How to Restore Japan's Fiscal Health in Line with Economic Growth

By Naoyuki HARAOKA

Japan Treated as Exception

At the G-20 Toronto Summit on June 26 and 27, 2010, advanced economies committed to fiscal plans that will at least halve deficits by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016. However, in the Toronto Summit Declaration, Japan was treated as an exception. "Recognizing the circumstances of Japan, we welcome the Japanese government's fiscal consolidation plan announced recently with its growth strategy," it said.

According to the Japanese fiscal consolidation plan, Japan committed to halving the deficit in the primary balance by FY 2015, with a surplus arising in the balance by FY 2020. (The primary balance is defined as that of expenditure – excluding net debt interest payments – and revenue – excluding public borrowing; if it is balanced, that means annual outlay will be covered by annual tax revenue.) This commitment became an international one after the Toronto meeting.

The G-20 countries have been engaged in implementing large-scale counter-cyclical measures in response to the economic crisis since the Lehman shock in September 2008, which resulted in the creation of a tremendous amount of fiscal deficits among the countries. However, since the euro crisis triggered by the revelation of the Greek government's unsustainable fiscal deficit, most governments, in particular those in Europe, have started to agree that the swollen fiscal deficits should not be kept as they are. This fundamental change in thought on economic policy has brought the G-20 consensus mentioned above.

Change of Policy Course: Cause for Concern

Like many other economists, I am concerned about this change of policy direction for the following reason. Hopes for global economic recovery seem to be based upon an expectation of recovery in exports of manufactured goods of the major economies against the background of a robust expansion of world trade. But is world trade in fact now robustly expanding?

According to the IMF's *International Financial Statistics* for the first quarter of 2010, world exports increased by 27.2% compared with the first quarter of 2009. However, comparison between the two first quarters is misleading because exports in 2009 were in a dramatically deep trough. To ascertain recovery, data on quarter-to-quarter improvement are far more informative than data presented year-on-year.

World exports in the first quarter of 2010 declined by 3% from the fourth quarter of 2009. World exports have not yet reached their level prior to the financial shock, namely those in the third quarter of 2008. This contraction in global trade must have left the world with a substantial industrial overcapacity due to the weak demand for manufactured goods worldwide. In this regard, we cannot expect world trade to be a key to global recovery. The concerted moves toward fiscal consolidation among the major countries could then worsen the economy through further contraction of demand. In order to sustain stable world economic growth, it would be better to avoid a quick withdrawal of fiscal expansion policy.

On the other hand, there are a few negative impacts to be noted on the fiscal deficit issue. First of all, the fiscal deficit must be reimbursed without fail. Otherwise the younger generation – our descendents – will have to pay it eventually.

Secondly, expansion of the fiscal deficit as a result of increasing national debt will lead the government to raise interest rates on debt issues to encourage people to buy them. Interest rates on commercial debt issues and loans will also rise in accordance with rate hikes on national bonds, which will discourage private and housing investment and thus drag down business recovery.

Thirdly, net government debt interest payments will increase due to fiscal deficit expansion, forcing the government to reduce other expenditures and thus take measures to achieve policy objectives under a limited budget.

In the light of the above-mentioned demerits, we have to pursue fiscal consolidation while at the same time maintaining economic activity. How can we achieve these contradictory policy targets simultaneously?

Structural Factors behind Fiscal Deficit

As shown in *Chart 1-1,* which is from the OECD's *Economic Outlook* database, after the financial crisis in 2008, the governments of all major countries saw their deficits expand, which is generally interpreted as the outcome of revenue decreases caused by the recession. However, if we look into the deficit more analytically, we will make a different observation. The deficit is divided into two parts: one brought about by the business cycle as mentioned above and the other by governmental discretionary policies to deal with the recession and other policies such as social welfare policy to respond to the needs of our aging society rather than countermeasures in response to the recession.

Each country's expanded fiscal deficit was created not only by a revenue decline caused by the recession but also by the country's discretionary policies to contain the recession after the financial crisis. However, the deficit increase was brought about by other structural factors as well.

In Japan, for example, as population aging progresses, expenditure for social security has increased steadily and consistently for many years. In the United States, expenditure for unemployment insurance has consistently expanded and, in both the United States and Europe, expenditure for professional training to expand job opportunities for the youth and thus reduce unemployment has consistently increased, reflecting the high sensitivity of employment to the business cycle.

We should pursue solutions to reduce deficits brought about by structural factors as described above, which vary from country to country. Given this fundamental thinking, we can try to achieve the two contradictory targets of maintaining economic growth and implementing fiscal consolidation.

The primary balance is an indicator showing how much freedom the government can have in implementing discretionary policies, according to the definition shown at the beginning of the article. *Chart 1-2* shows that among the OECD economies, the primary balance of Japan

CHART 1-1
General government financial balances

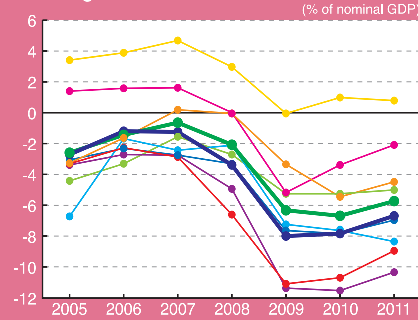

CHART 1-2
General government underlying primary balances

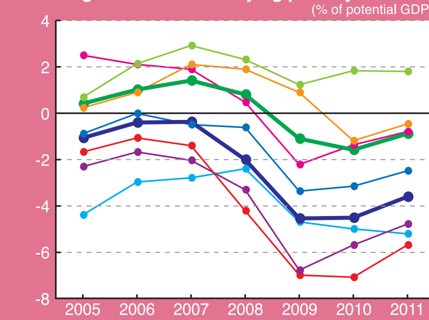

CHART 1-3
General government total outlays

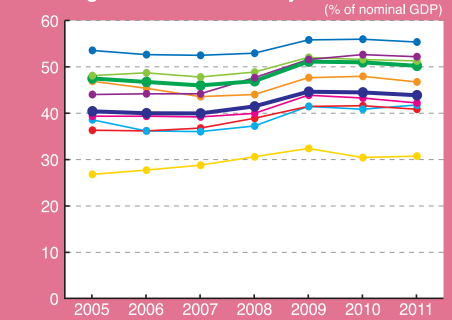

CHART 1-4
General government total tax & non-tax receipt

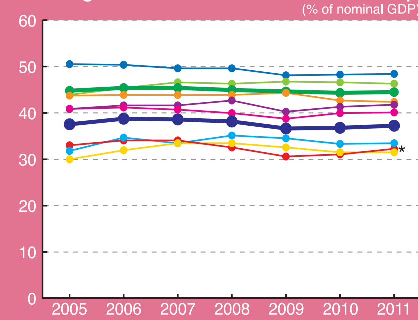

CHART 1-5
General government net financial liabilities

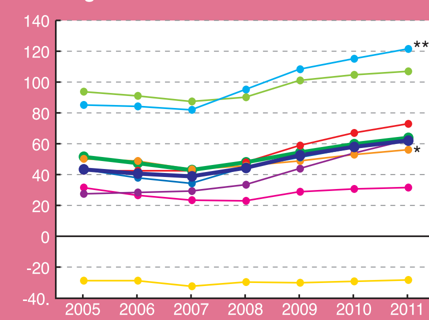

Chart 1-4 United States: * Excludes the operating surpluses of public enterprises

Chart 1-5 Germany: * Includes the debt of the Inherited Debt Fund from 1995 onwards

Japan:** Includes the debt of the Japan Railway Settlement Corporation and the National Forest Special Account from 1998 onwards.

Source: OECD Economic Outlook 87 database

is worse than that of the OECD as a whole. This is partly due to the country's snowballing expenditure for social security responding to its rapid aging, which is more serious than in the other OECD countries.

Finding a way to reduce a deficit in the primary balance will prove a means to achieve the two contradictory economic policy goals.

In the case of Japan, the most important solution for this should be to blueprint a society where people who are old but in good health can continue to work without depending on the government's social welfare policies. The traditional lifetime employment system is one of the main features of Japanese businesses and that could be a solution for the Americans and Europeans to reduce their government expenditures on unemployment insurance, which is a structural factor for their fiscal deficits.

But another main feature of Japanese management, the seniority system, could be a hindrance to the goal of letting more elderly people in good health continue to work. In this system, wages increase automatically as you get older and also you get promoted in principle as you work for many years. But the cost to the company of maintaining this system in an aging society while allowing more elderly people to continue working will be enormous. We have to create a new management system where elderly people can enjoy working as advisers to young people for lower salaries than they got before and young employees can benefit by learning from them.

For example, after my reaching a certain age for retirement, it would be a great honor for me to continue to work as an adviser to my assistant editor of *Japan SPOTLIGHT,* if I may.

Tax Hikes: Option for Japan

We also have to examine the aspect of tax revenue.

Chart 1-3 shows the percentage of total general-account government outlays in nominal GDP in the major OECD economies. The figure for Japan is lower than for all other countries except South Korea.

Chart 1-4 shows the percentage of total general-account tax and non-tax receipts in nominal GDP in the same countries. The figure for Japan is lower than for most countries except the United States and South Korea.

This means that at this stage Japan has a relatively small government compared with the international standard. However, its primary balance is in deficit and this deficit will grow due to further population aging in the future. Therefore, Japan could consider the option of raising taxes to prepare for the expected future increase in social security expenditure caused by aging.

According to the OECD's *Revenue Statistics,* the corporate tax rate in Japan is the highest among the OECD countries, while its indirect tax is the lowest. This suggests that, for its aging society, Japan can raise indirect tax to keep discretion in its policies.

Empirical Lesson for Rest of Asia

Chart 1-5 shows the percentage of net general-account liabilities in nominal GDP in the major OECD economies. The figure in Japan is the highest and how to reduce it is a major concern for the Japanese fiscal authorities. An improvement in the primary balance should be sought as the most important means to achieve this among other possible factors such as the nominal GDP growth rate and net debt interest payments.

The above-mentioned prescription on the revenue side as well as the expenditure side is also worth consideration.

Finally, fiscal consolidation in Japan, as it is exposed to the aging of society, can provide other Asian countries with an important lesson since they will also soon face the same problem as Japan does now.

JS

Naoyuki Haraoka is editor-in-chief, Japan SPOTLIGHT, and executive managing director, Japan Economic Foundation.