidation at a pace and with a flexibility that will not undermine economic recovery.
- Aim at achieving a PB surplus for central and local governments in FY2025 while maintaining the aim of reducing the public debt to GDP ratio steadily.
- Positioned the period from FY2019 to FY2021 as the "foundation-reinforcement period" centering on social security reform, and formulate a new reform time schedule by the end of 2018.
- Concerning social security expenditures, stick with the existing policy to restrain to an amount equivalent to the cost increase due to population aging in FY2019 to FY2021.
- Check the progress by setting three intermediate indicators in FY2021. (PB deficit to GDP ratio: about 1.5%; fiscal deficit to GDP ratio: 3% or below; public debt to GDP ratio: the low 180%-range)
- Set priority social security policies in FY2020.

### Social security

- Adopt prioritized initiatives to prevent lifestyle diseases and dementia
- Develop a public pension system neutral to the job status of the elderly
- Halve the regional gap of medical and nursing cost per individual
- Improve the productivity of medical and nursing services through data health reform, etc.
- Enhance the international competitiveness of the pharmaceutical industry
- Examine the medical and nursing burden that corresponds to one's "capability," including status of asset holding

### Social infrastructure development

- Improve productivity by 20% at construction sites
- Introduce concessions at all airports, in principle
- Reorganize and consolidate public facilities based on the Compact Plus Network concept

### Local public administration and finance reforms

- Promote the expansion and communalization of public services
- Examine the allotment of local allocation taxes that corresponds to reform efforts
- Promote the use of the My-Number system in family register administration

### Education, science and technology

- Increase the ratio of R&D investment to GDP to over 4% for the public and private sectors combined
- Set priorities in financial assistance to universities

### Cross-sectional initiatives on expenditure reform

- Introduce and expand allocation methods that correspond to reform efforts and results
- Establish the PDCA cycle, etc. based on objective data
- Promote nationwide dissemination of advanced and excellent practices
- Reduce administrative procedure costs by over 20% through digitalization

Source: Made by MHRI based on *Basic Policy on Economic and Fiscal Management and Reform 2018* (approved by the Cabinet on June 15, 2018).

Concerning Japan's fiscal policy, the main pillars of the Basic Policy are the deliberation on concrete measures to curb demand fluctuations accompanying the consumption tax hike to 10% scheduled in October 2019, and the replacement of the 2015 fiscal consolidation plan drawn up 3 years ago ("Former Plan") with the establishment of a new plan ("New Plan").

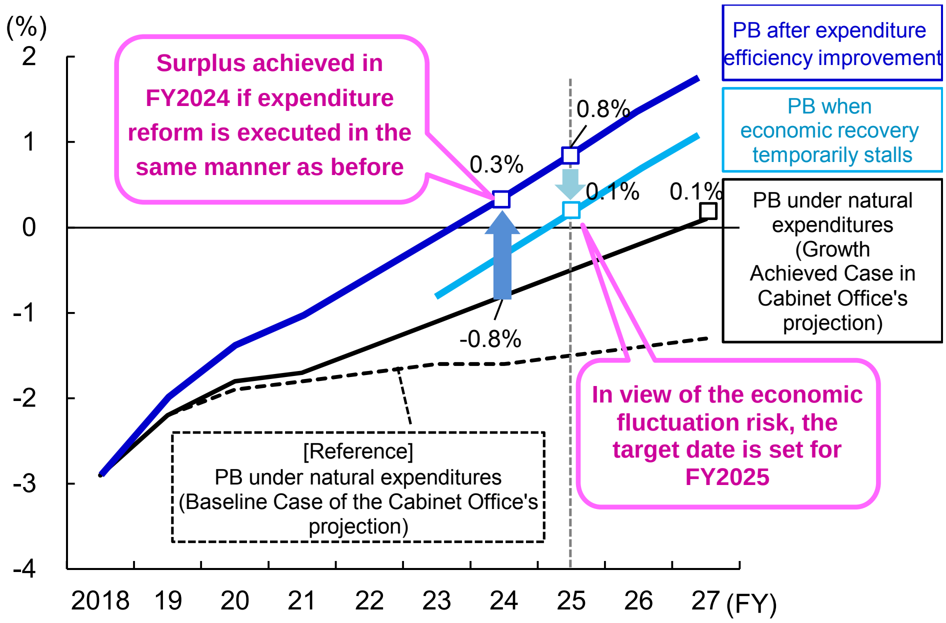
In this report, we explain and evaluate the New Plan that outlines the roadmap to achieve the new target of a PB surplus in FY2025.

## 1. Target setting assumes optimistic economic growth

Last fall, the Abe administration drafted a new policy to allocate a part of tax revenue growth, driven by the consumption tax hike to 10% in 2019, to provide free education, and abandoned its target to achieve a PB surplus by FY2020 toward which the government had been working on up until then. The focal point of the New Plan was how long the government would postpone the timing to achieve the PB surplus target, and as a result of examining various options, the government decided to set the target for FY2025.

The logic behind the new surplus target date was explained at the meeting of the Council on Economic and Fiscal Policy held on May 28 as follows: (1) the Economic and Fiscal Projections for Medium- to Long-Term Analysis published by the Cabinet Office in January 2018 states the PB surplus would be achieved in FY2027 if the Economic Growth Achieved Case (assumes relatively high medium-term economic growth rates of 2% in real and mid-3% in nominal terms) was realized; (2) if the government maintains the same level of efforts on its expenditure reform, which was not reflected in the Cabinet Office's projections, a PB surplus would be achieved in FY2024; and (3) considering the possibility of a temporary slowdown in economic growth, it would be realistic to set the PB surplus target for FY2025 (**Chart 3**).

**Chart 3: Basis for setting the new PB surplus achievement target date in FY2025 (PB to GDP ratio)**




Source: Made by MHRI based on *PB surplus target in the New Plan* (from the Council on Economic and Fiscal Policy on May 28, 2018).

The main concern here is that just as in the Former Plan , the achievement of a PB surplus in FY2025 seems doubtful because the New Plan envisages the path to a PB surplus on the basis of an optimistic economic outlook. Should the Japanese economy follow the “Baseline Case” (assumes medium-term economic growth rates of over 1% in real and latter half of 1% in nominal terms) or end up with even lower economic growth rates, Japan will most likely deviate greatly from the path to a PB surplus in FY2025. Although it is essential for the government to set an aggressive economic growth target, the government should adopt a more prudent economic scenario when paving the way to achieve fiscal consolidation. Just as in the Former Plan, it is quite possible that the PB surplus target may not be achieved again.

## 2. No numerical target to restrain expenditures has been set

Another discussion issue in the New Plan was how to establish a numerical target on restricting social security expenditures. In the end, no numerical criteria were set.

Social security expenditures in Japan are increasing naturally mainly due to the two major factors of population aging and advanced medical care. How to restrain their cost is the key to bringing about fiscal consolidation. The Former Plan estimated that social security expenditure growth would be restrained to about 1.5 trillion yen (0.5 trillion yen per year over three years), an amount equivalent to the cost increase caused by the aging factor, in the initial national budget for FY2016 to FY2018. This numerical target has been achieved for three consecutive years.

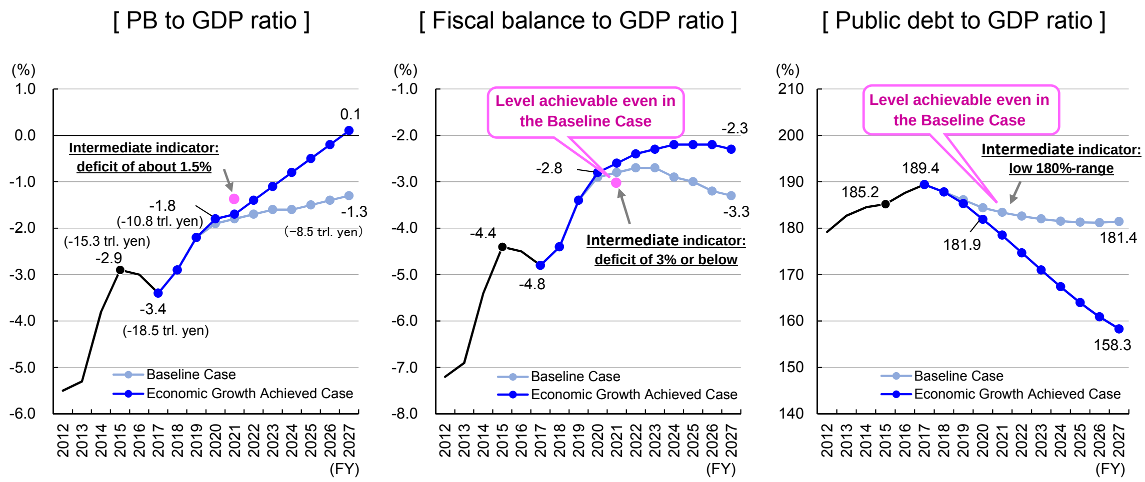
In formulating the New Plan this time, the main discussion issue within the government was the level of the numerical target concerning social security expenditures in FY2019 to FY2021, a period positioned as the “foundation reinforcement period” centering around social security reforms. In Japan, self-payment of medical costs becomes lighter (and the public burden heavier) once a person reaches 75 years of age. Therefore the number of people newly turning 75 years old has a significant impact on the increase of social security expenditures due to population aging. In FY2020 and FY2021, people who were born around the end of the Second World War, when the number of births was low, will turn 75 years old. Hence, increases in social security expenditures will slow from around 500 billion yen in FY2019 to about 400 billion yen in FY2020 and FY2021. Based on this assumption, the Ministry of Finance asserted that growth in social security expenditures for the three-year period should be “limited to 1.3 trillion yen.” However, the Ministry of Health, Labour and Welfare asked that the growth target be “restrained to 1.5 trillion yen” just like before. In the end, the two ministries could not come to terms and the numerical target itself disappeared.

Numerical criteria established in the Former Plan exerted a certain control over the increase in social security spending, at least in the initial national budget. In light of this, it is disappointing that a numerical target was not included in the New Plan. However, the New Plan states that social security expenditure growth for FY2019 to FY2021 will be restrained to the amount corresponding to the increase due to population aging. From this statement, it is reasonable to believe that the government has decided to appropriately reflect the slowdown in the natural growth of social security expenditures in the budget in FY2020 and FY2021, and this seems far better compared with the loose numerical threshold of 1.5 trillion yen in three years. In any event, a focal point is the course of discussions on social security expenditures in the coming budget finalization process.

## 3. Intermediate indicators in FY2021 would be easy to achieve

In the New Plan, the actual progress of the fiscal consolidation program will be checked and evaluated in FY2021 with three intermediate indicators established to that end. These indicators are all expressed as percentages of GDP as follows: (1) PB deficit will be about 1.5%, (2) fiscal deficit will be 3% or below, and (3) public debt will be the low 180%-range. Among these targets, (1) is worth noting since this level cannot be achieved by simply depending on economic growth but requires expenditure reforms as well. However, (2) and (3) can be attained easily even with a relatively low rate of economic growth (**Chart 4**).

**Chart 4: The government's fiscal outlook and intermediate indicators in the new fiscal consolidation plan**




Note: The Economic Growth Achieved Case assumes medium- to long-term economic growth rates of "about 2% in real and mid-3% in nominal terms" and the Baseline Case assumes "about 1% in real and latter half of 1% in nominal terms."
Source: Made by MHRI based on the Cabinet Office, *Economic and Fiscal Projections for Medium- to Long-Term Analysis* (January 2018), among others.

The establishment of these two easily achievable targets may enable the government to state that "fiscal consolidation is well under way" in the comprehensive evaluation, even in the event the level of PB falls short of the target in FY2021. In this sense, there are question marks concerning the level of the intermediate indicators for fiscal balance and public debt.

It should also be noted that fiscal balance, which is the sum of revenues and expenditures related to debt and PB, is a common indicator widely used in the international community to assess fiscal soundness in terms of cash flow. In Japan, however, interest rates have been kept extremely low due to the ultra-loose monetary policy implemented by the Bank of Japan for more than five years, and the government has benefited from this situation in the form of low interest payments. For this reason, we cannot deny the possibility that the use of fiscal balance that includes interest payment costs as an intermediate indicator may make it more difficult for the Bank of Japan to taper its ultra-loose monetary policy.

## 4. Reforms for "qualitative improvement of fiscal health" should be indicated in the reform time schedule at the end of the year

As mentioned earlier, the New Plan does not deserve a positive evaluation from the perspective of fiscal discipline, since it describes a roadmap to realize a PB surplus based on an optimistic economic scenario while lacking a numerical target to control social security expenditures. To compensate for this shortfall in the New Plan, it would be necessary to pay attention to the contents and development of the new time schedule (by December 2018) for the compilation of the integrated economic and fiscal reforms by the Committee for Promoting the Integrated Economic and Fiscal Reforms established under the Council on Economic and Fiscal Policy.

Under the Former Plan, the Abe administration placed stress upon expenditure reform that would promote the qualitative improvement of administrative and fiscal conditions by eliminating one-sided demands by government and across-the-board reduction of expenditures to the greatest extent possible. For example, (1) it revealed regional disparities in various administrative services including medical and nursing care in order to promote voluntary actions by regional municipalities and service providers, and (2) it disseminated advanced case examples to upgrade administrative efficiency throughout Japan. The New Plan also maintains this basic policy stance and sets a course of action to proceed with the existing structural reform efforts in major policy areas, such as social security, social infrastructure development, and local public administration and finance reforms.

According to estimates in the Interim Evaluation of the Integrated Economic and

Fiscal Reforms prepared by the above mentioned committee in March this year, the continuation of the current expenditure reform would have an expenditure reduction effect of about 0.9–1.2 trillion yen over the five-year period from FY2016 to FY2020, of which 0.5–0.6 trillion yen would be from national expenditures (general account) and 0.4–0.6 trillion yen from regional expenditures. In the reform schedule to be compiled this year, it is important to brush up the initiatives which should be taken and to verify the actual effects of the initiatives on a regular basis.

Furthermore, in view of the fact that Japan’s initial general account budget is almost 100 trillion yen each year, the reforms for “qualitative improvement of fiscal health” would be woefully inadequate if the expenditure curbs stemming from such reforms are only 1 trillion yen or so. If the effect of the reforms is such a paltry sum, then we would have to resort to quantitative or "surgical” expenditure curbs which would be accompanied by pain, in order to realize fiscal consolidation. Qualitative reforms which aim to slash costs through various efforts while maintaining the quality of administrative services are worthy of commendation. In the future, we expect the government to explore the possibility to upgrade qualitative reforms to improve the efficiency of expenditures.