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A primary surplus is possible without a tax hike

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Summary

: １． According to the “Medium-Term Projections” in the “Medium-Term Policy” (named the “Course and Strategy for the Japanese Economy”), a primary surplus of the central and local governments would be attained by FY2011 in a “higher economic growth” scenario. The projected primary deficit would shrink more than that described in the “Medium-Term Projections” last January. The improving budget projections reflect the current increase in tax revenues by ongoing economic expansion.

２． Comparing the tax revenues in the “Medium-Term Projections” with ones calculated by means of the ratio of tax revenues to GDP, you can see that a primary surplus would be achieved by FY2011 even in “lower economic growth” scenarios. In other words, the projections of tax revenues are implemented in a cautious manner in the “Medium-Term Projections,” while growth rates of output are set relatively high.

３． While attaining a primary surplus in FY2011 without a tax hike has been considered difficult so far, the consensus would turn more optimistic. However, we have to keep in mind that it is necessary to implement scheduled spending cuts steadily for the goal. The projections of a primary balance in the “Medium-Term Projections” are based upon spending cuts included in “Basic Policies 2006.” Ongoing political momentum for carrying out these spending cuts will be necessary.

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1. Introduction

On January 25th of 2007, the "Medium-Term Policy" (named the "Course and Strategy for the Japanese Economy") was endorsed by the Cabinet. The "Medium-Term Policy" describes medium-term strategies including economic policies for improving productivity and enhancing global competitiveness. Among the various strategies, the medium-term budget projections (hereafter "Medium-Term Projections") have attracted great attention. The "Medium-Term Projections" are not a subject of cabinet decision but used only as reference material submitted to the meeting of the Council on Economic and Fiscal Policy (CEFP). However, the "Medium-Term Projections" are one of the few budget projections that the government releases and are expected to be used as assumptions of the "Basic Policies," which formulate annual strategies of economic policies, released every summer. Hence, the medium-term budget projections play a major role in the process of formulating economic policies.

In the "Basic Policies 2006" released last summer, the necessary amount of spending cuts and tax hikes were determined as 16.5 trillion yen. The "Basic Policies 2006" said that drastic spending cuts are prioritized and if the goal of a primary surplus in FY2011 is difficult to be achieved only by spending cuts, tax hikes would also be added. Since the amount of spending cut was considered to be 11.4 to 14.3 trillion yen, 2.2 to 5.1 trillion yen would be covered by tax increase. The "Medium-Term Projections" were assigned to consider whether the budgetary strategies described in "Basic Policies 2006" are reasonable when current economic developments are reflected. In other words, the "Medium-Term Projections" played a role in judging whether the medium-term budgetary goal could be achieved without a tax increase reflecting current economic expansion, or the goal could not be achieved without taxes partly because of scheduled spending increase in the government's contribution to the basic pension in FY2009. The response set forth in the "Medium-Term Projections" was that the medium-term goal of a primary surplus of the central and local governments in FY2011 is possible without a tax hike, given a relatively high growth rate of output.

Since budget outlooks involve a certain degree of uncertainty, the projections must be understood with a considerable range. That is why the latest "Medium-Term Projections" not only represents a scenario that a primary surplus of the central and local governments would be achieved in FY2011, but shows scenarios that lower economic growth would serve as an impediment to primary balances turning into a budget surplus. However, compared with the "Basic Policies 2006" suggesting a tax increase of 2.2～2.5 trillion yen even with thorough spending cuts, the latest budget projections would be construed as improvement of fiscal consolidation in Japan.

This paper considers the content of the latest "Medium-Term Projections," and shows that ① the change in mid-term budget outlook stems from current increase of tax revenues, and ② a scenario that a primary surplus would be achieved without a tax hike is not necessarily based upon an overly optimistic revenue outlook.

2. The whole picture of the latest "Medium-Term Projections"

(1) A primary balance in the latest "Medium-Term Projections"

The latest "Medium-Term Projections" show two scenarios, depending upon the growth rate of the Japanese economy. The "higher growth scenario" assumes that the Japanese economy would enhance its potential growth rate of output as a result of implementing policies proposed in the "Medium-Term Policy." For instance, as shown in **Figure 1**, the potential GDP growth rate would rise from 1.6 percent in FY2006 to 2.4 percent in FY2011, and the nominal GDP growth rate would rise from 1.5 percent in FY2006 to 3.9 percent in FY2011. Meanwhile, the "lower growth scenario" assumes that the proposed policies would be ineffective and the deceleration of overseas economic activity would adversely affect the domestic economy. In this case, the potential GDP growth rate in FY2011 would decline to 1.0 percent, and the nominal GDP growth rate would remain 2.0 percent with the inflation rate subdued.

Figure 1 : The assumptions in the "higher growth scenario" and " lower growth scenario"

(%)

	06	07	08	09	10	11
(1) Higher growth scenario						
Potential GDP growth rate	1.6	1.8	1.9	2.1	2.3	2.4
Real GDP growth rate	1.9	2.0	2.1	2.2	2.4	2.5
Nominal GDP growth rate	1.5	2.2	2.8	3.3	3.7	3.9
GDP deflator	−0.4	0.2	0.7	1.1	1.3	1.3
Long-term interest rate	1.8	2.1	2.6	3.3	3.7	4.0
(2) Lower growth scenario						
Potential GDP growth rate	1.6	1.8	1.5	1.3	1.1	1.0
Real GDP growth rate	1.9	2.0	1.5	1.2	1.1	1.0
Nominal GDP growth rate	1.5	2.2	2.2	2.1	2.1	2.0
GDP deflator	−0.4	0.2	0.7	1.0	1.0	0.9
Long-term interest rate	1.8	2.1	2.5	3.0	3.2	3.2

Note: Spending cut case A, which requires spending cuts of 14.3 trillion yen.
Source: Cabinet Office, "Medium-Term Policy" (At a meeting of the Council on Economic and Fiscal Policy on January 18th, 2007).

Two cases regarding spending cuts are added to the growth rate scenarios. In the "Basic Policies 2006" released last summer, the spending cuts of 11.4～14.3 trillion yen are required to achieve a primary surplus of the central and local governments in FY2011. Regarding spending cuts, the latest "Medium-Term Projections" set forth a "spending cut case A" prescribing a 14.3 trillion yen spending cut and a "spending cut case B" prescribing a 11.4 trillion yen spending cut. Combining cases A and B, with scenarios of growth rates, the latest "Medium-Term Projections" present a total of four scenarios.

Looking at the projections of primary balances, in the "higher growth scenario" (spending cut case A), the primary balance of the central and local governments would turn positive (1.2 trillion or 0.2 percent of GDP) against a backdrop of solid economic activities (**Figure 2**). While the primary balance of the central government in FY2011 would remain negative (minus 7.2 trillion yen), those of local governments would continue to be positive (8.9 trillion yen).

Figure 2：A primary balance in the "higher growth scenario" (spending cut case A)

		06	07	08	09	10	11
The central government	(Trillion yen)	−13.3	−8.9	−8.0	−9.4	−8.6	−7.2
	(Percentage of GDP, %)	−2.6	−1.7	−1.5	−1.7	−1.5	−1.2
General account	(Trillion yen)	−8.6	−4.4	−5.4	−7.1	−6.0	−5.0
	(Percentage of GDP, %)	−1.7	−0.8	−1.0	−1.3	−1.0	−0.8
Special account	(Trillion yen)	−4.7	−4.5	−2.6	−2.3	−2.6	−2.2
	(Percentage of GDP, %)	−0.9	−0.9	−0.5	−0.4	−0.5	−0.4
Local governments	(Trillion yen)	5.1	5.7	5.9	7.2	8.0	8.9
	(Percentage of GDP, %)	1.0	1.1	1.1	1.3	1.4	1.5
The central and local governments	(Trillion yen)	−8.7	−3.1	−2.1	−2.8	−0.6	1.2
	(Percentage of GDP, %)	−1.7	−0.6	−0.4	−0.5	−0.1	0.2
(Reference) Debt by the public	(Trillion yen)	729.4	736.4	752.4	771.6	791.7	813.1
	(Percentage of GDP, %)	142.8	141.1	140.3	139.3	137.9	136.3
(Reference) Nominal GDP	(Trillion yen)	510.8	521.9	536.4	553.9	574.2	596.6
Growth rate	(Percentage of GDP, %)	1.5	2.2	2.8	3.3	3.7	3.9

Note: Special account of the central government is calculated by the author.
Source: Cabinet Office, "Medium-term Policy" (At a meeting of the Council on Economic and Fiscal Policy on January 18th, 2007).

A primary deficit of the general account of the central government would be cut in half to minus 4.4 trillion yen in FY2007 from the previous fiscal year. The primary deficit would widen in FY2008～2009, and would then shrink again after FY2010. The reasons for the increase in primary deficits in FY2008～2009 are that ① a backlash will occur in FY2008, reflecting that a primary deficit in FY2007 would be smaller than the actual situation because debt servicing costs would increase in FY2007 arising from the inheritance of debt from the special account of local allocation tax, and ② in FY2009 the proportion of the central government's contribution to basic pension will be raised, which costs about 2.5 trillion yen.

(2) The comparison of the latest projections and last January's projections

Comparing the figures in the latest projections with those in last January's projections, we can see that an improvement in the primary balance is caused by increasing tax revenue projections (**Figure 3**). As for the amount of expenditures in the general account of the central government, the latest figure in FY2011 is 98.8

trillion yen, larger than last January's figure of 95.9 trillion yen. Regarding general expenditures, the latest projections' figure of 51.7 trillion yen in FY2011 is larger than last January's figure of 49.7 trillion yen.

It is the tax revenue projections that made the primary deficit smaller in the latest projections. While last January's projections of tax revenues are 55.2 trillion yen in FY2011, the latest projections were revised upward by 6 trillion yen to 61.0 trillion yen. The improvement of tax revenue projections reflects the current increase of tax revenues. As for tax revenues in FY2006, while last January's projections were 45.9 trillion yen, the latest projections were upwardly revised to 50.5 trillion yen. It follows that the major part of the revisions of tax revenues in FY2011 are explained by the upward revisions of tax revenues in FY2006. The remainder seems to come from the assumptions of higher growth rate of output than before.

Figure 3：The latest projections and last January's projections

(Trillion yen)

	06	07	08	09	10	11
The latest projections (January, 2007)						
Expenditures	83.5	82.9	84.5	89.9	94.2	98.8
Gneral expenditures	47.8	47.0	47.4	50.3	50.9	51.7
Local allocation tax grants	16.7	14.9	16.4	16.9	17.6	18.2
Debt servicing costs	18.9	21.0	20.8	22.7	25.7	28.9
Revenues	83.5	82.9	84.5	89.9	94.2	98.8
Tax revenues	50.5	53.5	54.7	56.4	58.7	61.0
Non-tax revenues	5.5	4.0	3.6	3.7	3.8	3.9
Government bond issues	27.5	25.4	26.2	29.8	31.7	33.9
Primary balance	-8.6	-4.4	-5.4	-7.1	-6.0	-5.0
Nominal GDP growth rate (%)	1.5	2.2	2.8	3.3	3.7	3.9
The last January's projections						
Expenditures	79.7	83.5	86.7	90.7	93.6	95.9
Gneral expenditures	46.4	47.0	47.9	48.9	49.2	49.7
Local allocation tax grants	14.6	17.2	17.8	18.0	17.9	16.9
Debt servicing costs	18.8	19.2	21.1	23.7	26.4	29.3
Revenues	79.7	83.5	86.7	90.7	93.6	95.9
Tax revenues	45.9	48.4	50.2	51.8	53.6	55.2
Non-tax revenues	3.8	3.7	3.8	3.9	4.1	4.2
Government bond issues	30.0	31.3	32.7	35.0	35.9	36.5
Primary balance	-11.2	-12.1	-11.6	-11.3	-9.5	-7.2
Nominal GDP growth rate (%)	2.0	2.5	2.9	3.1	3.1	3.2

Note: General account of the central government. The latest projections are based upon the "higher growth scenario" (Spending cut case A). The last January's projections are based upon the "basic case" (the case of attaining a primary surp

Source: Cabinet Office, "Medium-term Policy."

3. Considering the tax revenue projections

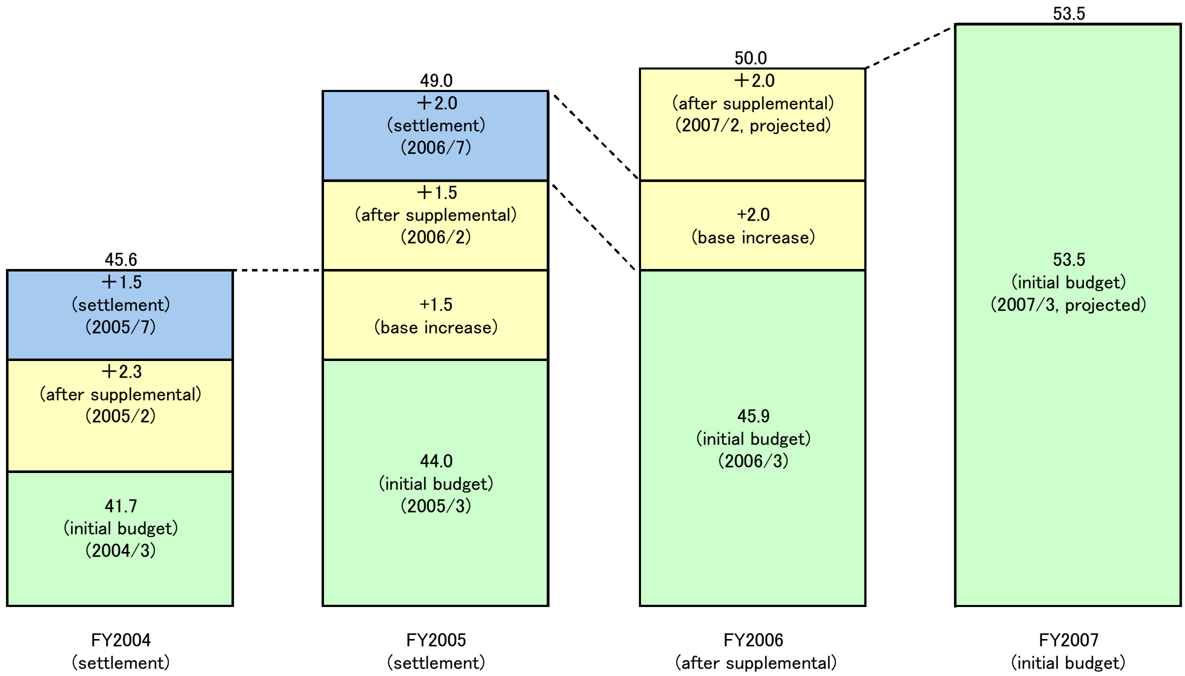
Next, we consider the characteristics of the tax revenue projections in the latest "Medium-Term Projections."

(1) Upward revisions of current tax revenues

First, we look at the revisions of current tax revenues. In recent years, tax revenue projections tend to be revised upward, reflecting solid economic activities at the time of the initial budget, supplemental budget, and settlement of account (**Figure** 4). We often see this tendency in times of economic expansion because financial authorities are inclined to fend off optimistic tax revenue projections, estimating tax revenues in an overly cautious manner.

Tax revenues in FY2006 was 45.9 trillion yen in the initial budget, but by upward revisions in the settlement of account of FY2005 (2.0 trillion yen) and projection errors that occurred during FY2006 (2.6 trillion yen), tax revenues expanded to 50.5 trillion yen. Tax revenues in FY2007 are calculated to be 53.5 trillion yen, considering the figure for FY2006, the projected economic expansion and the abolishment of the temporary tax cut in FY2007. The projected tax revenues in FY2007 are much larger than last January's tax revenue projections of 48.4 trillion in FY2007 (**Figure** 3).

Figure 4：Revisions in tax revenue projections



Note: Trillion yen.

Moreover, in recent years tax revenues tend to be revised upward in the settlement of account. If this tendency occurs in FY2006, upward revisions of tax revenues in the settlement of account on FY2006 would lead to a base increase in tax revenues in FY2007. In addition, if projection errors of tax revenues occur during FY2007, tax revenue projections in FY2007 would be revised upward, and it will also affect tax revenue projections in FY2008 onward. Since these calculations depend upon economic performance, we should not be too optimistic in fiscal projections. However, as long as we extrapolate current economic developments, there is a relatively high possibility that tax revenue projections would be revised upward.

(2) Tax revenue projections in terms of the ratio of tax revenues to GDP

Next, we consider what characteristics the latest tax revenue projections have in terms of the ratio of revenues to GDP. Tax revenue projections in terms of tax revenues to GDP ratio are often used in the President's budget and CBO's budget projections in the U.S. Using the ratio, we are able to judge how tax revenues will evolve in the future under the assumption of a certain ratio[1].

Looking at the ratio of tax revenues to GDP since 1955, you will find an underlying decline in individual and corporate income tax since the 1990s that cannot be explained only by economic fluctuation (**Figure 5**). They are mainly due to a string of tax cut strategies. In particular, as for corporate income tax, the large amount of operating loss carry-forwards caused by the plunge in corporate profit and the expansion of the period allowing operating loss carry-forwards contributed to the tax revenue slump.

Suppose the ratio of tax revenues to GDP for both individual and corporate income tax in FY2006 would rise to 3.3 percent in FY2007 and 3.5 percent in FY2008 and after[2], and the ratio of other tax items would remain the same since FY2006. These assumptions do not seem unrealistic when considering the abolishment of the temporary tax cut and the continuing economic expansion. Assuming each ratio of tax revenues to GDP as described, the ratio of whole tax revenues to GDP would be 10.9 percent, which is equivalent to the average of the ratio between in FY1980 to FY2005. Hence, these assumptions can be regarded as a return to a standard level of the ratio of tax revenues to GDP in Japan. By comparison, the ratio of 10.9 percent is smaller than

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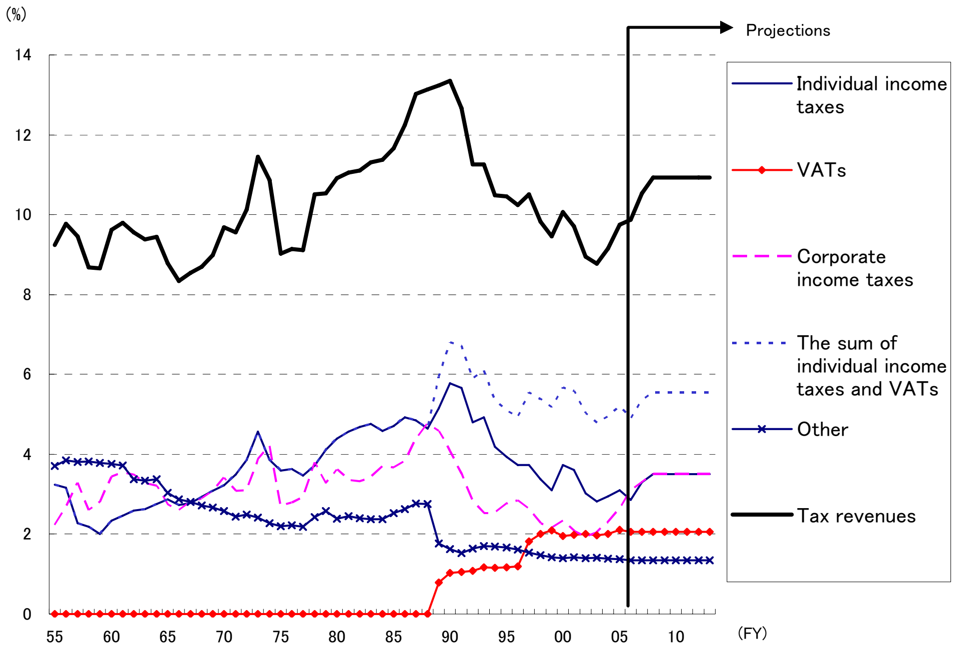
[1] When the ratio of tax revenues to GDP rises, the elasticity of tax revenues on GDP is larger than 1. When the ratio levels off at a certain level, the elasticity is 1.

[2] Each ratio of tax revenues to GDP in FY06 is set so that each tax revenue in FY06 is equal to the tax revenue after the supplemental budget of FY06.

the U.S.[3] which has repeated tax cuts in about five years.

Figure 5 : The ratio of tax revenues to GDP



Note: The ratios of individual income tax and corporate income tax are assumed 3.3% for FY07, and 3.5% for FY08 and after. The ratios of the other tax items are assumed unchanged since FY06.
Source: Ministry of Finance.

When you project tax revenues by using the ratio of tax revenues to GDP and nominal GDP growth rate assumed in the latest "Medium-Term Projections" as an alternative method, the results are shown as [② in the case of higher ratio of tax revenues to GDP] of **Figure 6**. Tax revenues in FY2011 are 65.0 trillion yen for the "higher growth scenario" and 61.8 trillion yen for the "lower growth scenario." Meanwhile, as shown in [① the latest "Medium-Term Projections"] of **Figure 6**, tax revenues in FY2011 the latest "Medium-Term Projections" would be 57.4～61.6 trillion yen. When you calculate the ratio of tax revenues to GDP for each scenario, they rise in FY2007 and remain almost the same since then. For instance, in the "high growth scenario" (spending cuts case A), the ratio rises from 9.9 percent in FY2006 to 10.3 percent in FY2007, and remains 10.2 percent since FY2008.

Note that in the case of higher ratio of tax revenues to GDP, even in the case of the "lower growth scenario," tax revenues would be larger than tax revenues of the four scenarios in the latest "Medium-Term Projections." This means that with the ratio of tax revenues to GDP returning to a historical level, reflecting the decrease of

[3] Excluding payroll tax.

corporations using operating loss carry-forwards, among others, even if GDP growth rate continues to be relatively low, we can expect tax revenues to increase enough to achieve a primary surplus in FY2011. In other words, while the economic assumptions are relatively optimistic in the latest "Medium-Term Projections," tax revenues themselves are projected in a relatively cautious manner in which the ratio of tax revenues to GDP remains the same since FY2007. Judging from the current situation surrounding tax revenues and the government's economic forecast, no wonder tax revenues in the latest "Medium-Term Projections" will be revised upward.

Rather, what should be avoided is unsuccessful economic management, making economic activity shrink to the extent that it leads to a negative growth rate of output. If events unfold in such a way, an economic and budget outlook would become more uncertain than in the current situation. Considering the past experience of the VAT rate hike in FY1997 that last-minute demand for cars and housing turned out to be larger than initially expected, followed by a substantial backlash in demand, it would be wise to fend off a disturbance to the economy by a strong-arm tax hike. Now that we are achieving a medium-term goal of a primary surplus of the central and local governments in FY2011, it would be unnecessary to take the risks of amplifying economic fluctuations.

Figure 6：The change in the ratio of tax revenues to GDP and tax revenue projections

			06	07	08	09	10	11
① The latest "Medium-term projections"								
	(1) Higher growth scenario	(Trillion yen)	50.5	53.5	54.7	56.4	58.7	61.0
	(Spending cut case A)	(Percentage of GDP, %)	9.9	10.3	10.2	10.2	10.2	10.2
		(Trillion yen)	50.5	53.5	54.9	56.7	59.1	61.6
	(Spending cut case B)	(Percentage of GDP, %)	9.9	10.3	10.2	10.2	10.3	10.3
	(2) Lower growth scenario	(Trillion yen)	50.5	53.5	54.3	55.1	56.4	57.4
	(Spending cut case A)	(Percentage of GDP, %)	9.9	10.3	10.2	10.1	10.1	10.1
		(Trillion yen)	50.5	53.5	54.5	55.5	56.9	58.1
	(Spending cut case B)	(Percentage of GDP, %)	9.9	10.3	10.2	10.2	10.2	10.2
② The case of higher ratio of tax revenues to GDP								
	(1) Higher growth scenario	(Trillion yen)	50.6	54.8	58.5	60.4	62.6	65.0
		(Percentage of GDP, %)	9.9	10.5	10.9	10.9	10.9	10.9
	(2) Lower growth scenario	(Trillion yen)	50.6	54.8	58.1	59.4	60.6	61.8
		(Percentage of GDP, %)	9.9	10.5	10.9	10.9	10.9	10.9
(Reference) Nominal GDP								
	(1) Higher growth scenario	(Trillion yen)	510.8	521.9	536.4	553.9	574.2	596.6
	Growth rate	(%)	1.5	2.2	2.8	3.3	3.7	3.9
	(2) Lower growth scenario	(Trillion yen)	510.8	521.9	533.4	544.8	556.4	567.4
	Growth rate	(%)	1.5	2.2	2.2	2.1	2.1	2.0

Note: The case of higher ratio of tax revenues to GDP means that the ratio of tax revenues to GDP is as shown in Figure 5.
Source: Cabinet Office, "Medium-Term Policy" (At a meeting of the Council on Economic and Fiscal Policy on January 18th, 2007).

4. Concluding remarks

We have to point out that the official announcements of the "Medium-Term Projections" are beneficial because fiscal debate is often performed without common numbers on budget projections in Japan. It is commended that the Abe administration continues to work on Medium-Term Projections as well as the previous administration.

The latest "Medium-Term Projections" are likely to have an impact upon fiscal debate because it made clear that a primary surplus of the central and local governments in FY2011 is possible without a tax hike. So far, the prevalent view on the fiscal situation has been that we cannot achieve the medium-term goal of fiscal consolidation without a VAT rate hike in FY2009. It is fruitful that the latest "Medium-Term Projections" showed that solid economic activities are able to overcome pessimistic views.

What remains as a short-term challenge is to implement spending cuts as scheduled. The latest "Medium-Term Projections" are based upon the spending cuts proposed in the "Basic Policies 2006." It is necessary to continue to rein in spending cuts for fiscal consolidation without tax increase. Ongoing political momentum for carrying out the spending cuts will be necessary.

Finally, we have focused mainly on medium-term fiscal management due to the urgency to stop the rise in the ratio of government debt to GDP by achieving a primary surplus. However, we cannot do without a long-term picture of fiscal situation to complete fiscal consolidation. As a next step, the government must set forth a blueprint of fiscal management for the next 50 years. Since long-term fiscal management includes debate on social security reform, tax reform, and the size of government activity, among others, a large gap in opinions would surface between generations and individuals. These challenges will be more difficult to solve than the medium-term goal of a primary surplus. The Japanese government will be facing testing times regarding long-term fiscal management.

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