Local Governments Key to Fiscal Reform:
Direction of Abe Administration's Fiscal Overhaul

By Doi Takero

As known well throughout the world, Japan has the worst fiscal condition among industrial nations. To change the situation, the Japanese government has put forward a number of specific plans for fiscal consolidation.

In July 2006, the government adopted an economic initiative known as "Basic Policies for Economic and Fiscal Management and Structural Reform 2006." The initiative features an "integrated expenditure and revenue reform" program aimed at future fiscal overhaul through simultaneous expenditure cuts and revenue increases. Although the "Basic Policies 2006" initiative is not limited to fiscal reform, this article will examine the results and challenges of the integrated expenditure/revenue reform program.

Heritage of Koizumi's Spending Cuts

The fiscal consolidation policy under the integrated expenditure/revenue reform program seeks to achieve a primary budget surplus in Phase 2 of this policy, between fiscal 2007 and the early 2010s, after an initial phase that transpired under the Koizumi administration (2001-2006). A primary budget surplus means an excess of tax revenues over general expenditures. More specifically, the policy calls for a primary budget surplus to be posted by fiscal 2011 on an overall government basis, including the national and local governments. Phase 3 of this reform policy, between the early 2010s and the mid-2010s, seeks to steadily reduce outstanding government debts as a percentage of gross domestic product (GDP).

The Basic Policies 2006 program calls for specific fiscal consolidation measures to be worked out in accordance with seven principles as in the *table*. According to the Ministry of Finance, these seven principles mean:

Principle 1: Make maximum efforts to cut expenditures, sell government assets and take other measures to minimize any increase in taxpayers' burden.

Principle 2: Boost real economic growth by enhancing Japan's growth potential to minimize any further rise in the people's burden, including burdens for future generations.

Principle 3: Reduce or rationalize expenditures on a fair basis "without any exception," including those for special accounts and independent administrative agencies, and specify priorities of spending in terms of the degree of importance of government programs. This marks a shift from the past practice of asking for uniform expenditure cuts for all areas and thus accentuates policy priorities.

Principle 4: Promote cooperation on the basis of mutual understanding between the national and local governments in their respective fiscal consolidation.

Principle 5: Reduce generational gaps in social security benefits and contributions, pay benefits mainly to needy people and promote efficiency of benefits to establish a sustainable social security program. The government should also project medium- to long-term changes in pension, healthcare, nursing care and other social security expenditures and secure stable financial resources for social security to prevent debts from being left to future generations. Efforts must also be made to make funding resources available to increase the national government's share of covering basic pension benefits from one-third to 50% in fiscal 2009.

Principle 6: Proceeds from the sales of government assets should be earmarked for debt redemption to reduce the amount of outstanding debts. In the past, such proceeds were mostly set aside for public works and other programs.

Principle 7: The national and local governments should maximize expenditure

Seven principles for integrated expenditure/revenue reform

Principle 1:	Minimize any increase in taxpayers' burden by streamlining government thoroughly.
Principle 2:	Enhance economic growth potential and take advantage of economic growth for improving people's lives and advancing fiscal consolidation.
Principle 3:	Clarify spending reduction priorities and reduce expenditures without exception.
Principle 4:	Make national and local governments cooperate for well-balanced fiscal consolidation.
Principle 5:	Establish a social security program that does not leave debts to future generations.
Principle 6:	Take bold steps to reduce government assets and reduce the size of the government balance sheet.
Principle 7:	Use any new contributions from taxpayers for their benefit rather than for expanding the public sector.

Source : Ministry of Finance

cuts before expanding revenues through tax measures.

National, Local Fiscal Conditions

The following is an outline of the fiscal conditions of the national and local governments. The *chart* below shows the primary budget balance has been a deficit for the central government and a surplus for local governments, and a combined deficit since fiscal 2005. In Japan, the national government transfers revenues equivalent to more than 6% of GDP to local governments in the form of tax grants and the like. The Japanese revenue transfer to local governments is substantially higher than in other industrial countries. The central government posts a primary budget surplus before the revenue transfer to local governments, meaning that its deficit results from such transfers. As well as social security expenditures, the revenue transfer to local governments accounts for a major part of the national government's total expenditures. If the state were to give priority to expenditure cuts in reducing a budget deficit, a decrease in tax grants to local governments would be indispensable. But a simple reduction in the revenue transfer to local governments may lead to a deficit transfer to them. What is essential, therefore, is to reduce expenditures by local governments, as described later.

Tax Revenue Gain Spawns Hope

Prime Minister Abe Shinzo formed his Cabinet in September 2006 and the Cabinet drew up its first budget toward the year-end. The fiscal 2007 budget features a substantial reduction in government bond issues and a considerable cut in the primary budget deficit. At a time when fiscal consolidation is urgently required, the government may be applauded for using the increase in tax revenue resulting from economic growth for cutting the budget deficit rather than expanding public works spending.

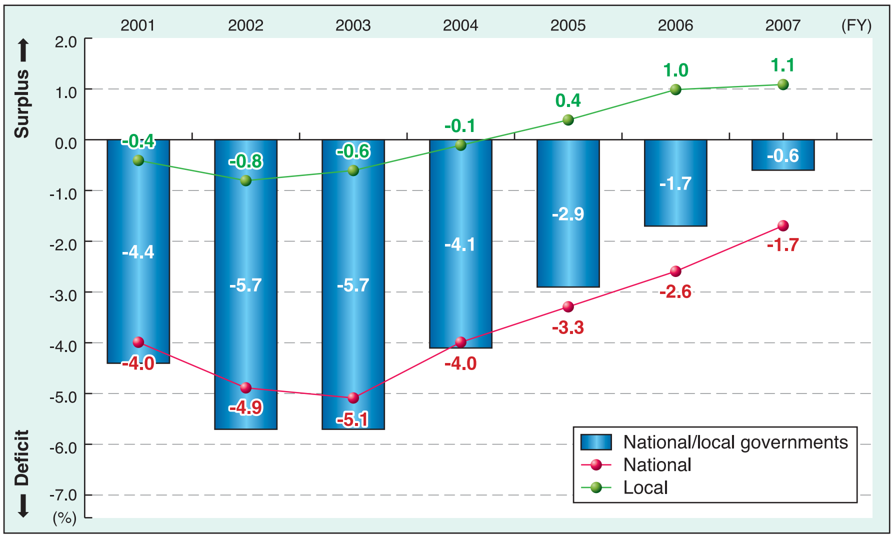
Deserving special attention is the suspension of new borrowings to finance tax grants to local governments. The national government had borrowed money for that purpose for 13 years until fiscal 2006. Apart from outstanding government bonds, borrowings for local tax grants have reached ¥52 trillion. After continuing to borrow money to cover tax revenue shortages, the central government at last has seen tax revenues recovering to a level enough to fully cover grants to local governments.

In fact, the achievement is attributable primarily to a tax revenue increase linked to economic growth. Fiscal 2007 general account tax revenues are projected to increase ¥7.6 trillion from an initial estimate of ¥45.9 trillion for fiscal 2006 to ¥53.5 trillion. Of the ¥7.6 trillion tax revenue increase, the government has set aside ¥4.5 trillion for a cut in government bond issues and ¥1.7 trillion for repaying borrowings for tax grants to local governments. About ¥6.3 trillion (a rounded figure) has thus been utilized for curbing government debts. The remaining ¥1.3 trillion includes ¥0.5 trillion for a rise in debt services, ¥0.3 trillion for an increase in general expenditures and ¥0.4 trillion for a tax grant increase accompanying the tax revenue growth. (The remainder covers institutional changes and the like.)

As indicated above, the government has earmarked most of the increased tax revenues for curbing debts instead of generously increasing expenditures. But expenditures have only been held down to a slightly higher level than the previous year. There have been no bold cuts in expenditures other than pubic works spending.

If no more expenditure cuts were devised, the government might possibly find it difficult to maintain its stance of fiscal consolidation without tax increases when it compiles the fiscal 2008 budget late this year.

Primary budget balance as percentage of GDP



Source : *National Accounts, Cabinet Office; Course and Strategy for Japanese Economy, Council on Economic and Fiscal Policy, January 2007.*

Photo: Kyodo News

The time is near when the Abe administration should make political decisions to reduce expenditures further and boost taxes to promote fiscal overhaul.

Tax Revenue Gain Limited

Behind the ¥7.6 trillion tax revenue increase from economic growth lie complicated factors, and the revenue rise must be interpreted more carefully. In fact, the fiscal 2006 supplementary budget had already incorporated ¥4.6 trillion of this amount. In other words, the amount of extra tax revenue from economic growth will be merely ¥3 trillion in the 2007 fiscal year. Even this amount includes ¥1.2 trillion of extra revenue from the planned abolition of a fixed-rate income tax credit in 2007, and ¥0.3 trillion through consolidation of special accounts. Since these are one-time special factors for fiscal 2007, the tax revenue increase that could be attributed to the government-projected 2.2% nominal economic growth in fiscal 2007 turns out to be only ¥1.5 trillion.

If all these special factors are eliminated, the rise of tax revenue through economic growth comes to about ¥1 trillion to ¥2 trillion a year. It would, therefore, be highly difficult for the government to implement future fiscal consolidation as substantial as seen in fiscal 2007 through economy-linked growth in tax revenues. The time is near when the government should make political decisions to reduce expenditures further and boost taxes to promote fiscal overhaul.

At present, however, both the ruling and opposition camps appear reluctant to discuss tax reform ahead of a House of Councillors election scheduled for July. In the past, Japanese voters tended to vote against any political party committing itself to tax increases in any election where tax increases were controversial. Partly because of such voter behavior, the Abe Cabinet has indicated that it will discuss tax reform in earnest only after the election is over.

Those who are eager to avoid tax increases argue the government can depend on a growth-linked natural increase in tax revenue for fiscal overhaul. The Abe administration itself seems eager to avoid tax hikes by putting priority on expenditure reductions for fiscal consolidation. As a matter of fact, if the economy-linked increase in tax revenues is greater than expected, the budget balance could be improved without a tax hike. There is, however, always a political temptation to use such extra tax revenue for expanding spending, or tamping down spending cuts. The government should resist such temptations and use extra tax revenue mainly for expansion of deposits at the National Debt Consolidation Fund, prematurity redemption of government debt issues and other measures to improve the budget balance and reduce existing debts. If the Abe administration expects to see a natural tax revenue increase greater than the general expectation, it should emphasize that such extra revenue should be used for reducing debts instead of expanding expenditures or curbing expenditure cuts.

Tax Hikes Inevitable Without Spending Cuts

There are other problems that must be resolved for fiscal consolidation. If the government were to continue emphasizing expenditure reductions for fiscal consolidation, it would have to find specific targets. Usually, politicians resist specific expenditure reductions while favoring a general concept of spending cuts. If the government were to clarify priorities and implement expenditure reductions, it should muster enough political muscle to overcome opposition. If the government lacks such political clout, we might as well accept that a tax increase is unavoidable. The Japanese fiscal situation is in such a dire state that the government can no longer afford to avoid tax increases while easing its grip on spending.

The government has already specified the overall expenditure cut targets for the national and local governments. But a specific expenditure cut for each side has yet to be worked out. In Japan, the ratio of national expenditures to local government spending is roughly at 2 to 3. Local governments spend more than the state. Local government expenditures include those based on state decisions. For example, the Ministry of Land, Infrastructure and Transport gives detailed instructions about standards for local public works projects, and the Ministry of Education, Culture, Sports, Science and Technology also issues detailed instructions on local elementary school education. Even so, local governments for their part should aggressively reduce public works and personnel costs. Unless they cooperate with the central government, fiscal consolidation would end up as simply a pie in the sky. It is sometimes heard from local governments that the state should undertake future expenditure reductions since local governments have already done enough to cut spending. While such a view is understandable, local governments must still do more to reduce the combined budget deficit at the state and local levels. JS

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