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How can the Japanese government
change primary budget estimates
in the future?

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Summary :

- 1 . "Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2006" showed a road map for fiscal consolidation in the near future, with ballpark figures of some specific policies. It is commended that the Japanese government set the stage for fiscal consolidation mainly by spending cuts and not by tax hikes.
- 2 . Meanwhile, there remains a problem that the sum of the amount of spending cuts and tax increase was determined as 16.5 trillion yen in a political context. In general, estimates on fiscal projections should be revised along with changes in economic developments and economic forecasts. Although a 1 to 2 percent rate hike in the Value-added tax (VAT) is recommended for a primary surplus in FY2011, no tax increase would be necessary in the near future, if the economy continues to expand at a robust pace going forward. If a large tax hike was determined politically without a reliable projection of a primary budget, it would cause a negative response among the public, and the approach of the government on fiscal consolidation would become questionable among voters.
- 3 . Hence, the Japanese government would be required to reveal calculation methods of the estimates and the economic assumptions for the amount of spending cuts or tax hikes in order to attain a primary surplus in FY2011 and to update the estimates periodically going forward. It might be a good idea to increase the frequency of the estimation of "Structural Reform and Medium-term Economic and Fiscal Perspectives" released by the Council on Economic and Fiscal Policy and link it to its fiscal consolidation policy and annual budget-making process.

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1. Introduction

On July 7th of 2006, the Council on Economic and Fiscal Policy's (CEFP) "Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2006" (hereafter, Basic Policies in 2006) was adopted in the Cabinet meeting of the Japanese government. The 6th release of the "Basic Policies" since 2001 is important for its presentation of a road map for fiscal consolidation, which is considered the most difficult problem to be solved in Japan.

The Japanese government has continued to address the fiscal issue since the end of last year mainly in the CEFP. This spring, there were numerous and varied opinions over the necessary amount of spending cuts and tax hikes, which ended up in futile arguments over the comparison of the long-term interest rate and the growth rate that cannot be settled. In particular, there was a total difference in opinions even between members in the CEFP within the government. Heizo Takenaka, Minister of Internal Affairs and Communications, argued for the need for spending cuts, entirely at odds with Kaoru Yosano, Minister of State for Economic and Fiscal Policy and Financial Services and others who were in favor of a tax increase. Hence, the "Basic policies in 2006" had been expected to put off a decision on the "score" of the total amount of spending cuts and tax hikes for a primary surplus in FY2011. In this regard, the fact that the necessary amount of spending cuts and tax hikes was unified within the government in the "Basic policies in 2006" was meaningful. Moreover, it is commended that Hidenao Nakagawa, the Policy Chief of Liberal Democratic Party (LDP), set the meeting which considers fiscal issues in collaboration with the government, and regained the momentum of spending cuts from tax increase in the debate.

However, there remains a problem that the necessary amount of spending cuts and tax hikes was determined through political negotiation and was completed as a product of compromise. Considering disruptions in fiscal debates thus far, a political settlement might have been the only choice. However, it is inappropriate that information on how changes of fiscal estimates occur depending upon economic developments is not made public. The government can not deny that it is attempting to implement a combination of spending cuts with a 1 to 2 percent (or more) VAT rate hike regardless of future economic developments.

In what follows, Section 2 reviews the approach for fiscal consolidation in the "Basic policies in 2006." Section 3 considers the changing conditions in the settlement of FY2005 budget, and points out the importance of reliable fiscal estimates based on clear economic assumptions.

2. Fiscal consolidation scheme in the “Basic Policies in 2006”

(1) Time table of fiscal consolidation

In the “Basic Policies in 2006,” following the period from FY 2001 to FY 2006 (the first period of fiscal consolidation) in which the Koizumi administration implemented intensive structural reforms, a primary surplus would be attained in the period from FY2007 to the early 2010s (the second period of fiscal consolidation). In the period from FY2010 to the mid- FY2010s (the third period of fiscal consolidation), the government debt as a share of GDP should be reduced. Moreover, FY2011 was set officially for the first time to be the year in which the central and local governments’ primary surplus would be attained (**Figure 1**).

Figure 1 Time table of fiscal consolidation

The second period (FY2007 to the early FY2010s) : Attaining a primary surplus
• Attaining a primary surplus of the central and local government in FY2011.
• The central government’s primary balance, which is in a severe condition, should be turned positive as soon as possible.
• The local government’s primary surplus should be maintained by spending cut in line with spending cut in the central government.
The third period (FY2010 to the mid-FY2010s) : Reducing the debt as a share of GDP
• Reducing the central and local governments’ debt as a share of GDP.
• The central government’s debt, which is in a severe condition, should be reduced as a share of GDP.

Note: Made by the author, using the “Basic Policies in 2006”

(2) Spending cuts in the “Basic Policies in 2006”

In an attempt to attain a primary surplus of the central and local governments in FY 2011, the necessary amount of spending cuts and tax hikes was determined as 16.5 trillion yen. Drastic spending cuts are prioritized and if the goal of a primary surplus in FY2011 is difficult to be attained only by spending cuts, tax hikes would also be added. Since the amount of spending cut is 11.4 to 14.3 trillion yen, 2.2 to 5.1 trillion yen would be covered by tax increase (**Figure 2**).

The candidates of spending cuts would be 1.6 trillion yen for social security-related spending, 2.6 trillion yen for labor costs of government, 3.9 to 5.6 trillion yen for public spending, and 3.3 to 4.5 trillion yen for others. In social security-related spending which account for about 40 percent of general spending of the central government, employment, welfare benefits, nursing care, and medical care were listed as areas which need additional reforms.

For instance, the social security-related spending cut proposals include overhauls of the government's contribution to unemployment benefits, the criteria for welfare benefits, the contents of benefits and the relationship between contribution and benefit in nursing care and medical care, and drug cost. As for the governments' labor costs, the reduction in numbers of central and local government officials, and the reform of compensation system of government which are based on the "Government Reform Act" just passed this March were proposed. The central government's public spending would be reduced at the same pace as in the past few years, that is, a rate of minus 1 to 3 percent every year. The local government's public spending would also be reduced at the same pace as in the past 5 years (more than 5 trillion yen cut in 5 years).

Figure 2 Spending cuts in following 5 years

	FY2006	FY2011	FY2011	The amount of spending cut
		Natural stance	After reforms	
Social security-related	31.1 trillion yen	39.9 trillion yen Growth rate : 5.1%	38.3 trillion yen Growth rate : 4.3%	1.6 trillion yen
Labor cost	30.1 trillion yen	35.0 trillion yen Growth rate : 3.1%	32.4 trillion yen Growth rate : 1.5%	2.6 trillion yen
Public works	18.8 trillion yen	21.7 trillion yen Growth rate : 2.9%	16.1~17.8 trillion yen Growth rate : -3.1~-1.1%	3.9~5.6 trillion yen Growth rate : [Central government : -3%~-1% Local government : -3%~-1%]
Others	27.3 trillion yen	31.6 trillion yen Growth rate : 3.0%	27.1~28.3 trillion yen Growth rate : -0.1~0.7%	3.3~4.5 trillion yen Growth rate : [Science and technology : +1.1% ~Economic growth rate ODA : -4%~-2%]
Total	107.3 trillion yen	128.2 trillion yen Growth rate : 3.6%	113.9~116.8 trillion yen Growth rate : 1.2~1.7%	11.4~14.3 trillion yen
	The amount of the sum of spending cuts and tax hikes which are necessary for a primary surplus in FY 2011 : 16.5 trillion yen Spending cuts : 11.4~14.3 trillion yen Tax hikes : 2.2~5.1 trillion yen			

Note: The sum of the central and local governments. Growth rates are calculated by the author.
 Source: Made by the author, using the "Basic Policies in 2006."

As for others, the rise in spending on education and science (excluding labor costs in the central government's budget) would be restrained at 0.1 percent. Spending on national defense would be restrained at zero growth by reducing the number of self-defense forces and by avoiding collusive bidding among others. ODA would also be restrained by international competitive bidding and the promotion of streamlining in Japan International Corporation Agency's (JICA) operations among others, while the real amount of operations would be maintained in line with the government's external commitments.

On the whole, although the "Basic Policies in 2006" lack details of spending cuts in each spending area, rough numbers in spending cuts were showed clearly so as to define the overall picture. In **Figure 2**, in terms of the annual rate of spending cuts, social security-related spending would be about 4 percent less than the amount in the event it is allowed to grow without any restraints, government labor costs would be half the amount without restraints (1.5 percent), public works would continue to be reduced at the same pace as before, and others would be zero. The basic stance of the "Basic Policies in 2006" is that tax hikes would be fended off as long as spending cuts work well enough to attain a primary surplus in FY2011.

Moreover, regarding the distribution of contributions of the central government and local governments, no radical reform plan which change the current allocation of tax revenues was stipulated. As for local allocation tax, ① current tax rates which determine the ratio of allocation from the central government to local government are maintained, ② the sum of local tax and local allocation tax (fiscal plans of local government basis) was guaranteed. On the other hand, ① decentralization of power would be promoted by relevant laws, ② a new and simple criteria which determine the amount of local allocation tax are included.

3. The problem in the “Basic Policies in 2006”

(1) The lack of calculation basis

While the “Basic Policies in 2006” set the stage for fiscal consolidation, there remains a problem that the necessary amount of spending cuts and tax hikes was determined as 16.5 trillion yen in a political manner without showing an explicit calculation method. When the estimates change along with economic forecasts, it is not clear how much the necessary amount for fiscal consolidation would be needed. Although the “Basic Policies in 2006” says the necessary tax hikes is 2 to 5 trillion yen, the estimates could change reflecting real GDP growth rate and interest rates among others. In particular, since fiscal conditions are projected in a conservative manner, actual tax revenues are prone to be larger than the anticipated tax revenues in expansion periods. Conversely, if inflation expectations occur for some reason and interest rates increase, fiscal consolidation would be more difficult because of increasing debt-service costs.

The reason for the lack of explicit budget estimates in the necessary amount for a primary surplus in FY2011 is that private members in the CEFPP insisted that the necessary amount for a primary surplus in FY2011 is 20 trillion yen without explicit budget estimates (meaning no official announcement to the public). Before then, the budget estimates were usually represented in the form of time-series data of each spending and revenue item, economic growth rate, and interest rates, described in the CEFPP’s “Structural Reform and Medium-term Economic and Fiscal Perspectives” and the Ministry of Finance’s (MOF) “Budget Effect on Expenditures and Revenues in the Coming Years¹.” By these data presented in a time-series manner in the matrix of economic and fiscal conditions, we could judge the CEFPP’s and MOF’s stance in the fiscal projections. In contrast, private members of the CEFPP represented the huge amount of 20 trillion yen as the necessary amount for a primary surplus in FY2011 without clear fiscal estimates. Although the estimates were much higher than other estimates², it became established as the necessary amount for a primary surplus in FY2011, supported by the proponents of tax increase. The estimates were taken as if it were a predetermined number and some advocated a VAT rate of 10 percent or more for attaining a primary surplus in FY2011.

¹ The comparison of the calculations in “Medium-term Projection” with different economic assumptions are represented in Suzuki (2006).

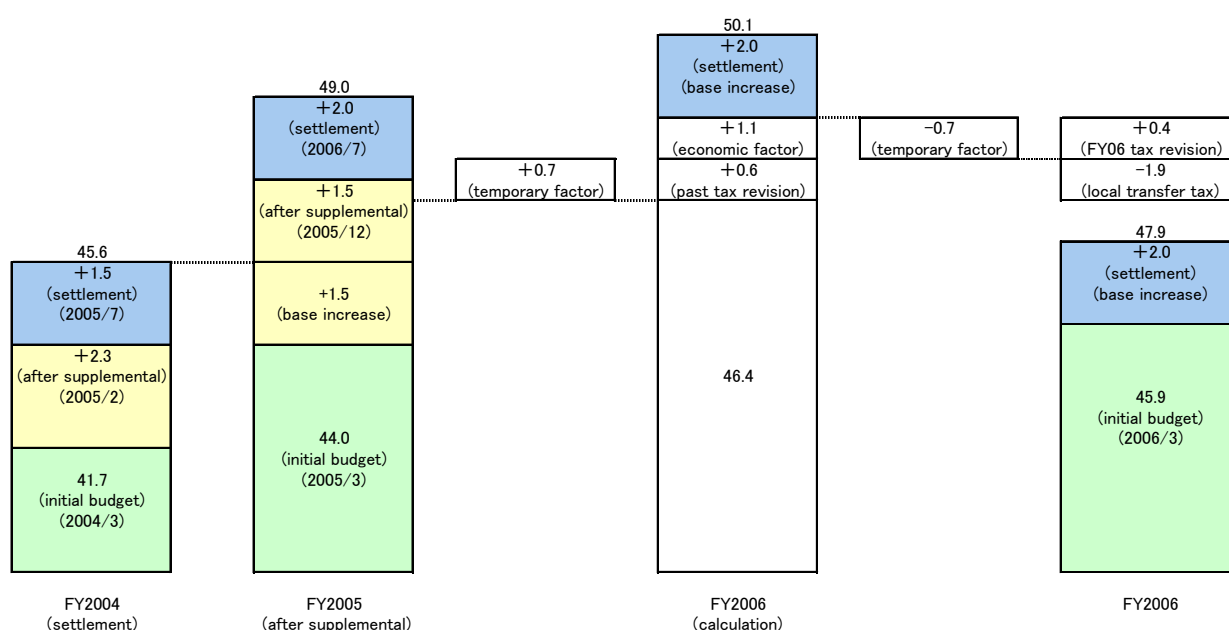
² Even the fiscal system council, which is considered the most conservative in terms of fiscal projections, had projected minus 13 trillion yen of a primary balance in FY2011 with the assumptions that each spending items grow at the same rate as nominal GDP growth rate.

The lack of explicit calculation methods in fiscal estimates creates problems because these numbers are not usually calculated in a manner to reflect changing economic conditions. Suppose tax revenues are 50 trillion yen and the real GDP growth rate is 1.6 percent. In this case, even when the elasticity of tax revenues to nominal GDP growth rate is 1, tax revenues would increase by 800 billion yen each year only from real economic growth³. After 5 years, tax revenue increase would be more than 4 trillion yen, which is almost equal to 2 to 5 trillion yen of necessary tax increase for a primary surplus in FY2011 described in the “Basic Policies in 2006.”

(2) Swelling tax revenues

Indeed, current tax revenues have been increasing than the initial projection of tax revenues by the MOF against a backdrop of sustained economic expansion. Most recently, the final tax revenues on FY 2005 were released and it became clear that tax revenues surpass even the latest figure of tax revenue by 2 trillion yen⁴, which is the second year of a large upward revision of tax revenues following FY2004.

Figure 3 Tax revenues projection after the settlement in FY2005



Note: Trillions of yen.

³ Tax revenue increase from inflation is assumed to be completely offset by spending increase such as increase in debt-service costs.

⁴ By the MOF in July 3rd of 2006.

Looking closer at the series of revisions of tax revenues, the initial revenues in FY 2005 were revised upward by 1.5 trillion yen reflecting “positive misjudgment” in the settlement of FY2004, and again were upgraded by another 1.5 trillion yen after a supplemental budget was enacted. In addition, since 2 trillion yen of tax revenue increase occurred in the settlement of FY 2005, as noted before, eventually the tax revenues in FY2005 were revised substantially to 49.0 trillion yen from 44.0 trillion yen in the initial budget.

In the initial budget of FY2006, tax revenues were projected at 45.9 trillion yen. The projection is calculated on the basis of economic factors and tax system revision as described in **Figure 4**. However, given the 2 trillion yen base increase (from the upward revision in the settlement of FY2005), projected tax revenues were revised to 47.9 trillion yen. Looking forward, if sustained economic growth continues, more tax revenues could be anticipated in the post-supplemental budget of FY2006 and in the settlement of the FY2006 budget.

Considering the variability of fiscal projections, the lack of explicit fiscal projections in the “Basic Policies in 2006” seems problematic. In the discussion of the “Basic Policies in 2006,” intensive debate on what score is appropriate for the necessary amount might have been kept away because the formation of a specific number of the necessary amount for a primary surplus in FY2011 was prioritized. To date, public reaction is mild and there are no severe criticisms because the government showed an attitude of moving forward with a fiscal consolidation plan mainly by spending cuts and not by a major tax increase.

However, in the next stage in which the details of the tax hikes are revealed, reliable fiscal projections could be required to convince the public to accept severe tax hikes. If the government moves forward “spending cut and a 1 to 2 (or more) of VAT rate hike” along the “Basic Policies in 2006,” whatever economic conditions would be, the government would not necessarily obtain the public’s support for its attempt for fiscal consolidation.

(3) Who takes the role of the CBO in Japan?

So, how should the government provide fiscal estimates? The U.S. case could be a reference, in which fiscal estimates substantially affect discussions in the Congress. In the U.S. Congress, the Congressional Budget Office (CBO) exclusively calculates the fiscal estimates of each budget-related bills including the President’s budget proposals. While the Office of Management and Budget (OMB) in the White House calculates the fiscal effect of the President budget proposals in February every year, the CBO which is considered politically neutral, repeats the same on the part of the Congress because the

OMB might give biased estimates based on assumptions advantageous to the White House. Unless the CBO calculates the estimates, the essential debates of the Congress would not proceed.

In Japan, there is no institution equivalent to the CBO in part because of having different congressional system from the U.S. Since the MOF calculates the fiscal effect of the current budget on the latter year's budget in the "Budget Effect on Expenditures and Revenues in the Coming Years," we can also find the same sort of estimates of the OMB in Japan. However, the MOF's estimates are often considered biased toward tax hikes, which prevent productive discussions on fiscal policy.

At present in Japan, since the CEFP hosted by the prime minister, takes an important position for policy decision-making process, it should be appropriate for the CEFP to give the medium-term fiscal projections. It is the case that the CEFP is not considered politically neutral because it is substantially affected by the intention of the administration⁵, but the negative effects by each ministries which are prone to seek interest of their own more than that of the whole nation would be kept to a minimum.

At the moment, while the CEFP releases the "Medium-term Projection" in January each year, the fiscal estimates of the "Medium-term Projection" does not directly affect the "Basic Policies" and the following budget-making process. It is in contrast to the U.S. in which the scores provided by the CBO are treated as absolute given numbers and are used for all budget-related bills proceeding.

As an important implication for Japan, it is pointed out that one of the factors in which the CBO's estimates works very well is that the chairman or the ranking member of the Budget Committee could require the CBO to give estimates based on the specific assumptions they request⁶. For instance, if the Bush administration drops the extension of the alternative minimum tax (AMT) intentionally for the budget proposal and present the fiscal effect of the budget proposal on the basis of assumptions advantageous to the administration, Democrats could require the CBO to give another estimates of the effect of the budget proposal including the extension of the AMT. Likewise, even the fiscal effect of a social security reform proposed by Democratic think-tank could be easily estimated, if it is required by the ranking member of the Budget Committee. By considering several proposals with reliable fiscal estimates provided by the CBO, the U.S. Congress is able to move forward in a productive way.

⁵ The CEFP is equivalent to the National Economic Committee of the White House in the U.S.

⁶ In addition to the chairman and the ranking member of the Budget committee, members of Congress are also empowered to request another estimation.

Applying it to Japan, it means that the CEFPP members could require the staff to provide estimates based on different assumptions they request in addition to the baseline projections in the “Medium-term Projection.” Since there are budget hawks and budget doves in the CEFPP, if the members of the CEFPP could require the staff to estimate based on different assumptions, the CEFPP’s estimates would get reliable scores of policies and could be helpful for the policy debates.

The bottom line is that experts of fiscal projections calculate in a manner to accept the demand of the members of the CEFPP, and fiscal debates could proceed in a productive way with a unified number that everyone accepts excluding the difference of the economic assumptions. This would be much more desirable than the current situation in which budget hawks and budget doves do not trust each others’ estimation. Moreover, in these sorts of fiscal projection process, the CEFPP which has only a small group of staff could cooperate with the MOF to give unbiased fiscal estimates.

4. Concluding remarks

Since fiscal projections change along with economic conditions, the government needs to have the flexibility of policy options for fiscal consolidation. It depends upon the credibility of the government whether the public will accept more severe spending cuts or tax hikes in the future. Therefore, it would be critical for the government to present appropriate information on what economic assumptions lie in the fiscal projections and on how the projections are affected by the change in both domestic and external economic conditions. If a new budget-making process is formed in which the CEFP's "Medium-term Projection" are linked to "Basic Policies" each year and are directly reflected in each budget, it would be useful for improving accountability and enhancing credibility of the government.

[Bibliography]

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