

The Path to Fiscal Reconstruction

Overcoming Disaster and Bequeathing Sound Public Finances to Future Generations



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NIRA Report

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Executive Summary

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Against the background of a long-term economic slump and the rapid aging of the population, the state of Japan's public finances continues to worsen, and concern over the effect that this will have on the government bond market is increasing. It is also important at the present juncture to consider how Japan's fiscal problems will be transformed in the wake of the recent earthquake and tsunami disaster. This report organizes points of discussion in relation to these issues, and offers policy proposals concerning the form and the method of implementation of the fiscal reconstruction necessary to enabling us to bequeath sound public finances to future generations.

(1) Reconciling recovery from disaster with fiscal reconstruction

Prioritizing recovery from disaster necessitates the expenditure of enormous sums, and this will increase the pressure on Japan's already severely burdened public finances. We must consider the following three directions if we wish to reconcile the securing of funds for recovery with fiscal reconstruction.

1) Reexamination of existing government expenditure

Large-scale reexamination of existing government expenditure, including expenditure forming part of the ruling party's Manifesto, in order to enable the urgent fiscal expenditure represented by funds for disaster recovery.

2) Use of reconstruction bonds

Creation of a mechanism that will provide an incentive to encourage as many citizens as possible to invest funds in reconstruction bonds, enabling us to mobilize the efforts of citizens who seek to make a contribution, no matter how small, to the nation's recovery.

3) Introduction of a reconstruction tax

Introduction of a reconstruction tax, not as a temporary measure to secure funds for reconstruction, but in a form which links it to a desirable long-term tax system for Japan. For example, if the rate of consumption tax were to be increased or a carbon (or electricity) tax introduced, when these measures had fulfilled their purpose as reconstruction taxes, they could remain in place as an increase in consumption tax to provide funds for social security, or an environment tax to provide funds for the protection of the environment.

(2) Evaluation of the risk of a dramatic decline in the price of Japanese government bonds

The stability of the market for Japanese government bonds despite the high level of the nation's outstanding debt is due to the fact that against a background of low growth and deflation, excess funds from the household and corporate sectors are flowing into the market via financial institutions. Fiscal problems are problems in the long-term balance between government income and expenditure, but at the same time, they are also short- and medium-term macroeconomic problems and financial market problems. In considering future trends in the government bond market, it will be necessary to focus on the following points.

1) Signs of global inflation

Concerns are developing over increases in commodity prices in advanced nations against the background of factors such as economic overheating (in particular in emerging nations) and spiraling prices of primary products. It will be essential to consider the effects on Japan in the event that an inflationary tendency becomes conspicuous globally and long-term interest rates increase.

2) Effect of the earthquake and tsunami disaster on the government bond market

The increase in government expenditure necessary for disaster recovery will place a new burden on the government bond market. In addition, if constraints on supply and the stimulation of demand by recovery efforts relieve deflationary pressure, upward pressure will be placed on long-term interest rates. Because interest rates would presumably be affected by predictions of future increases in commodity prices and increase earlier than commodity prices, it is possible that this would place a considerable burden on public finances.

3) Will and ability on the part of the government to achieve fiscal soundness

The prior history of measures instituted to achieve fiscal soundness, i.e. their impasse in the face of economic slowdowns, suggests that the will and ability of politicians and the public in this area are not especially strong. The question is whether the government will develop policies designed to realize fiscal soundness before we reach a situation in which there is a precipitous fall in the price of government bonds, and whether such policies will be supported by the public.

(3) Fiscal reconstruction: Form and method of implementation

Given that the time available for Japan's fiscal reconstruction is extremely limited, it will be important to rapidly delineate a path towards the achievement of this goal and win the confidence of the markets. Reform in the area of social security and reevaluation of the taxation system will be key factors in enabling this, and the following should be points of particular focus.

1) Selection and focusing of public sector involvement in the area of social security

As the nation's birth rate declines and its population ages, the radical prioritization of the social security system will be essential in order to ensure the maximal functioning of public assistance using tax resources. In addition, it will be necessary to maximally utilize self-help and mutual assistance by citizens, and to provide policy support to mobilize private sector economic activity.

2) Design of systems to avoid moral hazard

It will be necessary to consider system design to ensure that the public support system does not generate moral hazard in the form of excessive consultations or use of services in the areas of healthcare and nursing care.

3) Bequeathing sound finances to coming generations

In order to prevent an excessive burden being passed on to future generations, it will be necessary to rapidly effect social security and taxation reforms, and to realize a sound social security system and financial base as much as possible in the present generation.

(Overview of chapters)

Chapter 1 Organizing Points of Discussion concerning Government Bond Issues – Is Anxiety over a Fall in the Price of Government Bonds a Case of Crying Wolf?

Anxiety over the state of Japanese government bonds and fears of a precipitous decline in their price have been discussed for more than 10 years now, but nevertheless the bond market has continued to function stably. In the background here is the fact that amid ongoing adjustment of the balance sheet and deflation since the latter half of the 1990s, loans to the corporate sector have declined despite quantitative easing by the central bank, and financial institutions have invested their excess funds in the bond market. In addition, the fact that despite the enormous scale of Japan's fiscal deficit, its current account balance remains in the black, and essential funds can largely be sourced in the country itself, can also be pointed to as a factor in this stability.

The reason that financial institutions have continued to invest in Japanese government bonds despite the staggering government debt is that Japan's tax burden is extremely low in comparison to the international standard, and they can therefore

anticipate the potential for improvement of the government's fiscal position through the imposition of increased taxes in order to generate increased tax revenue. However, with uncertainty over whether it will actually be feasible to increase taxes, and the market aware of the limits to the ability to consume government bonds as the outstanding amount of debt increases, it has become impossible to simply dismiss anxiety over government bonds as crying wolf.

In order to ensure the sustainability of Japanese government bonds in such a situation, it will be essential to focus on "the three Cs": communication (dialogue with the market), credibility (the formulation of a "Government Bond Manifesto" that outlines medium- and long-term paths to fiscal reconstruction), and coordination (cooperation between the market, the government, and the Bank of Japan to form a "government bond triumvirate"). In addition, the adjustment of the outstanding debt, rather than a drama involving a collapse in bond prices, should be conducted steadily by means of fiscal reconstruction and the creation of resources for bond redemption via the formulation of growth scenarios.

(Hajime Takata)

Chapter 2 What can We Learn from a History of Failures? – A Case Study of Major Sovereign Debt Crises and Defaults and Lessons for Japan

As the state of Japan's public finances grows steadily worse, there is a certain significance from a crisis management perspective in considering the potential triggers that might plunge Japan into a fiscal crisis and lead to a debt default, the effect that this might have, potential policy responses, and related issues. Given this, the author has attempted to derive lessons for Japan from a comparative consideration of major domestic and overseas examples of sovereign debt crisis and default.

The main lessons to be learned from this study can be summed up as follows.

- 1) The situation in Japan with regard to unchecked burgeoning expenditure and the postponement of essential reforms is either similar to or worse than the situations in the examples considered
- 2) In the majority of examples considered, the trigger for the crisis was the market's loss of faith in economic and fiscal sustainability, indicating the importance of constant efforts to maintain or increase market confidence
- 3) For Japan, where holdings of government bonds are concentrated in domestic financial institutions, the risk of a fiscal crisis or default becoming a financial system crisis is high; enhancement of risk management and spreading of bond holdings by financial institutions is therefore essential
- 4) The cost of resolving problems increases enormously in the event of a fiscal crisis or default and it is therefore essential to persist tenaciously in effecting orderly fiscal reconstruction

5) A correct awareness of the situation on the part of the public and the political leadership is an important factor in overcoming a fiscal crisis

While it is not possible to make simple comparisons between the examples considered and contemporary Japan, overconfidence could lead the nation into the same errors. Learning from these examples, it will be important for us to pursue autonomous fiscal reconstruction efforts, rather than waiting for pressure from the market.

(Tetsuo Ota)

Chapter 3 Fiscal Reconstruction: Concept and Method of Procedure – Deficit Ceiling and Deficit Taxation

In order to study mechanisms for effective setting of ceilings in proceeding with fiscal reconstruction within a political economy framework, the author compared two cases – hard budget constraints and soft budget constraints – and analyzed their effect on economic welfare. This analysis showed that a commitment to hard budget constraints has the potential to produce cases in which not only future generations and members of present generations with an interest in fiscal reconstruction, but also members of present generations with no interest in fiscal reconstruction, are able to benefit. By contrast, under soft budget constraints, when there are numerous individuals with no interest in fiscal reconstruction and moves to secure vested interests are inefficient, finances might deteriorate significantly due to the increase in vested interests, resulting in negative effects for both individuals with and individuals without interest in fiscal reconstruction. This suggests that the timing of ceiling-setting is important for the success of fiscal reconstruction, and that it is also important to make a thorough commitment to ceilings set in advance, and not to easily revise these ceilings.

In addition, in order to proceed effectively with fiscal reconstruction, in the event of an increase in the fiscal deficit, the adoption of fiscal reconstruction rules (after a specified period of time) providing for reductions in expenditure and increased taxes would also represent a benefit. Because economic actors would predict that taxes, etc. would increase in line with increases in the fiscal deficit, under this scenario not only would the attempt to secure vested interests be controlled, but the incentive to voluntarily cooperate in fiscal reconstruction would increase because postponing the burden until the future would generate greater pressure for tax increases.

As this indicates, the application of constraints by means of financial rules is important to the process of fiscal reconstruction, but whether this functions effectively or not is dependent on how far politicians and their constituents are prepared to follow the determined constraints. The question is whether we are capable of implementing policies that adopt a long-term perspective and take future generations into consideration.

(Toshihiro Ihori)

Chapter 4 Fiscal Discipline for Success in Fiscal Reconstruction – Examples from Other Countries and Implications for Japan

In a democracy, governments frequently experience pressure leading towards the expansion of the fiscal deficit through increases in expenditure or reductions in taxes, and fiscal reconstruction therefore necessitates a strong commitment. For this reason governments in Europe and the U.S. have conducted budget system reforms which have included the incorporation of appropriate fiscal discipline in the budget formulation process.

Fiscal discipline can be either rule-based or discretion-based, but in the 1990s fiscal management based on the setting of rules became the dominant trend. In addition to the introduction of cap systems and the pay-as-you-go principle, EU member nations set upper limits on fiscal deficits and the ratio of outstanding debt to GDP based on the Maastricht Treaty, and this has had a significant effect in ensuring fiscal soundness.

In Japan also, targets for fiscal soundness were set by the 1997 Act on Special Measures concerning the Fiscal Structure Reform and the “Big-boned Policy” put into effect from 2001, but in both cases the targets were retreated from due to the rapid worsening of the national economy. The Fiscal Management Strategy formulated by the DPJ administration also includes targets for fiscal soundness such as returning the primary balance to the black and reducing the ratio of outstanding public debt to GDP, in addition to elements of fiscal discipline such as the pay-as-you-go principle, but provides insufficient indication of concrete measures for the achievement of these goals. Transparency of targets, flexibility in relation to changes in the economic situation, and the guarantee of feasibility can be pointed to as the desirable conditions for fiscal discipline. The Fiscal Management Strategy is in particular need of a radical overhaul in relation to the last of these.

(Naoki Shimoi)

Chapter 5 Integrated Reform of Social Security and Tax Systems – Combining Pension Reform with Individual Self-help Efforts

The achievement of consistency between the enhancement of social security and fiscal reconstruction is an important factor in conducting integrated reform of the social security and tax systems, and it is necessary to proceed while attempting to achieve increased efficiency in the social security system. In European countries, reform of the pension system has involved enhancement and reform of private pensions (company pensions and individual pensions) at the same time as reform of the public pension system. Japan should refer to these cases in considering the introduction of a new system predicated on individual self-help efforts.

In specific terms, the author proposes the establishment of a system which exempts

pension funds accumulated by individuals from taxation (a Japanese IRA), in order to supplement public and company pensions and to support asset formation for old age by self-help efforts. By means of reasonable preferential tax measures, such a system would support asset formation by citizens' own self-help efforts without reliance on the government or companies. In addition to supplementing the shortfall of public and company pensions, it could also be expected to have the effect of easing the impact of company bankruptcies and resolving issues of portability, and also of eliminating inequalities between companies and within generations. With regard to the pension taxation system, given its simplicity and clarity, and the fact that it offers advantages including a low fiscal burden due to the lack of a tax reduction upon entry to the system, a taxed-exempt-exempt (TEE) system, which taxes contributions but not gains or benefits, should be adopted as the system of taxation for savings.

It is essential that we reduce the burden on citizens and ease inequalities between generations by optimizing a private pension system through measures such as the introduction of a Japanese IRA in order to enable the effective use of limited public resources.

(Shigeki Morinobu)

Chapter 6 Simulation Analysis of Fiscal and Social Security Reform

The author conducted simulations using a macroeconometric model in order to quantitatively examine how the enhancement of social security can be made consistent with fiscal reconstruction. Because there were upper limits to the rates of increase in consumption tax that could realistically be expected, the simulations also examined the choices available for fiscal reconstruction and the introduction of a guaranteed minimum pension(GMP) within these ranges (here, considered as an increase to 10% for the short term and to 15% for the medium- to long-term).

The analysis showed that in order to achieve the targets of the Fiscal Management Strategy – the achievement of equilibrium in the primary balances of the national and local governments in fiscal 2020 and, further, the reduction of the ratio of outstanding public debt to GDP thereafter, it would be necessary to increase consumption tax to 16% in respect of the first goal, and to 22% in respect of the second. Given this, the achievement of fiscal reconstruction under the upper limits for consumption tax will necessitate additional efforts on a significant scale to improve the fiscal balance.

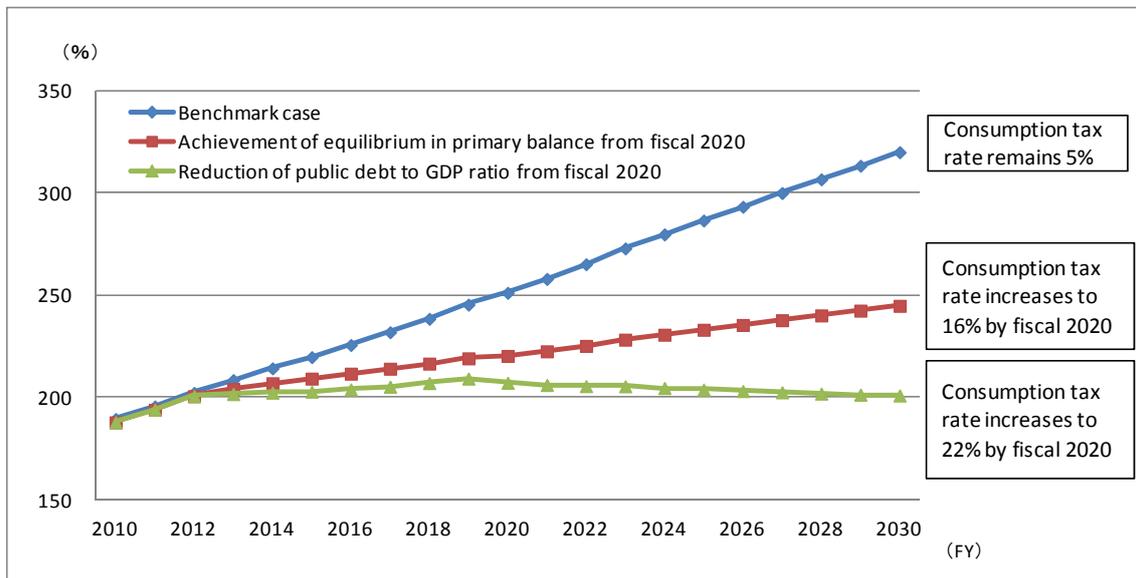
The level of benefits of a GMP financed by the increase in revenue generated by increases in the consumption tax within the same limits was calculated in the same way. In the case of provision of a uniform pension irrespective of income, the simulation indicated that benefits would fall well below the level of the current basic pension. However, when a large-scale clawback was introduced to the GMP, the level of benefits for individuals qualifying for full benefits exceeded that for the current basic

pension.

This indicates that the achievement of fiscal reconstruction and the introduction of a GMP within the scope of the tax burden that can realistically be expected to be applied will be no easy matter, and will necessitate additional improvement of the fiscal balance and a greater focus on pension benefits.

(Itaru Sato)

Projections of ratio of outstanding national and local government debt to GDP



(Note) Extract from results of simulation using macroeconomic model (Chapter 6)

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The National Institute for Research Advancement (NIRA) is an independent, private-sector research institute which defines urgent policy issues and formulates bold and timely policy proposals, seeking to contribute to the revitalization and further development of Japanese society and the Japanese economy.

Utilizing a network of scholars, researchers, and specialists in a wide range of subjects, NIRA works for the public benefit from a fair and neutral perspective, attempting to reinvigorate policy debate and contribute to the process of policy formation in Japan. The institute focuses on domestic social and economic policy, international relations, and regional issues in Japan as its principal areas of research.

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