

Expenditure Reforms that inspire Public Confidence

Japan's government has formulated a Basic Policy on Economic and Fiscal Management and Reform, looking towards the realization of its target for fiscal consolidation in fiscal 2020. For the government, seeking to realize economic growth and fiscal reconstruction, the reform of expenditure, and in particular the reduction of social security expenditure, is of paramount importance. But how will it be possible to achieve public consensus regarding uncomfortable reform measures?

MyVision

CONTENTS

Expert Opinions

What does Expenditure Reform Mean for the Japanese Public?

Present the choices and promote public discussion

Yasushi Iwamoto

Professor, Graduate School of Economics,
The University of Tokyo

Indicate the concrete consequences of reductions for each item

Ryuzo Miyao

Professor, Graduate School of Economics,
The University of Tokyo

Allow public finance to function as a shared social foundation

Naohiko Jinno

Emeritus Professor, The University of Tokyo

Government Finance should be looked at from the perspective of people and not solely from that of Ministry of Finance

Koichi Hamada

Tuntext Professor emeritus of Economics, Yale University

We must learn from Germany's social security reforms

Kenji Hirashima

Professor, Institute of Social Science,
The University of Tokyo

What does Expenditure Reform Mean for the Japanese Public?

What meaning does expenditure reform, taking in the reduction of social security expenditure, hold for the Japanese public?

How should we approach the reduction of expenditure?

In this issue of *My Vision*, experts in the fields of financial policy, macroeconomic policy, and fiscal policy offer their perspectives on these questions.

An expert in German politics also considers the success of Germany's social security reforms.

Interviewer: Reiko Kanda, NIRA Executive Vice President

Editor: Kazuyoshi Harada

Period of interviews: April - May 2015

Present the choices and promote public discussion

Yasushi Iwamoto

Professor, Graduate School of Economics, The University of Tokyo

There is an absolute imbalance between the amount of tax paid to the government by the public and the cost of the provision of the services that the public receives from the government in Japan's current government budget. The government is therefore funding public services of a value greater than the value assumed by the public. Given this, if the public is averse to tax increases, the government must restrict its funding of public services to a level that matches tax revenues.

How to control social security expenditure is the major issue in reducing public expenditure. Against the background of a deflationary environment, income levels have declined significantly as a result of the Lehman Brothers collapse and the Great East Japan Earthquake, but the cost of medical and long-term care services and the level of pension benefits have remained the same, and the ratio of social security expenses to income has therefore increased dramatically. Fiscal expenditure also spiraled due to responses to the Lehman Brothers collapse and the Great East Japan Earthquake, and has not fully returned to the level projected by a normal budget. Expenditure is high, and I believe that there is adequate margin for reduction.

At present, new private savings which would provide the government with funds are drying up, and the limit for absorption of government bonds is also being reached. It will not be possible to continue to rely on displacing the problem onto future generations.

The choice is whether to increase taxes and maintain the level of public services, if resistance to tax increases is strong, to lower the level of public services and reduce expenditure, or the combination of them. It will be essential to offer the public these choices and stimulate public discussion. Another reason that imposing the problem on future generations is of concern is that it represents a political process that does not suffi-

ciently reflect the opinions of younger generations and future generations. It might be possible in public discussion of the issue to give only the 20-something generation the right of decision. Leaving the decision in the hands of this generation, which will be long-lived and will support Japan's future, would certainly be one way of approaching the issue. ■

Professor Iwamoto conducts research on policy issues related to social security and macro fiscal management. He is an authority in the areas of analysis of the social security system using frameworks derived from economics and empirical research using both micro and macroeconomic data.

Indicate the concrete consequences of reductions for each item

Ryuzo Miyao

Professor, Graduate School of Economics, The University of Tokyo

There can be no argument that it is essential from a long-term perspective for Japan to reconstruct its public finances, but realizing steady growth is the first priority. At a point when we are experiencing the effects of an increase in consumption tax on the business conditions, we should not implement forced, uniform reductions that lose sight of the economic environment because of an excessive commitment to fiscal 2020 targets. The concrete method of procedure to be adopted for the reduction of government expenditure, and the pace of reductions, are particularly important points. Unlike public works projects, in the case of a reduction in social security expenditure, we can imagine a variety of routes by which the national economy may be affected, depending on the details of the reductions. It will be important to continue in efforts towards the realization of the government's targets for fiscal soundness following a quantitative analysis of the effect of reductions for each item of expenditure.

From the perspective of the redistribution of income, reductions which diminish the functioning of the social safety net will have a negative

effect on growth. However, because it would promote an increase in saving for the period following retirement, the reduction of pension benefits would have a positive effect on investment and growth in the long-term.

On the supply side of the economy, raising the age at which the pension is paid would increase the incentive to work, and thus increase the labor supply. In addition, if there is inefficiency or excessive supply in the areas of medical and nursing care, reforms would boost the efficiency and growth potential of the economy. With regard to the effect of the reduction of social security expenditure on the business conditions and the demand side of the economy, the magnitude of the negative effect on consumption would differ depending on whether pension benefits or medical expenditure were reduced, or on the details of the potential reductions.

The government must therefore not stop with qualitative discussions, but rather push ahead with detailed quantitative analyses of the effects of reductions on the redistribution of income and on the supply and demand sides of the economy. The government should compile concrete figures and present the public with a comprehensive picture of the effect of reductions in expenditure on the economy. This stance would also be effective in promoting the formation of a consensus among the public. ■

Professor Miyao conducts theoretical and empirical research on Japan's monetary and macroeconomic policies. From 2010 to 2015, he was a member of the Policy Board of the Bank of Japan. Professor Miyao emphasizes the supply side of the economy, and advocates aggressive monetary easing in order to boost its functioning.

Allow public finance to function as a shared social foundation

Naohiko Jinno

Emeritus Professor, The University of Tokyo

There is little likelihood of a country collapsing due to a fiscal deficit. The important thing is whether or not public finances function effectively, minimizing social and economic risk and unifying society. This is not the case in Japan.

The role that public finance should fulfill is to provide a shared social foundation that provides the preconditions for the successful functioning of economic activity. Contemporary Japan is lagging behind in putting in place two “nets” that will enable the nation to transition from a heavy manufacturing industry-based economy to a knowledge-based economy; these are a net of social capital infrastructure, and a social safety net. Because the nation does not possess these nets, which are oriented towards a new era, new industries are not being created, and public finance is not fulfilling its role as a shared social foundation. Put another way, this means that we do not possess a future vision of the society that we will become. Because of this, it is difficult to convince the public that there is meaning in facing the discomfort of fiscal reform.

In addition, in the case of Japan, there are problems in the budget process. The nation has adopted the principle of perennial taxation, and there is no discussion of revenue during the drafting of budgets. However, revenue and expenditure must inherently be discussed in tandem. The fundamental principle of public finance is to quantify expenditure and control income. The necessary expenditure for the public services provided should be estimated, and a tax burden commensurate with this amount should be assented to by the public. The process of discussion towards this goal would also foster an awareness of public finance among the public.

Today's Japanese public is confused about what type of society it wishes to build, and undecided concerning its stance regarding public finance. The nation's taxation rate is low, but it is experienced as a heavy burden. The time is coming when we will have to provide services to all

without applying income restrictions, and call for mutual sharing of the burden in order to mount shared social projects. ■

Professor Jinno serves as Chairman of the Local Public Finance Council. He believes that the function of public finance is to integrate politics, economics and society in order to enable citizens to actively improve their quality of life, and is a critic of the truncation of public services.

Government Finance should be looked at from the perspective of people and not solely from that of Ministry of Finance

Koichi Hamada

Tuntex Professor emeritus of Economics, Yale University

The state of a nation's public finance should not be judged solely from the standpoint of the Ministry of Finance, but from the perspective of a nation. It is often said that the Japan's present generation is imposing a financial burden on future generations.

However, the fact that the Japanese public holds the largest amount of net foreign assets in the world indicates that there is hardly any nation so thoughtful regarding its descendants as Japan.

There is a problem concerning the fact that the Japanese government just manages to keep the nation afloat by means of government bonds. Because funds are allocated to servicing the interest on its mounting debt, the government is unable to guarantee the necessary funds for public expenditure. And if a disaster occurs or another risk manifests, it will be unable to provide the necessary financial response in a rapid fashion. Increasing the taxation rate in order to fund interest payments will impede the efficiency of the national economy. These are the negative consequences of fiscal imbalance.

The reexamination of unnecessary expenditure should be a matter that is always on the agenda. It is essential to constantly check government waste. The provision of social security, i.e., the sharing of income with the poorest strata of society, is a vital social policy. Today, however, we are seeing an increase in waste in the form of the provision of benefits from wealthy people to people who are not experiencing significant difficulty. Leaving this type of waste unrectified makes it difficult to impose an increased tax burden on the public. Increases in the taxation rate or insurance premiums should be considered only after the efficiency of expenditure is addressed.

The Ministry of Finance is tireless in proclaiming Japan's fiscal crisis both domestically and overseas, but to the market, that is, to investors, the nation's public finances appear extremely sound. Because of this, the interest on Japanese government bonds remains low by international standards. ■

Professor Hamada serves as a Special Advisor to the Abe Cabinet. He was a key figure in the formulation of the government's reflationary policy, and has been a sharp critic of the Bank of Japan's austere monetary policy before Haruhiko Kuroda became its head.

Learn from Germany's social security reforms

Kenji Hirashima

Professor, Institute of Social Science, The University of Tokyo

Germany is a federal republic, and as such the nation's systemic arrangements are disadvantageous for the rapid implementation of political reforms. In addition, the nation has been compelled to respond to issues which have lingered from its reunification a quarter of a century ago.

Nevertheless, by contrast with Japan, which prioritizes immediate problems and has postponed the work of fiscal reconstruction, Germany remained aware of the necessity of addressing its fiscal status, and pushed steadily ahead with reform of its federal system and its social security system. In the context of reform of its federal system, aiming towards the realization of balanced federal finances from 2020, Germany essentially set about balancing its state finances and revised the Basic Law, setting an upper limit on the ratio of the federal government fiscal deficit to GDP. In the area of the medical insurance system, Germany looked to Holland and other nations as examples, and instituted reforms on an annual basis. Germany presents many points from which we can learn when considering systemic reform in Japan.

After its reunification, reform stagnated in Germany from the mid-1990s, and the nation's economic situation worsened until it was labeled "the sick man of Europe." Following successive reforms in the 2000s, however, Germany is today a European leader, and appears to have succeeded in fiscal reconstruction.

Under the Hartz reforms, a series of labor market reforms instituted during the chancellorship of Gerhard Schroeder, advisory committees were es-

tablished from the top down by the Chancellor (as opposed to the system of establishment of deliberating councils by government departments), and the reform proposals they suggested were implemented one by one. Even when the upper and lower houses of the parliament were controlled by different partisan majority, a not-uncommon situation in Germany, proposals were able to be formulated via compromise between the parties in the "Grand Coalition" and the splitting of the opposing majority in the Bundesrat.

No matter how difficult, Japan must also seek to reconcile fiscal reconstruction with the creation of a sustainable social security system. ■

Professor Hirashima presents a dynamic vision of political change in contemporary Germany based on detailed analyses of systemic reforms in response to changes in factors such as European unification, globalization, a declining birth rate and aging population, and deindustrialization.

This is a translation of a paper originally published in Japanese. NIRA bears full responsibility for the translation presented here. Translated by Michael Faul.

About this Issue

Expenditure Reforms that inspire Public Confidence

Reexamination of the structure of government expenditure, in particular the determination of how to reduce social security expenditure, are vitally important issues that must be addressed on a priority basis for the sake of Japan's future. As the nation's birth rate declines and its population ages, and abundant taxation revenues can no longer be expected, the time is coming for a fundamental reconsideration of how we can order the structure of government expenditure in order to enable consolidation of Japan's public finances.

In its research report "Social Security Reform: The Only Way Forward," NIRA indicated that the implementation of aggressive social security reforms and the reduction of government expenditure would be essential to the reconstruction of public finances in Japan. Following on from this, in this issue of *My Vision*, experts in a range of disciplines discuss the issues facing Japan's public finances.

At first glance, there appear to be numerous conflicting points in the opinions expressed by the experts. What is common to all, however, is an emphasis on the importance of considering the details of government expenditure with a focus on the meaning of reforms for the public. While their viewpoints may differ, all of the experts clearly indicate the necessity of reexamining where and to what extent government expenditure is allocated.

The question of how to approach the reduction of government

expenditure in the four-year period until fiscal 2020 will be concretely examined in Japan based on the effects of the Basic Policy on Economic and Fiscal Management and Reform and the orientation of the budget for each fiscal year. Even if there is agreement concerning the generalities in the discussion regarding the reduction of expenditure, objections will be raised to specific courses, and it will be difficult to realize a consensus. However, there will be no way forward if we attempt to avoid this process.

The time for cool discussion of how, and on the basis of which conceptual framework, to approach the reduction of social security expenditure is coming. Each of the opinions presented in this issue of *My Vision* offers a wealth of suggestions that can serve as a reference for consideration of these issues.

Social security expenditure is intimately bound up with the lives of the nation's citizens, and it will be essential to focus that expenditure as efficiently as possible in the areas in which it is genuinely needed. It is time for us to go beyond superficial emotionally-charged arguments, and adopt a constructive stance in discussing reform.

Noriyuki Yanagawa, NIRA Executive Vice President
(Professor, Graduate School of Economics, The University of Tokyo)

National Institute for Research Advancement (NIRA)

4-20-3 Ebisu, Shibuya-ku, Tokyo 150-6034, Japan

(URL: <http://www.nira.or.jp/english/>)

(Facebook: <https://www.facebook.com/nira.japan>)

For more information : info@nira.or.jp

Tel +81-3-5448-1710 Fax +81-3-5448-1744