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A Study on Japanese Fiscal Sustainability and Fiscal Discipline

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This report focuses on the analysis of the Japanese government's fiscal discipline mechanism as the controversy on the fiscal sustainability of the Japanese government is rekindled in the wake of the Great Japanese Earthquake of 2011. In particular, by expanding the scope of the study from not only on Japan's central government but also to the local governments and social security funds, this report reviews the issue of Japan's fiscal sustainability. Also, by explaining the mechanism why the fiscal discipline did not work in these areas, this report draws political considerations for the Korean government's fiscal management. This is because when we consider the speed of aging and the onset of low growth rate in Korea, there is a sufficient possibility that Korea may be following Japan's footsteps.

1. Japan's Fiscal Sustainability

Japan's gross government debt already exceeded 100% of its GDP in 1997, and reached 200% by 2011. Studies dealing with Japan's fiscal sustainability from the economic perspective have already concluded in the early 2000's that Japan's public finances are not sustainable. In other words, the ratio of Japan's government debt to its GDP had entered into a nonstationary state as it passed the 1990's, and there had been predictions that the government's intertemporal budget constraint would not be satisfied to the extent that the government debt could not be repaid with the future government revenues. Despite this, however, Japan did not experience fiscal crisis, thus far owing to the low growth rate in 1% range and zero interest rate policy.

Another factor that helped Japan avoid fiscal crisis was the fact that foreigners had no significant holdings of Japan's government bonds. However, in the long run, the aging of the Japanese society would cause the household savings, the ultimate source that allowed Japanese domestic investors to buy up its government bonds, to decline, which will leave no choice for Japan but to sell its bonds to foreign investors. In light of this, the issue of Japan's fiscal sustainability is an ongoing one.

For Japan's fiscal sustainability, tax reform is the most important. Although the Japanese government's social security expenditure has become the largest budget item since 2005, the Japanese government focused on financing it by issuing a government bonds instead of undertaking tax reform. The Japanese government's tax reform did have a limited success but only in consumption tax. Japan's effective corporate tax rate as of January 2013 of 35.64%, which is the second highest after the U.S.'s 40.75%, makes it unrealistic to secure funding by raising corporate taxes. Also, the Japanese government has been reluctant to raise individual income tax because it works as a disincentive for work and saps the energy out of the economy. In the end, for the Japanese government, raising its consumption tax, which is substantially lower than the rates in the range of 20-25% of the European countries and is stable unlike other taxes, was the only choice for tax reform. However, when we consider the fact that it took as many as 23 years for Japan to raise its consumption tax, which was at 3% at its inception in 1989 to 8%, we can see what difficult political process it is to secure funding for social securities through raising consumption tax in Japan.

2. Japan's Fiscal Discipline

The first instance of relaxing of fiscal discipline is that the principle of issuing 'construction government debt', a sort of a rule for fiscal balance as defined under article 4 of the Japanese Fiscal Act, has virtually not been abided since 1975. The amount of the Japanese 'deficit government debt' issuance was JPY 4.1 trillion in 1994 (25.1% of the entire amount of government debt), but it jumped to JPY 34.7 trillion by 2010 (82% of the entire amount of government debt). The second instance is the excessive supplementary budget. Unlike the original budget, the supplementary budget is free from the Ministry of Finance's ceiling, so it has been point out that it became a common practice to include those projects that did not have sufficient economic efficiency in the supplementary budget. The ratio of supplementary budget to original budget in general accounting shows that it exceeded 10% in the late 1990s and late 2000s. The third instance is the fact that the Ministry of Finance's ceiling is losing its effectiveness. The Ministry of Finance's ceiling was credited to solve the problem of fiscal deterioration in the 1980s after the oil shock. However, it is now criticized for being guilty of partaking in pork barreling without giving due considerations to investment efficiency centered on public investment. Lastly, the issue of relaxing of fiscal discipline by the Japanese government is not unrelated to the fact that the authority of the Ministry of Finance is weak. The Ministry of Finance's review function in budgeting, which it used for fiscal discipline, was possible in the high growth period when revenues were on the rise. In the long recession when revenue is at a standstill or decreasing, it is very difficult to maintain fiscal discipline by controlling the budget demands of "iron triangle" composed of assemblymen, bureaucracy, and industry groups.

The Japanese government's three fiscal reforms since the late 1990s may be reduced to attaining fiscal balance through cut-in government spending. The Hashimoto cabinet in 1997 set expenditure cap for social security, public investment, and education and declared the goal of keeping the level of reliance on government bonds to 1997—level by suspending issuance of government debt and reducing the ratio of fiscal deficit to GDP to under 3% by 2003. The goal of "fundamental policy 2006" set by the Koizumi cabinet was also to reform revenue and expenditure structure at the same time in order to turn the primary fiscal account to surplus by 2011. In June of 2010, the democratic party (DPJ) administration sought to pursue fiscal soundness through 'fiscal management policy.' The fiscal rule adopted at this time was also spending rule, i.e., reduction in government expenditure.

Of course, these fiscal reforms were somewhat successful from the perspective of reduction of spending, but it can be said that the ultimate goal of rule of fiscal balance and rule of debt were not met. They did not last more than two years due to various reasons, such as the Asian Financial Crisis in late 1997, Japan's own instability in its financial system, global financial crisis of 2008, and DPJ's election defeats in 2012.

3. The Fiscal Sustainability and Fiscal Discipline of Japan's Local Government

First of all, a review of Japan's local government's public finances through indexes, such as revenue collection and expenditure shows that the most significant factor that threatens Japan's local government's fiscal sustainability could be summarized into the lack of independent revenue source from revenue collection perspective and social security spending from the perspective of revenue spending. The portion that local taxes take up in revenue collection fell from 44.2% in 2007 to 34.1% in 2011. Also, the ratio of social security-related spending to total expenditure hovered above 30% in 2010 after reaching 25% in 2004.

The Japanese government has thus far sought to promote fiscal sustainability of local governments through reform of local revenue-sharing system and local tax system. The core issue in improving local revenue-sharing system is the excessiveness of the function of the current local revenue-sharing system. In early 2000, the Koizumi administration had undertaken 'trinity reform' under the determination that the local public finances became lax because the local revenue-sharing system exacerbated the local government's reliance on local revenue-sharing. Discussion about reforming Japan's local revenue-sharing system is focused on reduction of reliance on temporary local bonds, adjustment of local subsidy through identifying local fiscal demand, pursuing decentralization of local power through the adoption of horizontal fiscal transfer system, and reinforcing accountability of local government's fiscal management. On the other hand, the task related to local tax system is correcting the distribution of national and local revenue sources. In 2006, the Japanese government undertook transfer of revenue source of JPY 3 trillion to local governments, and measures to improve local tax rates for income tax and individual resident tax through the trinity reform of 2006. However, the ratio between national and local taxes shows no significant change with about 5.5:4.5 and expenditure at about 4.2:5.8. Accordingly, the Japanese government is discussing the reform of local tax system centered on whether to abrogate the local corporate special tax and to expand the assessment by estimation on the basis of the size of business.

From the perspective of fiscal discipline of Japan's local governments, the Local Fiscal Consolidation Act of 2007 has a great significance. The law makes local governments disclose their financial situation in an objective manner and defines four fiscal indexes, including actual deficit ratio, consolidated deficit ratio, actual bond costs ratio, and future burden ratio in order to determine the need for early debt rescheduling. Therefore, if any one of these ratios exceeds the early debt reschedule level, the Japanese local governments must establish fiscal consolidation plan by the last day of the year in which such relevant ratios were announced. Also, in the event that any one of the ratios for determining debt rescheduling exceeds debt reschedule level, then fiscal consolidation plan must be established by the last day of the year in which such ratio was announced. Considering that these four indexes are improving lately, it can be concluded that the Local Fiscal Consolidation Act is effective in strengthening fiscal discipline of local governments.

4. Social Security System's Sustainability and Fiscal Discipline

Japan's fiscal deterioration starting in the 2000s was rooted in its reliance on the issuance of government bonds in financing the drastically increasing social security-related expenditures. However, as the country's ratio of government debt to its GDP exceeds 200%, the country's fiscal sustainability, including social security is coming into question. Although, for the sustainability of social security system, system reform for additional tax increases and coverage cut is necessary in addition to raising consumption tax by 10%, it must be predicated on resolving the problem of inequality between and among generations. The intragenerational issues are rooted in the discriminatory method of funding among occupational groups and intergenerational problems are caused by the fact that the benefits are funneled to the seniors because of the 'imposition-type' fiscal management. On the other hand, the income redistribution function of Japan's social security system gives a high ratio to social security spending to seniors, whereas the transfer income to the low income class is low. In this sense, it lacks effectiveness as compared to OECD average.

Upon reviewing the reform process of Japan's social security system, one can understand how significant the problem of system design that did not anticipate what the aging society and long-term low growth was. First, during the developmental stage of social security prior to the first oil shock, the social security system was refurbished. However, as a result of selecting increased coverage without the increase in premium, it became a burden on national budget. Second, during the reform period until 1985, although weaknesses in fiscal foundation of local social security systems surfaced, various reform measures made the public pension system more complicated because of increased fiscal burden and imbalance with the existing system. Third, in the ensuing a period of preparing for the aging of society, the macroeconomic slide system adopted in 2004 pension reform is not fully functioning under the deflation, and the announcement to raise consumption tax in 2012 is not sufficient to respond to low birth and aging.

By reviewing the problems with two main underpinnings for Japan's social security system, namely the public pension and medical insurance system, and the reform measures of the Japanese government, the following conclusions were drawn. First, in the public pension system area, the Japanese government repeatedly implemented such measures as increasing insurance premium, cutting coverage and raising the age of entitlement for fiscal stability. These reform methods have limits in preemptively responding to low birth and aging society. Second, in operating public medical insurance system, the reform measures, such as system reform for stabilization of medical insurance finances, adjustment of finances between the insureds and measures to reform senior medical system are major issues. However, because the Japanese government is responding in a fine-tuning approach as to fiscal adjustment, insurance premium rate, and insurance coverage without attempting fundamental reform measures to resolve inter-system inequality, such as the integration of medical insurance system, the sustainability of the system cannot be guaranteed. KIEP