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Chapter 3

The fiscal policy response to the crisis and achieving fiscal sustainability

The top priority at present is to achieve a sustained economic recovery. However, a credible fiscal consolidation plan is important to maintain public confidence in Japan's fiscal sustainability as the budget deficit is set to approach 10% of GDP in 2010 and gross public debt nears 200%. Although the goal of a primary budget surplus by FY 2011 is no longer feasible, the government should move promptly once a recovery is in place to implement tax increases and spending reductions, notably in public investment and government wages. While the plan of the previous government to allocate all consumption tax revenue to social security may make it politically easier to raise the consumption tax rate, it could also limit flexibility in spending. A broad-based tax reform, including improvements in direct taxes, is essential to boost revenue and support growth, which is also important to reduce the public debt ratio.

Japan's progress in fiscal consolidation between 2002 and 2007 was reversed by the crisis. With additional spending in fiscal stimulus packages and the cyclical impact of the steep recession, the budget deficit as a share of GDP is projected to approach double-digits in 2010. Consequently, the gross public debt ratio, which is already the highest ever recorded among OECD countries, is set to increase further. Fiscal consolidation as the economic recovery takes hold is thus an important priority for Japan. This chapter outlines Japan's fiscal response to the crisis and its impact on the fiscal situation. The second section reviews government programmes aimed at improving the fiscal situation, followed by a discussion of the policy options. Recommendations are presented in Box 3.2.

The fiscal response to the crisis

The budget deficit fell from 8.2% of GDP in 2002 to 3.2% in 2007, excluding one-off factors, with the decline almost equally divided between increased revenue and expenditure cuts (Table 3.1). Cyclical factors explained about half of the rise in revenue, which was concentrated in corporate income tax receipts. In addition, hikes in the pension

Table 3.1. **Evolution of the fiscal situation since 2002**[1]

	Per cent of GDP			Change in percentage points	
	2002	2007	2010[2]	2002-07	2007-10[2]
Total revenue	30.6	32.8	32.4	2.2	–0.4
Direct taxes on households	5.2	5.3	5.3	0.1	0.0
Direst taxes on business	2.9	4.2	2.7	1.3	–1.6
Social security contributions	10.5	10.9	11.6	0.4	0.7
Indirect taxes	8.4	8.4	8.7	0.0	0.3
Interest receipts	1.6	1.8	1.8	0.2	–0.1
Others	2.0	2.1	2.4	0.1	0.2
Total expenditure	38.8	36.0	42.1	–2.8	6.1
Government consumption on wages	6.7	6.1	6.6	–0.6	0.5
Government consumption on social benefits[3]	3.7	4.2	5.2	0.5	0.9
Other government consumption	7.5	7.6	8.9	0.0	1.3
Social security benefits paid	11.1	11.6	13.5	0.5	1.9
Government fixed capital formation	4.8	3.1	3.5	–1.7	0.3
Interest payments	3.0	2.5	3.1	–0.5	0.7
Other expenditures[4]	2.0	0.9	1.3	–1.0	0.4
Budget balance	**–8.2**	**–3.2**	**–9.7**	**5.0**	**–6.5**
Primary budget balance[5]	–6.8	–2.6	–8.3	4.2	–5.8
Cyclically-adjusted budget balance	–7.2	–4.2	–7.3	3.0	–3.2
Cyclically-adjusted primary budget balance[5]	–5.9	–3.5	–6.1	2.3	–2.6

1. Excluding one-off factors, which ranged from –1% to +2% of GDP between 2002 and 2010.
2. OECD estimate for 2010, excluding the impact of one-off factors.
3. Mainly health and long-term nursing care.
4. Includes subsidies, other current payments, capital transfer payments and consumption of fixed capital.
5. Excluding net interest payments.

Source: Cabinet Office, *Annual Report on National Accounts*, OECD (2009b), *OECD Economic Outlook*, No. 85 and OECD Secretariat calculations.

contribution rate boosted social security receipts. The cut in spending between 2002 and 2007 (by 2.8% of GDP) was achieved despite a 1% of GDP rise in social benefits due to population ageing. In sum, Japan appeared on track to achieve its target of a primary budget surplus for central and local governments by FY 2011. However, the downward trend in the deficit was reversed with the end of the economic expansion in late 2007 and the onset of the global crisis, as both the automatic stabilisers and discretionary stimulus measures widened the deficit.

The fiscal stimulus packages

The government froze the medium-term plan to limit spending[1] and launched a series of stimulus packages: two supplementary budgets in FY 2008, followed by additional stimulus in the regular FY 2009 budget and the supplementary budget in May 2009. Taken together, this discretionary stimulus amounted to 4.7% of GDP in 2008, the largest among the G7 countries after the United States and above the average of 3.9% for explicitly crisis-related stimulus programmes in OECD countries (Table 3.2). Increased spending (4.2% of GDP) accounted for the bulk of the stimulus in Japan, whereas stimulus was almost evenly divided between higher spending and tax reductions in the OECD as a whole. One reason for the large fiscal stimulus is the small size of automatic stabilisers in Japan, reflecting its low tax ratio and low level of social spending.[2]

Table 3.2. **Composition of fiscal packages in the major countries**[1]

	Net effect	Tax measures					Spending measures					
		Total	Individuals	Firms	Consumption	Social contributions	Total	Final consumption	Investment	Transfers to households	Transfers to firms	Transfers to sub-national government
Canada	–4.1	–2.4	–0.8	–0.3	–1.1	–0.1	1.7	0.1	1.3	0.3	0.1	..
France	–0.7	–0.2	–0.1	–0.1	0.0	0.0	0.6	0.0	0.2	0.3	0.0	0.0
Germany	–3.2	–1.6	–0.6	–0.3	0.0	–0.7	1.6	0.0	0.8	0.3	0.3	0.0
Italy	0.0	0.3	0.0	0.0	0.1	0.0	0.3	0.3	0.0	0.2	0.1	0.0
Japan	**–4.7**	**–0.5**	**–0.1**	**–0.1**	**–0.1**	**–0.2**	**4.2**	**0.2**	**1.2**	**0.6**	**1.5**	**0.6**
United Kingdom	–1.9	–1.5	–0.5	–0.2	–0.6	0.0	0.4	0.0	0.4	0.2	0.0	0.0
United States	–5.6	–3.2	–2.4	–0.8	0.0	0.0	2.4	0.7	0.3	0.5	0.0	0.9
OECD average[2]	–3.9	–1.9	..	..	..	..	–2.1	..	..	..	..	..

1. The amounts shown in the total columns do not always match the sum of the columns shown because some components either have not been clearly specified or are not classified in this breakdown.
2. Weighted average of countries that adopted positive stimulus programmes.

Source: OECD (2009b), *OECD Economic Outlook*, No. 85, OECD, Paris.

The impact of fiscal stimulus on economic activity depends on its composition, duration and timing. Recent studies suggest that fiscal multipliers in OECD countries may be around unity for government spending and about half that for tax measures, although with lower multipliers for more open economies. However, in the current downturn, the propensity of households and firms to save for precautionary reasons may have increased and dysfunctional credit markets may be limiting activity, thus reducing multipliers, particularly for tax cuts (OECD, 2009c). At the same time, however, very accommodating monetary conditions, ample economic slack and an increase in the proportion of credit-constrained households may have raised the multiplier. The total fiscal stimulus in Japan amounts to around 4% of GDP, excluding transfers (0.7% of GDP) to recapitalise public financial institutions.[3] According to the government, the first three stimulus packages

would add 1% to GDP in FY 2009 and the fourth stimulus package another 1.9% in FY 2009, giving a total impact of 2.9%. In addition, the multi-year time horizon of the fourth package is projected to add another 1% to GDP in FY 2010 and beyond. Hence, the government's projection suggests that it expects the multiplier on spending to be around one.

Transfers to firms and households account for about half of the increased spending in Japan's stimulus packages (Table 3.2). For households, the key component was a supplementary fixed-sum income payment of 12 000 yen ($125) for each person between 19 and 64 years of age and 20 000 for everyone else. Transfers – 2 trillion yen (0.4% of GDP) in all – were given to all households to achieve rapid implementation of the stimulus package. Although the impact may have been larger if the transfers had been concentrated on low-income households, this approach has some advantages. As it was a fixed amount, the relative benefit was larger for poorer households, who are more credit constrained and therefore more likely to spend the money. In addition, the timing of the payments – beginning in March 2009 – sustained private consumption when output was still falling sharply. Transfers to firms, which amount to around one-fifth of additional outlays, include a payment to highway companies to compensate them for a temporary reduction in tolls that was intended to stimulate domestic demand. The cut in tolls has had positive impacts on households and the business sector through reductions in travel and logistics costs. However, it caused several side-effects such as shifting travellers from other means of transport, thereby boosting CO_2 emissions and traffic jams. The change in relative prices created deadweight losses that blunted the impact of fiscal stimulus. While transfers to business may be useful in increasing aggregate demand in the short term, they undermine the long-term production capacity of the economy by postponing necessary restructuring (OECD, 2009a).

Supply-side effects are also important. Some fiscal measures can be effective both in responding to economic downturns and in increasing long-term growth potential (OECD, 2009a), notably:

- *Increased spending on infrastructure and education.* Investment in social infrastructure accounts for a quarter of additional spending in the recent packages (Table 3.3), although this is well below past experience (Box 3.1). Outlays on education, science and technology are significant, accounting for 7.2% of the additional outlays.
- *Expanded spending on active labour market policies, including training.* Labour market measures, including employment subsidies, job-search assistance, job creation and training, amounted to 8.3% of the expenditure in the packages.
- *Reduction of personal income taxes, notably on low-income earners.* As noted, tax measures are small at only 0.5% of GDP, with cuts in social contributions accounting for the largest share. Changes include reductions in health-care insurance contributions by low-income elderly and a cut in the employment insurance contribution rate in FY 2009.[4] Direct support through expanded unemployment benefits may have had a larger effect.

The outlook for the fiscal situation

The budget deficit is projected to increase from 3.2% of GDP in 2007 to 9.7% in 2010, excluding one-off factors (Table 3.1), which would be the fourth largest among OECD countries. On a cyclically-adjusted basis, expenditures are projected to rise by 2% of potential GDP over 2007-10. The stimulus packages account for about three-quarters of that, with the rest primarily due to pensions and health care (Chapter 4), which is driven

Table 3.3. **Fiscal stimulus packages in Japan since 1992**[1]

Category	1992-95	1998-2000	2001-02	Average for 1992-2002	2008-09[2]
A. Composition of net additional spending (%)					
Social security and welfare	3.9	20.4	26.9	15.6	13.2
Social insurance	1.5	6.6	15.2	6.2	2.5
Public assistance	2.4	13.7	11.7	9.4	10.7
Employment	0.4	1.7	16.7	3.7	8.3
Education and science technology	9.3	6.9	1.5	6.9	7.2
Social infrastructure investment[3]	105.0	63.7	65.8	78.7	26.7
Grants to local governments[4]	–21.7	–5.5	–9.3	–11.9	22.5
SME-related expenses	4.9	11.1	9.9	8.7	14.0
Other	–1.8	1.7	–11.5	–1.7	8.1
Total	100.0	100.0	100.0	100.0	100.0
Total in trillion yen	14.9	20.1	7.0	42.0	18.1
Annual average in trillion yen	3.7	6.7	3.5	4.6	9.1
B. Composition of packages (% of GDP)[5]					
Net additional spending	0.8	1.3	0.7	0.9	1.9
Capitalisation of public institutions	0.0	0.1	0.1	0.0	0.4
Debt-servicing costs	–0.1	0.1	–0.2	–0.1	0.0
Tax cuts	0.3	0.8	0.0	0.4	0.2
Financial measures	2.2	2.7	1.9	2.5	11.0
Credit guarantees	0.3	1.3	1.6	0.9	3.0
Measures by other accounts[6]	1.9	0.6	0.3	1.5	0.8
Financial measures to support banks	0.0	0.0	0.0	0.0	7.3
Total in trillion yen	62.1	62.7	24.7	49.8	132.2
Total as per cent of GDP	3.2	4.2	2.5	3.3	13.4

1. The table covers economic packages that include additional spending measures. There were six packages during 1992-95, four during 1998-2000 and three during 2001-02.
2. Includes: *i)* the Comprehensive Immediate Policy Package, August 2008, 11.5 trillion yen (Cabinet Office, 2008a); *ii)* Measures To Support People's Daily Lives, October 2008, 26.9 trillion yen (Cabinet Office, 2008b); *iii)* Immediate Policy Package to Safeguard People's Daily Lives, December 2008, 37 trillion yen (Cabinet Office, 2008c); and *iv)* Policy Package to Address Economic Crisis, April 2009, 56.8 trillion yen (Cabinet Office, 2009c).
3. The composition of social infrastructure investment is shown in Figure 3.1.
4. Contingency local grants, which were counted as "social infrastructure investment" (1.4 trillion yen) and "other" (1.6 trillion yen) in the original budget data, are included in "grants to local governments".
5. Average annual spending as a per cent of average annual GDP over the period of the packages. OECD estimate for 2009 GDP.
6. Includes spending by special accounts, such as labour, investment by public corporations and acquisition of land.

Source: Ministry of Finance, Cabinet Office and OECD Secretariat calculations.

Box 3.1. **Comparison of 2008-09 fiscal stimulus to previous packages**

Since the end of the bubble in the early 1990s, Japan has implemented 17 economic stimulus packages containing additional fiscal spending during four episodes: 1992-95, 1998-2000, 2001-02 and 2008-09 (Table 3.3).[1] The focus has varied depending on the economic and political situation. The fiscal stimulus in 2008-09 stands out from past episodes in terms of the total size of the packages, its emphasis on increased spending and the composition of outlays:

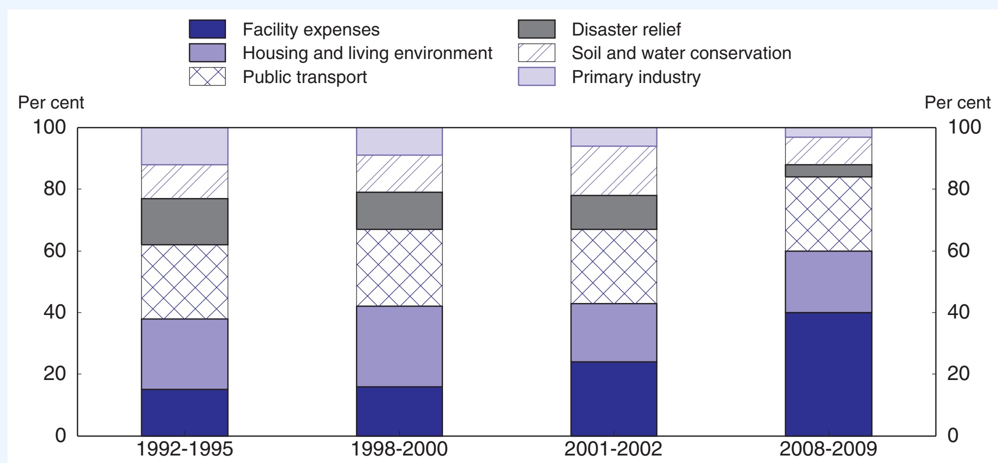
- The total size, including net additional spending, tax cuts and financial measures, is four times larger (in per cent of annual GDP) than in the previous three episodes. This is primarily due to the large size of financial measures, such as recapitalisation of financial institutions, loans to enterprises and guarantees on loans to SMEs, to cope with the financial-sector origins of this recession. However, the amounts shown in Table 3.3 indicate the maximum funding levels, which may not be reached.

Box 3.1. **Comparison of 2008-09 fiscal stimulus to previous packages** *(cont.)*

- Reductions in taxes and social contributions are only half that in the previous three episodes.
- Net additional spending per year is more than double that in the previous three episodes.
- The share of spending on social insurance is relatively small compared to earlier episodes, when stimulus packages were used to reduce anticipated deficits in social insurance programmes. In contrast, social assistance is large, reflecting the range of measures to help low-income households.
- Employment-related spending is more than double the average of past episodes, reflecting measures to expand employment insurance coverage and employment subsidies.
- Central government transfers to local governments account for almost a quarter of additional net spending to avoid pro-cyclical tightening.
- SME-related spending is relatively large at 14% of total spending, reflecting more generous credit guarantee treatment by public financial institutions. In addition, the 3.7 trillion yen to capitalise public financial institutions is larger than the previous episodes combined and will facilitate public lending to SMEs.

The share of public investment is substantially less than the average of the previous three episodes, when it accounted for almost four-fifths, reflecting an explicit effort to avoid repeating past mistakes of investing in unnecessary infrastructure. Moreover, the composition of public investment has changed (Figure 3.1). An effort to improve the quality and energy efficiency of public buildings, including schools, doubled the share of facility expenses from an average of 17% of total public investment in the previous three episodes to 40% in 2008-09. Such investment is likely to have a more immediate impact on economic activity than traditional infrastructure projects. The increased investment in public buildings was balanced by declines in investment in primary industries and disaster relief. In sum, the fiscal stimulus packages in 2008-09 are better designed than those in past episodes.

Figure 3.1. **Allocation of public investment**



Source: Ministry of Finance, Cabinet Office, and OECD Secretariat calculations.

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1. Five economic packages did not include supplementary budgets as they were designed to promote specific regulatory changes.

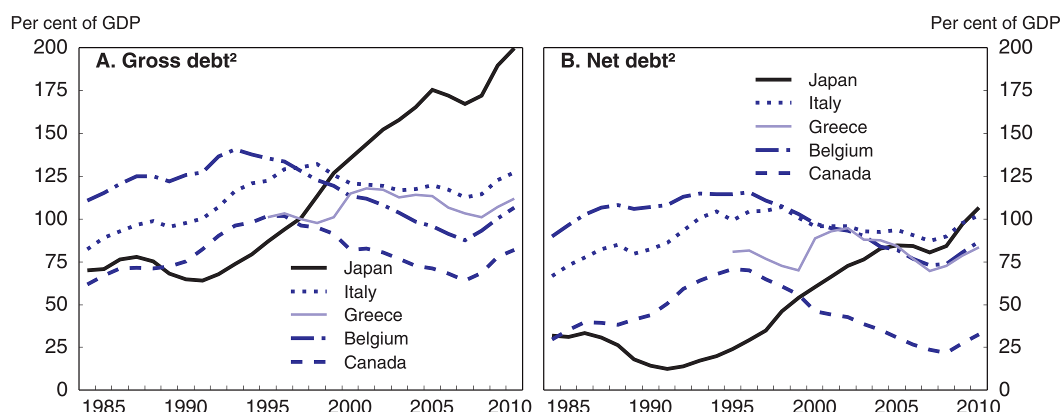
by population ageing. Although social spending was relatively stable between 2003 and 2007, reflecting measures to raise the pension eligibility age and to limit health spending by cutting medical fees and prices and boosting co-payment rates, a significant expansion is expected in coming years in the absence of further reform measures.

The large budget deficit and the decline in output are projected to put renewed upward pressure on the public debt ratio. Gross debt rose from 64% of GDP in 1991 to 175% in 2005, by far the highest in the OECD area, before declining in the following two years (Figure 3.2).[5] On a net basis, debt has also risen substantially, largely due to the primary budget deficits recorded every year since 1991 (Figure 3.3). Another factor has been the slow growth of nominal GDP, which increased at an annual rate of less than 0.5% since 1991 in the context of deflation. Weak output growth makes it difficult to stabilise the government debt ratio, which requires that nominal GDP grow as fast as the stock of government debt. On the other hand, the decline in interest payments has helped limit both the budget deficit and public debt. Indeed, interest payments fell from 3.3% of GDP in 2000 to 2.6% in 2008 despite the increase in public debt, thanks to a decline in borrowing rates (Figure 3.4).The effective interest rate paid on government gross debt dropped from 2.7% in 2000 to 1.5% in 2008. It averaged 1.7% over the period 2001-08 compared to 4.6% during the 1990s.[6]

The fall in long-term interest rates and their stabilisation at a low level reflects a number of factors:

- Japan has abundant domestic savings and significant home bias that keeps those funds in Japan.[7] Although the household saving rate has declined significantly since 2000, it was offset during the first half of the decade by rising corporate surplus saving as firms deleveraged (Figure 1.8). Corporate surplus saving then declined in 2006-07 in the context of strong output growth. This also boosted tax revenue, thereby reducing government net borrowing and helping to maintain domestic saving and low interest rates.

Figure 3.2. **Gross and net debt in selected OECD countries**[1]



1. The five countries with the highest gross debt ratios in the OECD area in 2000.
2. OECD estimates for 2008 and projections for 2009-10.

Source: OECD (2009b), *OECD Economic Outlook*, No. 85, OECD, Paris.

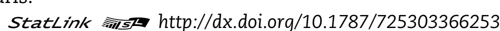

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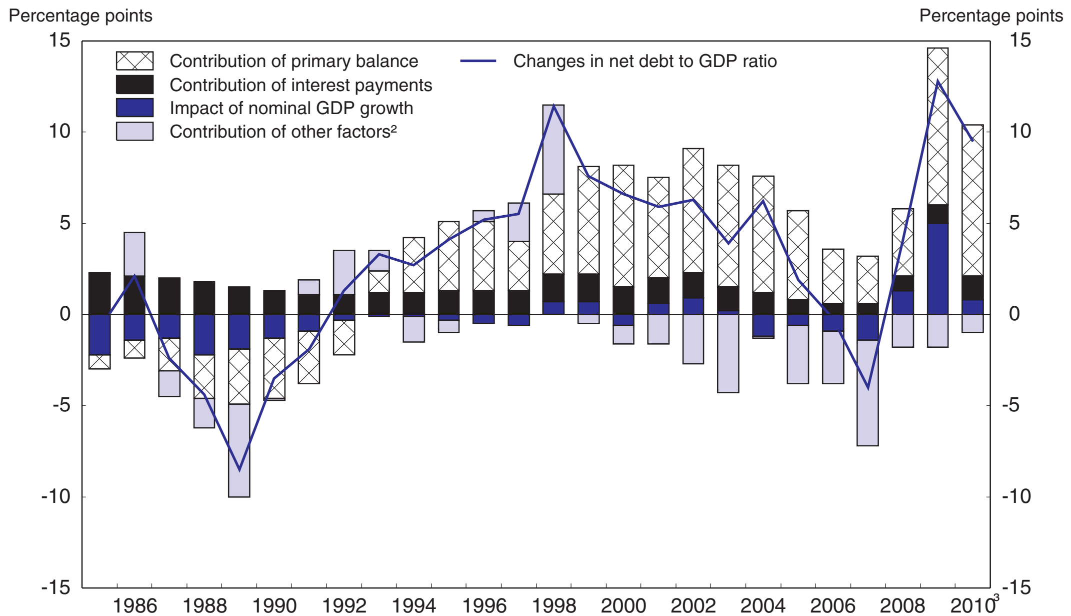
Figure 3.3. **Factors explaining changes in the net public debt ratio**[1]



1. The formula is as follows: $(B_0/Y_0) - (B_{-1}/Y_{-1}) = (B_{-1}/Y_0) * (i\text{-}g) + PB_0/Y_0 + e$, where B, Y, I, g, PB and e represent net debt, nominal GDP, the effective interest rate, the GDP growth rate, primary balance and other factors, respectively.
2. Other factors, which are calculated as a residual, include changes in asset prices, net income from asset sales, transfers to or from public financial institutions, and acquisitions of asset and liabilities from non-government institutions that are not recorded in the flow data.
3. OECD estimates for 2008 and projections for 2009-10.

Source: OECD (2009b), *OECD Economic Outlook*, No. 85 Database, OECD, Paris.

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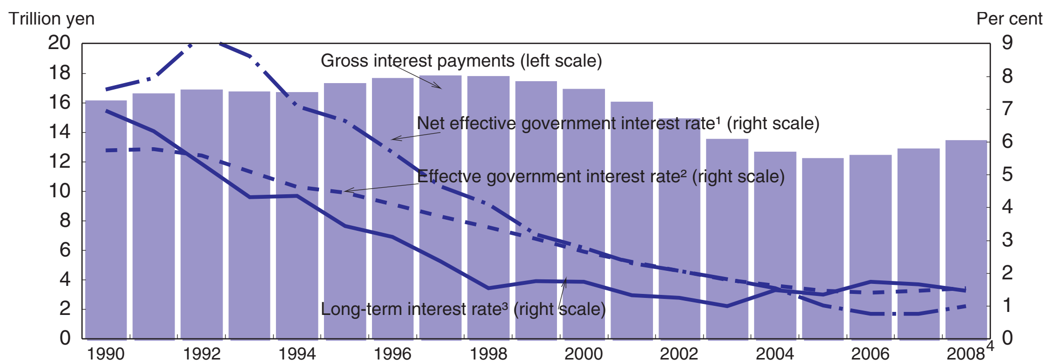
- About half of government bonds are held by the public sector (Figure 3.5), meaning that net debt is significantly lower than gross debt in Japan (Figure 3.2). Holdings of the remaining government bonds are relatively concentrated in financial institutions

Figure 3.4. **Interest payments by the government**



1. Defined as interest payments minus interest receipts divided by net government debt.
2. Defined as interest payments divided by gross government debt.
3. Ten-year government bonds.
4. OECD estimate for interest payments and receipts in 2008.

Source: Cabinet Office and OECD Secretariat calculations.

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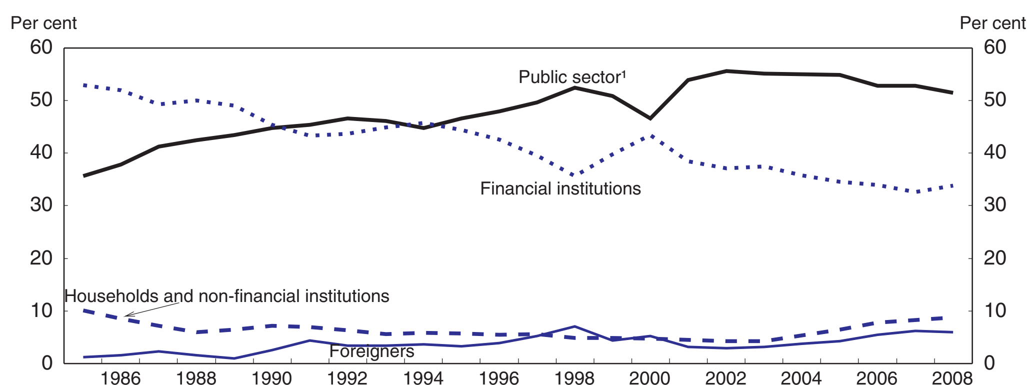
Figure 3.5. **Ownership of government bonds in Japan**

In per cent at the end of each fiscal year



1. The public sector includes the general government, central bank, public financial and non-financial corporations and Japan Post Bank and Japan Post Insurance, which became separate companies due to the privatisation in 2007 and aim to be listed on the stock market in the early 2010s.

Source: Bank of Japan, *Flow of Funds*.

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including banks and insurance companies. Consequently, households, non-financial firms and foreigners each hold less than 10% of outstanding government bonds. The risk-free weight of government bonds in BIS regulations and their safety during deflationary periods encourages banks to hold them. In addition, investment rules and asset allocation models encourage long-term investors, such as pension funds and insurance companies, to hold government bonds.

- The financial crisis resulted in a flight of capital to safer assets, pushing down the interest rate on government bonds in Japan and other countries.

Looking ahead, the normalisation of financial conditions and a recovery in loan demand are likely to involve a general increase in long-term interest rates. Assuming a rise in Japan's long-term interest rate to 2.2% by the end of 2010, the OECD projects that gross public debt will reach 200% of GDP (100% for net debt, which would also be the highest in the OECD area). The rising level of debt increases the risk of a more significant increase in interest rates in coming years. Indeed, a common finding in the economic literature is that fiscal imbalances boost long-term interest rates.[8] In Japan, the outlook also depends in part on whether the factors that have reduced rates and kept them at a relatively low level in recent years will remain in place. A weakening in home bias and a decline in financial institutions' purchases of government bonds could contribute to a rise in interest rates. The risk of increasing interest rates going forward lends urgency to Japan's efforts to overcome its budget deficit problem.

Past measures to improve the fiscal situation

Basic Policies for Economic and Fiscal Management and Structural Reform 2009

In June 2009, the government released *Basic Policies 2009*, which outlines key directions for the coming years. The target set in 2006 to achieve a primary budget surplus for central and local governments in FY 2011 is no longer feasible given the global financial crisis and the stimulus packages. Indeed, the combined central and local government primary budget deficit is projected to worsen from 1.3% of GDP in FY 2007 to 8.1% in FY 2009. In addition, the objective of creating "a medium-level welfare state" (see below) has changed spending

plans, leading to a decision not to cut social spending in FY 2010. Overcoming the recession is now the priority.[9] The former government set a medium-term target to stabilise the public debt-to-GDP ratio in the mid-2010s, and reduce it steadily from the early 2020s. This is to be realised by cutting the primary budget deficit by half by FY 2013 and achieving a surplus by FY 2019.

In order to limit the run-up in debt and the risk of higher interest rates, it is important to achieve at least the pace of fiscal consolidation targeted by the government's *Basic Policies 2009*. Additional fiscal stimulus would not be appropriate, because there is a risk that its positive impact would be offset by higher interest rates in light of the current fiscal situation. Given that the government's basic target was the public debt ratio, it would be better to focus on the overall budget balance, which determines the evolution of debt, rather than the primary balance.

Medium-term Programme for Establishing a Sustainable Social Security System

Basic Policies 2009 incorporated the December 2008 plan approved by the Cabinet, the *Medium-term Programme for Establishing a Sustainable Social Security System and Securing Its Stable Revenue Sources* (hereafter, the *Programme*), for tax and social policy reform that pursues the establishment of a "medium-level welfare society" matched with a "medium-level burden" to finance it. It is based on the premise that Japan, with public social spending of 18.6% of GDP in 2007, should aim at a "medium-level welfare society" somewhere between the United States, at 16%, and some European countries, where public social spending approaches 30% (Figure 1.10).[10] The vision of an upgraded social welfare system, as spelled out in the final report of the National Commission on Social Security (2008) includes: *i)* strengthening the basic pension to provide minimum income security; *ii)* promoting the co-ordination of health and long-term care (see Chapter 4); and *iii)* developing child-care services. The *Programme* is a reversal of the 2006 Integrated Reform of Expenditures and Revenues, which aimed at reducing the growth of social spending from its baseline level. This planned spending restraint provoked public dissatisfaction, even though its targeted growth rate of 4% was double the 1.9% average recorded between 2000 and 2007.

In the *Programme's* vision of a welfare state, the objective of tax reform is to fund expanded social spending and to make up for the existing revenue shortage for such programmes, thereby striking a balance between ensuring a sense of security among present generations and taking responsibility for future generations. However, the implementation of tax reform is contingent on an economic recovery. Consequently, additional tax revenue was not available to finance the hike in the government's contribution to the basic pension from a third to a half in FY 2009.

Reform of the pension system

The 2004 reform of the public pension system is intended to limit outlays to around 9% of GDP through FY 2015 and ensure the sustainability of the system for 100 years. *First*, the pension contribution rate is being gradually increased from 13.6% in FY 2004 to 18.3% by FY 2017. *Second*, the government contribution to the basic pension was increased from one-third to one-half in FY 2009. *Third*, pension spending will be limited through "macroeconomic indexation", which adjusts the growth rate of benefits based on changes in the number of contributors and life expectancy. Indexation will be introduced once the consumer price index rises 1.7% above its 2005 level,[11] a condition that has not yet

been met.[12] The 2004 reform also requires that the average replacement rate for a couple with a dependent spouse, which was 62.3% in FY 2009, remain above 50%. The rates for some individuals, notably relatively high-income persons and single persons, are already below that lower bound. Indeed, the gross replacement rate of a single person is only 34%, the second lowest among OECD countries (OECD, 2009d). With these reforms, the public pension system is expected to remain sustainable, defined as a Fund at least large enough to cover annual expenditure in the preceding year, through 2105 (Table 3.4).[13]

The projections are sensitive to the economic and demographic assumptions and additional reforms may become necessary in the future if the assumptions are not met. The 2009 projection assumes a higher rate of return at 4.1% (compared to 3.2% in the 2004 projection) and wage growth of 2.5% (compared to 2.1%), thus widening the gap between the return on investment and wages from 1.1% to 1.6%. It is questionable, though, whether the current portfolio can generate returns consistent with this projection.[14] If further reforms become necessary, one option would be to allow the average replacement rate to fall below 50%. However, the scope for decline is limited as it may discourage contributions to the public pension scheme in favour of relying on social assistance, although the latter is subject to an asset test. Already in 2009, 39% of those covered by the National Pension System (the self-employed, non-regular workers and others not included in the Employees' Pension System) did not pay their contributions. A second option, a further hike in the contribution rate, should be avoided as it would have an adverse impact on the labour market. The best option would be to further raise the pension eligibility age in line with the increase in life expectancy.[15] This should be accompanied by reforms in the labour market and working environment to encourage the participation of older workers.

Table 3.4. **Long-run projections for the public pension system**[1]

	2004 projection					2009 projection				
	Revenue	Expenditure	Balance	Fund	Ratio to outlays[2]	Revenue	Expen-diture	Balance	Fund	Ratio to outlays[2]
2005	32.3	36.1	–3.8	174.7	4.9					
2006	34.1	37.4	–3.3	171.4	4.7					
2007	35.8	38.6	–2.8	168.7	4.4					
2008	37.8	39.9	–2.1	166.5	4.2					
2009	41.5	41.5	0.0	166.5	4.0	39.7	40.5	–0.8	154.4	3.8
2010	43.2	42.6	0.6	167.0	3.9	39.9	41.4	–1.6	152.8	3.7
2015	50.5	47.3	3.2	176.3	3.7	50.4	48.1	2.4	155.1	3.2
2020	56.5	49.7	6.8	204.2	4.0	59.9	51.8	8.1	185.5	3.4
2025	61.8	52.5	9.3	246.3	4.5	66.8	55.2	11.6	236.2	4.1
2030	67.4	57.5	9.9	295.8	5.0	74.1	59.4	14.7	304.8	4.9
2040	77.4	73.5	3.9	368.8	5.0	88.0	75.9	12.1	447.0	5.7
2050	86.6	87.8	–1.2	377.0	4.3	101.8	93.8	8.0	544.3	5.7
2060	95.3	97.7	–2.4	356.3	3.7	114.5	110.6	3.8	603.2	5.4
2070	103.1	107.3	–4.2	324.1	3.1	124.2	127.7	–3.4	602.1	4.7
2080	111.9	117.8	–5.9	273.1	2.4	132.6	140.5	–7.9	540.3	3.9
2090	123.1	130.0	–6.9	207.4	1.6	141.2	153.5	–12.3	439.4	2.9
2100	136.7	143.9	–7.2	136.7	1.0	148.6	169.5	–20.9	272.3	1.7
2105						151.9	178.2	–26.3	151.9	1.0

1. The sum of projections for the National Pension System and the Employees' Pension System. Figures are in trillion yen unless otherwise noted.
2. Ratio of the Fund at the end of the previous year to annual pension outlays.

Source: Ministry of Health, Labour and Welfare (2009b) and OECD Secretariat calculations.

Many working spouses limit their working time and earnings to avoid social insurance and/or tax burdens. Secondary earners with an annual income below 1.3 million yen ($13 700) are exempt from social insurance premiums for pensions, health care and long-term nursing care, as long as they work less than three-quarters of the working hours or days of regular workers. The same exemption applies to firms, giving them an incentive to hire part-time workers to avoid insurance co-payments. Reducing disincentives for full-time employment of secondary earners would encourage labour supply and help reverse the rising share of non-regular workers. A revision proposed to the Diet in 2009, although it did not pass, aimed at expanding the coverage of the Employees' Pension System by changing the criteria for inclusion:

- At least 20 hours of work per week compared to about 30 hours under the current system.
- A reduction in the earnings threshold to 1.18 million yen a year. An exemption for low-income persons from social contributions, as from income tax, makes sense. However, there is no reason to also exempt employers. Given that the self-employed pay the fixed amount of National Pension System premiums as both employer and employee, it would be reasonable for employers to pay the pension co-payments of all employees regardless of their wage level.[16] This would also narrow the gap in labour costs between regular and non-regular workers, a factor fuelling labour market dualism.
- At least one year of employment, which is aimed at limiting the administrative burden on employers, is required. However, the size of any burden should be very small as the necessary information for social insurance premiums should be virtually identical to that for income tax. If such burdens are in fact significant, the best solution would be to harmonise administrative procedures between tax and social insurance systems rather than maintain a time criteria for employment. Such harmonisation could be achieved by introducing a social security card.

The proposed reforms would only boost the number of workers eligible for the Employees' Pension System by 0.1 to 0.2 million, generating additional premium payments of 10 billion to 20 billion yen. A more extensive reform of the criteria for the exemption of firms from co-payments for pension premiums would reduce inequality across different types of employment contracts and promote labour supply.

Policies to achieve fiscal sustainability

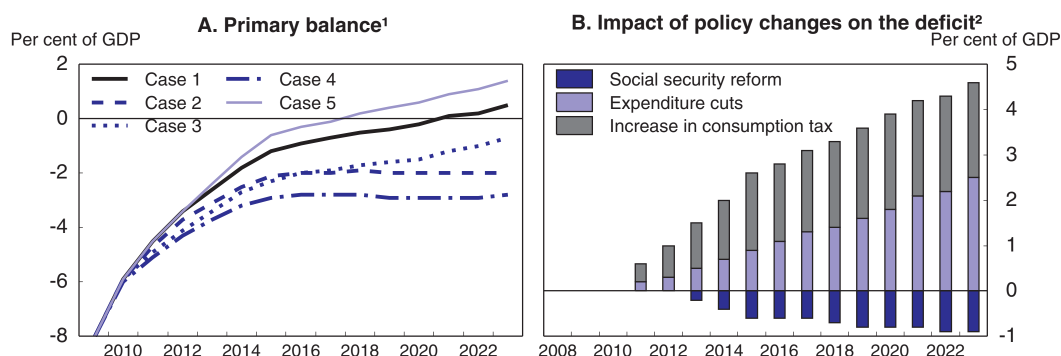
The government's June 2009 Reference Projection

The June 2009 *Reference Projection* provided a quantitative picture of how fiscal consolidation can be achieved. Figure 3.6 shows the evolution of the primary balance of central and local governments in the scenario of a steady recovery in the world economy.[17] The five cases, explained in Table 3.5 correspond to different combinations of policies with respect to: the consumption tax (left at 5% or raised to 10%), cuts in spending (11.4 trillion yen or 14.3 trillion yen) and reform of the social security system. A number of important results emerge from the *Reference Projection*:

- If the consumption tax were to remain at 5% (Cases 3 and 4), the primary deficit in FY 2023 is projected at between 0.7% and 2.8% of GDP (depending on the size of spending cuts) even without social security reform. In short, achieving a primary surplus is not possible without a hike in the consumption tax rate.[18]
- Social security reform is expected to boost the primary deficit by almost 1% of GDP (Figure 3.6, Panel B). Achieving a primary budget surplus (Case 1) would require doubling

Figure 3.6. **The 2009 *Reference Projection***

Primary balance of central and local governments as a per cent of GDP



1. The five cases from the *Reference Projection* are explained in Table 3.5.
2. The bars indicate the change in the primary budget balance of central and local governments resulting from a reform of social security, spending cuts and an increase in the consumption tax from 5% to 10%.

Source: Cabinet Office (2009a) and OECD Secretariat calculations.

StatLink http://dx.doi.org/10.1787/725357615570

Table 3.5. **The different cases in the *Reference Projection***

	Consumption tax	Cut in spending		Reform of social security?	Primary balance in 2023[1]
		By FY 2011	After FY 2012		
Case 1	Raised to 10%	14.3 trillion yen	Constant in nominal terms	Yes	0.5
Case 2	Raised to 10%	11.4 trillion yen	Constant in real terms	Yes	–2.0
Case 3	Unchanged at 5%	14.3 trillion yen	Constant in nominal terms	No	–0.7
Case 4	Unchanged at 5%	11.4 trillion yen	Constant in real terms	No	–2.8
Case 5	Raised to 10%	14.3 trillion yen	Constant in nominal terms	No	1.4

1. Primary balance of central and local governments as a per cent of GDP.

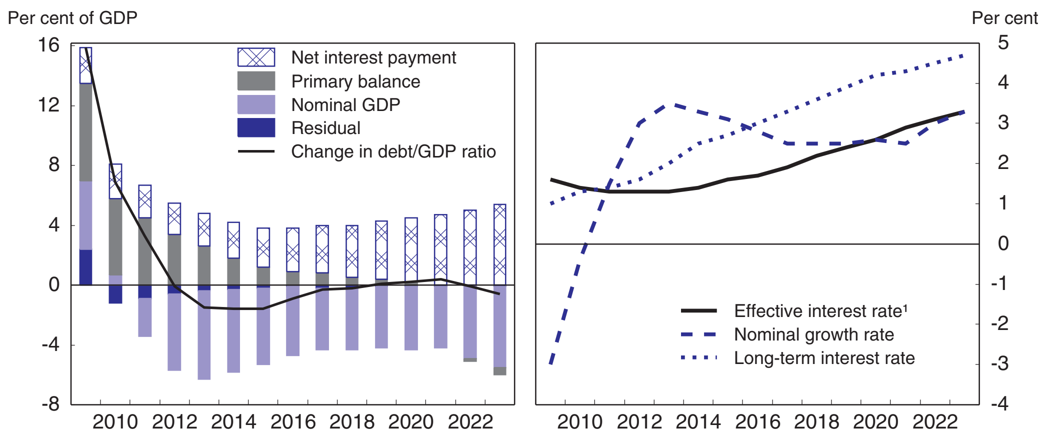
Source: Cabinet Office (2009a).

the consumption tax to 10% as well as cutting spending by 14.3 trillion yen (2.8% of 2008 GDP) and keeping it fixed in nominal terms thereafter.

Even with a primary budget deficit until at least FY 2021, the debt ratio is projected to stabilise from FY 2012 in Case 1 (Figure 3.7), as the projected rise in nominal GDP offsets continued primary budget deficits and rising net interest payments. This relatively benign outcome depends, however, on the key assumption that the effective interest rate on government debt is less than the growth rate of nominal GDP through FY 2020. Nominal growth is boosted by a projected pick-up in inflation; during the decade from FY 2013, the annual increase in the consumer price index in the *Reference Projection* remains consistently above the 1% midpoint of the Bank of Japan's understanding of price stability (0 to 2%) and above the 2% upper bound in the final four years. In addition, the effective interest rate on government debt lags behind the expected rise in the long-term interest rate, as it is held down by the maturity of government debt, which averages around five years.

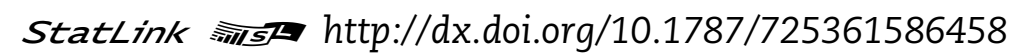
The *Reference Projection*'s assumptions differ markedly from those in the OECD's medium-term scenario,[19] which has a higher effective interest rate, lower nominal and real GDP growth and lower inflation between 2010 and 2017 (Table 3.6). As a result, the OECD scenario shows an increase in the debt ratio over that period, in contrast to the slight decline in the *Reference Projection*, even though the OECD scenario is based on a larger reduction in the fiscal deficit (5.5 percentage points *versus* 4.8 points).[20]

Figure 3.7. **Debt dynamics in Case 1 of the *Reference Projection***



1. Defined as interest payments minus interest receipts divided by gross government debt (net debt is unavailable).

Source: Cabinet Office (2009a) and OECD Secretariat calculations.

StatLink  http://dx.doi.org/10.1787/725361586458

In sum, the early stabilisation of the debt ratio in the *Reference Projection* hinges on nominal GDP growth exceeding the effective government interest rate for several years during the 2010s, which is not the historical norm, making it unlikely to occur consistently in the future. The effective rate in Japan has averaged 3.3% since 1990, considerably above the 0.9% nominal GDP growth rate. While this certainly was influenced by Japan's economic stagnation during the 1990s, an effective interest rate that is higher than the nominal growth rate is the norm in the OECD area. Indeed, the average effective interest rate has exceeded the nominal growth rate by about two percentage points between 1990 and 2008.[21] In Japan, nominal growth may exceed the effective interest rate for several years during the 2010s as output growth picks up and the large output gap closes,[22] as in the OECD's medium-term scenario. Such an outcome would help slow the build-up of public debt. However, this situation is unlikely to last as ageing will drag down economic growth, while the high and

Table 3.6. **Comparison of medium-term fiscal scenarios**

	OECD's medium-term scenario		Reference Projection[1]	
	2010	2017	FY 2010	FY 2017
Potential GDP growth rate	0.8		1.0	
Effective interest rate[2]	1.9		1.5	
Nominal GDP growth rate	2.2		2.8	
Real GDP growth rate	1.7		2.1	
GDP deflator	0.5		0.7	
Unemployment rate	5.7	4.3	5.4	4.1
Fiscal balance/ GDP[3]	–8.7	–3.2	–8.8 (–8.1)	–4.0 (–3.9)
Gross financial liabilities/GDP[4]	200	208	170	168

1. Case 1 in Table 3.5.
2. The effective rate in the *Reference Projection* is calculated as net interest payments divided by gross liabilities as defined by the government.
3. General government basis. The figures in parentheses show the balance of central and local governments combined that is consistent with gross financial liabilities in those years.
4. The coverage of debt in the OECD's medium-term scenario is different from that in the *Reference Projection*. See footnote 20.

Source: OECD (2009b), *OECD Economic Outlook*, No. 85 and Cabinet Office (2009a).

rising level of public debt will tend to push up interest rates. Therefore, faster consolidation than envisioned by the government may well be needed to ensure that the public debt-to-GDP ratio stabilises from the mid-2010s and falls from the early 2020s.

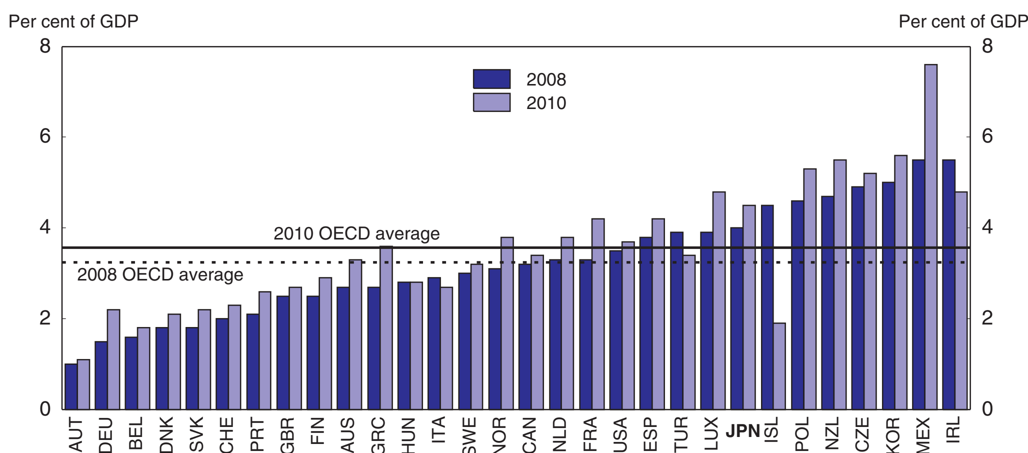
The scope for spending reductions

Increased social spending is projected to raise the primary deficit by almost 1% of GDP by FY 2023, as noted above, while expenditure reductions in other areas would reduce it by 2.5%. Between 2002 and 2007, public spending was cut by 2.8% of GDP. However, future spending reductions are more difficult given that public investment has already been scaled back to a large extent. This section will focus on the scope for additional cuts in public investment and in the government wage bill.

Public investment

Public investment, including by public enterprises, fell from 8.4% of GDP in 1996 to 4.0% in 2008 (Figure 3.8), closer to the OECD average of 3.3% of GDP. The fiscal stimulus packages implemented in many OECD countries in the wake of the global crisis are projected to raise the OECD average by 0.3% of GDP by 2010, compared with a 0.7% increase in Japan. It is essential to unwind this increase in public investment, as shown in the *Reference Projection*, which included a decline from 4.5% of GDP to around 3½ per cent, the current OECD average. However, further declines would raise concerns about regional income disparities and the need to maintain existing public infrastructure.

Figure 3.8. **Public investment in OECD countries**



Source: OECD (2009b), *OECD Economic Outlook*, No. 85, Paris, OECD.

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Public investment has long been used to promote regional equality; low-income prefectures thus tend to receive more of it (2008 *OECD Economic Survey of Japan*). However, public investment has not been an efficient tool for reducing regional inequality as it has failed to create a foundation for sustainable growth and the marginal gains, in terms of attracting private investment, are small relative to the cost. The allocation of public investment, therefore, should be driven more by economic criteria, while regional inequality is addressed through other measures, such as well-targeted social welfare programmes, tax

transfers among prefectures and policies to boost productivity growth in services. However, such policies should not be allowed to discourage economically rational migration.

The rising share of public investment needed to maintain and renew existing infrastructure is another constraint on further reducing spending. According to the Ministry of Land, Infrastructure and Transport (2005), expenditure on maintenance and renewal will exceed the amount of new investment by 2011 and will totally crowd out new investment by 2022, if the pace of spending cuts in *Basic Policies 2006* were achieved. However, this calculation assumes that the existing stock of infrastructure is maintained, which is not economically efficient in the context of a falling population, internal migration and population ageing. Japan's working-age population is projected to fall by 13% between 2010 and 2025, with the extent of the decline ranging from 3% to 27% in Japan's 47 prefectures. Meanwhile, the population over 65 will rise by 24% nationwide, with the rate of increase by prefecture varying between 8% and 47%. Such shifts imply that the type and quantity of public infrastructure needed will change rapidly. The government should thus write off unnecessary infrastructure to make room for new investment.

Further cuts in public investment should be accompanied by measures to increase its efficiency. The government aimed at reducing the "general cost index" – which reflects the current cost as well as the duration and future maintenance costs of public works – by 15% between FY 2002 and FY 2007. In the event, a 14% reduction was achieved. The government targeted another 15% cut in a new composite index that takes into account technological and environmental factors between FY 2007 and FY 2012 (Cabinet Secretariat, 2008a and 2008b). This new programme should enhance the efficiency and transparency of public works by providing a common basis to evaluate quality and efficiency.

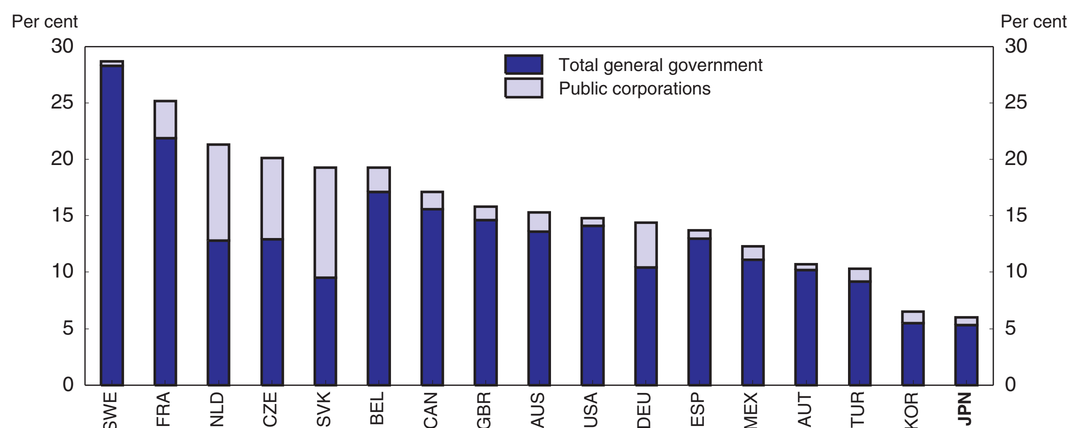
Increasing the efficiency of government and reducing its size

The *Reference Projection* maintained the target in *Basic Policies 2006* of reducing the government wage bill by 0.5% of GDP by FY 2011 below a baseline that assumes 3% nominal GDP growth and no reform. This was to be achieved by cutting employment and reforming the wage system. Indeed, central government employment in FY 2009 is 6.8% below that in FY 2005 and 5.5% below for local governments. However, the scope for cutting the size of the central government is limited by the fact that its workforce is already small. Indeed, there were only 2.6 central government workers per 1 000 population in Japan, compared to 4.0 in the United States in 2006 (2008 *OECD Economic Survey of Japan*). Given that workers in the central government account for only one-tenth of public-sector employees in Japan, efforts to reduce the public-sector wage bill should focus on local governments and public enterprises. However, overall government employment is also low as Japan has the lowest share of public workers in the labour force of any OECD country (Figure 3.9). Moreover, the share has continued to decline since 2005 (Figure 3.10).

Despite the cut in the number of employees and deflation, the budgeted wage bill of central and local governments fell by only 2.6% between FY 2005 and FY 2009 due to continued wage gains. Indeed, since 1996, public-sector wages have increased by 18%, compared to only 5% in the private sector (Figure 3.10).[23] This widening gap does not reflect greater productivity gains but a number of other factors, including a sharper increase in low-paid non-regular workers in the private sector. In addition, the public sector has a steeper wage-tenure profile and more downward rigidity in wages. The large number of people retiring also has a bigger effect on the public sector, as the longer average tenure boosts the lump-sum retirement allowances by more than in the private sector.

Figure 3.9. **Employment in government and public corporations in OECD countries**

In per cent of labour force in 2005 or latest year



Source: OECD (2008a).

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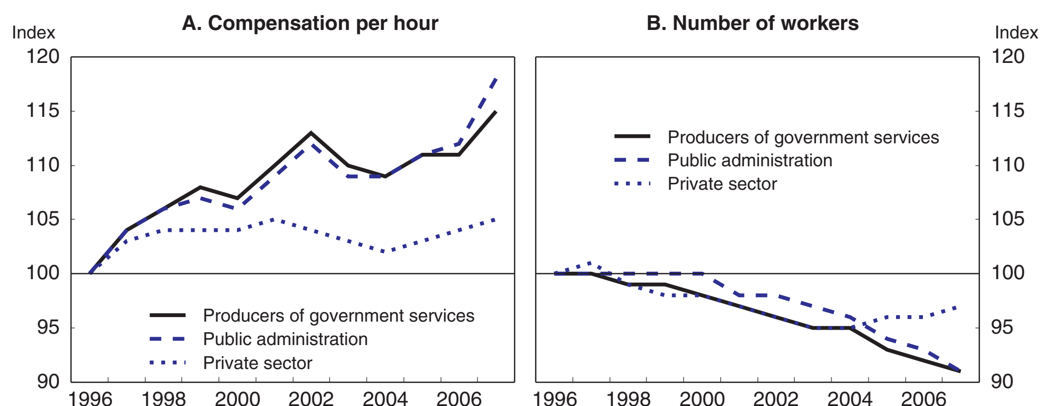
Reductions in the government wage bill should be accompanied by policies that enhance productivity and efficiency in the public sector. The priority should be to further reform aspects of the rigid and closed wage and employment system, such as the steep seniority-based wage curve and the retirement pay structure that discourages job changes, resulting in low labour mobility. In this regard, the full implementation of the planned reform of the remuneration and retirement pay structure in FY 2010 is expected to help alleviate the problem. Introducing more flexible career paths and wage structures, combined with active personnel exchanges with the private sector, would enhance productivity. Privatisation and greater use of the 2006 market-testing initiative to outsource activities to the private sector, where appropriate, may further reduce the government wage bill.

Figure 3.10. **Changes in wages and number of workers in the private and public sectors**

1996 = 100



Source: Cabinet Office, *National Accounts*.

StatLink http://dx.doi.org/10.1787/725440024780

Furthermore, there is scope to reduce the wages of local government workers. The variation in public-sector wages across regions does not appear to accurately reflect differences in cost of living. In particular, the gap between public and private-sector employees is larger in lower-income areas, suggesting scope for reducing the local government wage bill (2008 *OECD Economic Survey of Japan*).

The need for additional revenue: size, timing and instruments

Since the early 2000s, spending cuts have been the priority in the government's plan to achieve a surplus in the primary balance of the combined central and local government budgets by FY 2011. In contrast, there were few measures to increase tax revenues. The *Reference Projection* assumed a hike in the consumption tax rate from 5% to 10% in Case 1.[24] However, a number of factors suggest that an even larger revenue increase may be necessary:

- The size of the reductions in spending in the *Reference Projection* – a 2.8 percentage point of 2008 GDP cut by FY 2011 and constant in nominal terms thereafter (Case 1) – appears extremely challenging, even given the scope for reducing public investment and the government wage bill noted above. Indeed, the latter condition implies a 23% reduction in inflation-adjusted terms by FY 2023. Failure to meet the spending targets would require a larger revenue increase.
- Even if the spending targets were met and the consumption tax rate were raised to 10%, the *Reference Projection* (Case 1) shows a primary budget deficit through FY 2020. This seems incompatible with the objective of stabilising the debt ratio from the mid-2010s and reducing it from the early 2020s. Indeed, the debt ratio is constant between FY 2020 and FY 2023 even in Case 1 (see Figure 3.7).
- Continuing to run primary budget deficits for more than a decade leaves Japan vulnerable to a loss of market confidence in the sustainability of its public finances, pointing to the need for larger revenue increases to accelerate fiscal consolidation.

In addition to the size of the necessary revenue increases, there is also the question of timing, which was debated in the preparation of the FY 2009 tax law. Clearly, tax increases are contingent on an economic recovery. The Council on Economic and Fiscal Policy (CEFP) argued that tax reform should be implemented once observed growth exceeds potential.[25] While appealing theoretically, this approach has difficulties. *First*, there is great uncertainty about the potential growth rate, which has only increased since the onset of the crisis. *Second*, it is thought to be difficult in Japan to quickly implement a hike in the consumption tax rate once the condition is met, given the necessary administrative procedures and preparations. Thus, the authorities should be prepared to move ahead promptly with tax reform once a recovery is in place, rather than waiting for a mechanical trigger point.

The *Programme* offered a number of ideas for tax reform. *First*, additional consumption tax revenues are to be spent only on the social security system, *i.e.* pensions, health and long-term care and measures to raise the birth rate. *Second*, the personal income tax system should be revised by increasing the tax burden on high-income earners and reducing that on middle and low-income earners. *Third*, the corporate tax rate should be reduced and the base broadened. Given that the latter reforms may tend to be revenue-neutral, the consumption tax would be the primary source of additional revenue. However, the plan to dedicate additional consumption tax receipts to boosting social security outlays would mean that reducing the primary deficit from 8.1% of GDP in FY 2009 depends entirely on spending cuts and cyclical factors.

The recommendations in the 2008 *Survey* for a comprehensive tax reform plan for Japan remain pertinent, although little progress in implementing them has been achieved thus far (Table 3.7):

- The negative impact of taxes on economic growth can be minimised by shifting the composition of taxes from direct to indirect taxes. A hike in the consumption tax should thus be the main source of additional revenue, as proposed in the *Programme*.

Table 3.7. **Taking stock of structural reforms: reforming the tax system**

Recommendations in the 2008 *Survey*	Actions taken or proposed by the authorities
Consumption tax	
Boost the consumption tax rate from 5% to raise additional revenue and increase the share of indirect taxation.	No action taken.
Maintain a single consumption tax rate to avoid the complications inherent in multiple-rate systems.	No action taken.
Retain flexibility in allocating additional tax revenue.	No action taken.
As the consumption tax rate is increased, maintain the share that is allocated to local governments.	No action taken.
Corporate income tax	
Reduce the statutory tax rate by phasing out local taxes on corporate income.	No action taken. However, the temporary reduction in the national corporate rate for SMEs from 22% to 18% has reduced the tax base of the local inhabitant tax on corporations.
Broaden the corporate tax base by reducing the number and size of tax expenditures, particularly those that target specific industries and regions, thereby improving the allocation of resources.	The number of tax expenditures was unchanged while the amount fell slightly from 1.1 trillion yen in FY 2008 to 0.8 trillion yen in FY 2009. The ceiling on exemptions for entertainment expenses for SMEs was temporarily raised from 4 million to 6 million yen in 2009.
Maintain incentives only if rigorous cost-benefit analysis demonstrates that they expand productivity-enhancing activities to socially optimal levels.	No action taken.
Increase the proportion of firms that pay the corporate income tax by modifying generous exemptions allowed in the tax code, while retaining loss carryover provisions.	No action taken.
Personal income tax	
Raise additional revenue by broadening the income tax base, focusing on reducing the deduction for wage income and increasing the tax compliance of the self-employed.	No action taken.
Reform the deductions and allowances in the personal income and local inhabitant taxes that encourage secondary earners to limit their hours of work.	No action taken.
Reduce the preferential tax treatment of lump-sum retirement allowances in order to promote labour mobility.	No action taken.
Address income inequality primarily through the introduction of an Earned Income Tax Credit.	No action taken.
Reduce exemptions, which tend to benefit high-income households, such as the mortgage deduction, to help reduce income inequality.	No action taken. On the contrary, the mortgage deduction was extended and expanded as a part of fiscal stimulus. The amount of deduction for life insurance premiums was also expanded.
Strengthen pension taxation by reducing the deduction on benefits and taxing corporate-based pensions more strictly.	No action taken. On the contrary, the exemption of contributions to the defined contribution corporate pension plan was raised.
Broaden the base of the local inhabitant tax.	No action taken.
Continue to move in the direction of a unified tax on financial income at a uniform rate to reduce distortions in the allocation of capital, while expanding the scope of loss offsets between various financial investments.	The reduced tax rates on dividends and capital gains were extended for two years (until the end of 2011). Dividends on listed securities are combined with capital losses after January 2009.
Property and inheritance taxes	
Bring the assessment of property values used for tax purposes closer to market prices.	Preferred registration tax rates on real estate trade and entrustment were extended for two years. A new deduction scheme for long-term real estate holders was established.
Strengthen the role of the inheritance tax by reducing the basic deduction and raising the top tax rate, to promote equality.	No action taken. On the contrary, inheritance taxes for SMEs' equity and agricultural land were reduced. The exemption of gift taxes on bequests to family for housing investment was extended for two years.

- The *Programme* proposed to allocate all consumption tax revenues to social security. Although earmarking may make it politically easier to raise the consumption tax rate, it could also limit flexibility in spending.
- Broadening the corporate tax base, thereby lowering the proportion of firms that do not pay tax, would allow scope for cutting tax rates, which would be positive for economic growth, as proposed in the *Programme*.
- There is also considerable scope for boosting revenue by broadening the personal income tax base, given that less than half of wage income is taxed. One priority is to increase the proportion of self-employed income that is taxed. Raising tax rates on high incomes, which are already above the OECD average, should be avoided as it would reduce work incentives. Relative poverty should be addressed through the introduction of an Earned Income Tax Credit.
- Tax reform should also focus on improving the local tax system, which is exceptionally complicated, with 23 taxes, while allowing only limited fiscal autonomy to local governments.

Conclusion

Achieving fiscal consolidation will require a combination of discretionary spending cuts, reform of social insurance programmes and tax increases. The early announcement of a comprehensive medium-term consolidation programme, even if its implementation is conditional on actual economic developments, would sustain market confidence in fiscal sustainability and hold down the cost of financing higher debt levels. The key elements of such a programme are shown in Box 3.2.

Box 3.2. **Recommendations to achieve fiscal sustainability**

- Phase out the spending increases and tax cuts in the stimulus packages once the recovery has taken hold.
- Achieve a pace of fiscal consolidation that is at least as fast as that targeted by the previous government's medium-term plan to limit the run-up in debt and the risk of higher interest rates.
- Ensure the sustainability of public pensions by further raising the pension eligibility age if additional reforms are necessary in the future.
- Implement a programme of spending cuts, once the recovery takes hold, focusing on:
  - Cutting public investment, while allocating it on the basis of efficiency criteria and demographic changes, thereby mitigating the impact of the reduction in investment outlays.
  - Reducing the government wage bill, focusing on local jurisdictions, where wage levels seem out of line.
- Implement a comprehensive tax reform, as recommended in the 2008 *OECD Economic Survey of Japan*, to provide additional revenue, while increasing efficiency to enhance Japan's growth potential.
- Retain flexibility in allocating revenues which could be limited by earmarking.

Notes

1. The 2006 *Integrated Reform of Expenditures and Revenues* (CEFP, 2006), which was part of the *Basic Policies 2006*, established spending limits by category to achieve the FY 2011 target. It assumed 3% average annual nominal GDP growth over FY 2006-11.
2. In 2007, public social spending in Japan was 19% of GDP compared to an OECD average of 21%. According to one study, the stabilisation effect of social spending in Japan over 1980-2003 was the weakest among 11 major OECD countries under consideration (Furceri, 2009).
3. Such transfers do not directly boost effective demand. The overall figure also assumes that local governments spend the 0.6% of GDP in transfers from the central government rather than using it to reduce their own budget deficits, which would negate the intended economic stimulus.
4. In addition, the tax rate on some SMEs was reduced from 22% to 18% through FY 2010 and the basic exemption for gift taxes was expanded for a year to promote the transfer of housing to younger generations.
5. The decline was due to strong GDP growth and some one-off factors, notably a reduction in debt through a transfer from the Fiscal Loan Fund Special Account and the sale of government assets, which declined by 6.5%, from 397 trillion yen in March 2006 to 371 trillion yen in March 2007.
6. The effective interest rate on assets fell less, from 3.7% to 2% over that period, reflecting the fact that assets contain securities other than bonds. This helped reduce the net effective rate to below 1% in 2005-06.
7. One study compared the observed allocation of assets by international banks and their implied risk-returns against an optimal, risk-minimising allocation yielding a similar return (García-Herrero and Vázquez, 2007). The deviation of the actual allocation from the optimal one in Japan was 37 percentage points, biased toward domestic assets, from 1995 to 2004, the second largest gap among G7 countries after Italy.
8. See Table 3.5 in the *OECD Interim Economic Outlook* (March 2009). For example, Laubach (2003) finds that a 1 percentage point of GDP rise in expected fiscal deficits increases interest rates on ten-year US government bonds by about 25 basis points. There is also some evidence that interest rate effects are non-linear and tend to be greater at higher levels of indebtedness.
9. The annual revision of the mid-term policy plan, re-named the *Medium to Long-term Fiscal Policy and Economic and Fiscal Outlook for Next Ten Years* (hereafter the *Outlook*) in January 2009 had set an objective of achieving a surplus in the primary balance "as soon as possible", while "placing top priority on achieving an economic recovery" (Government of Japan, 2009b).
10. As noted in Chapter 1, there is a need for caution in comparing the percentages across countries, as these gross numbers do not include the impact of the tax system on social expenditure.
11. There was a temporary change in the indexation of pension benefits to prices. The fall in the consumer price index (CPI) between 1999 and 2001 was not reflected in pension benefits. To bring benefits back into line with prices, pension benefits will be adjusted in line with the CPI when it declines but not when it rises.
12. According to the 2009 *Reference Projection*, "macroeconomic indexation" will come into force sometime between FY 2012 and FY 2014 depending on economic developments and continue until 2038 when the replacement rate falls to 50.1%.
13. In the 2004 projection, indexation was projected to continue only until 2023. The expected delay of 15 years in ending indexation according to the 2009 projection is mainly attributable to changes in the population projection (MHLW, 2009).
14. Pension laws state that asset management should be "safe and efficient", thus giving little guidance. At present, 67% of the Fund is allocated to domestic bonds, 11% to domestic equities, 8% to foreign bonds, 9% to foreign equities and 5% to short-term liquidity.
15. In FY 2009, the eligibility age for receiving the flat-rate portion of the pension was 64 for men and 62 for women, respectively. It is to be raised to 65 in 2013 for men and in 2018 for women.
16. In Germany, for example, the lower boundary applies only to employees. Those earning less than € 400 per month do not have to pay social security contributions, but employers do have to pay. For earnings between € 400 and € 800, contributions increase gradually for employees. Thus, the incentive for non-regular employment applies only to employees and not to the employer.
17. There are also "rapid recovery" and "sluggish recovery" scenarios for the world economy.

18. Under the rapid recovery scenario, there is a case in which a primary budget surplus is achieved without any hike in the consumption tax rate.
19. The OECD's medium-term scenario is a stylised scenario based on a number of assumptions, including: *i)* the gap between actual and potential output is eliminated by 2017 and unemployment returns to its structural rate; *ii)* oil and commodity prices rise by 3% per annum in real terms; and *iii)* exchange rates remain unchanged in nominal terms (OECD, 2009b).
20. The definition of gross debt used in the *Reference Projection* – normal central and local government bonds and bank borrowing by the special account for the local allocation tax – is narrower than the OECD's general government measure. The OECD's SNA-based measure also includes Zaito bonds and other borrowings.
21. This calculation is for the 12 OECD countries with a government that is a net debtor and data on net debt and interest payments over the period 1991-2008. The effective interest rate exceeds nominal growth in each of the 12 countries.
22. An increase in the consumption tax rate assumed in the government projection affects the development of the GDP deflator instantly.
23. The goal in *Basic Policies 2006* of a 0.5 trillion yen cut per year requires reducing wage growth to 1.5% a year, which is far below recent trends.
24. The *Reference Projection* assumes a tax hike beginning in FY 2011. In Case 1, the consumption tax rate rises by 1 percentage point a year for five years. In other cases, the hike is accomplished in one or two steps, although this does not influence the FY 2023 outcome.
25. The CEFP is an important advisory body to the prime minister. Based on past data, an expert member of the CEFP argued that an acceleration occurs one year after the trough of the business cycle (CEFP, 2008).

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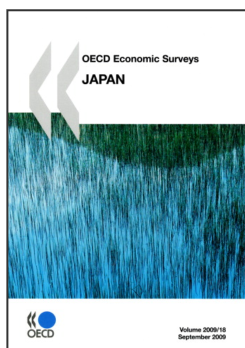

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