Economic Report Spring 2018

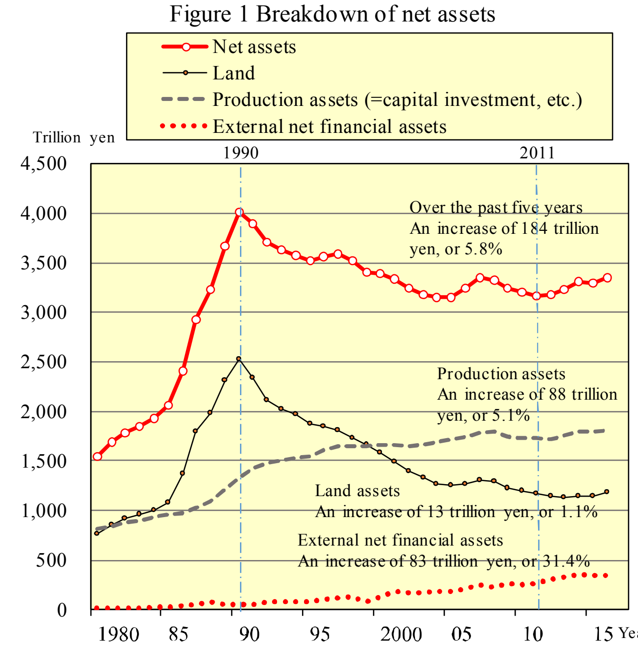
Fiscal Deficit and Solutions

According to the Annual Report on National Accounts for 2016, announced at this time by the Cabinet Office, the value of net assets in Japan, including land and buildings owned by the government, companies and households, has recently increased moderately, producing positive effects on the economy. However, as far as the government sector is concerned, it is highly likely that at some point in 2017 or 2018, Japan fell into a state of excess debt, with the value of debts exceeding the value of assets. The primary reason for this is that the share of the costs borne by beneficiaries themselves in the overall expenditures on healthcare for the advanced elderly (people aged 75 or older) is very low, at 10% in most cases, and that the own-cost burden rate is determined on the basis of beneficiaries' income level, rather than on the value of their asset holdings. In the case of private-sector companies, the status of excess debt could mean a very serious crisis that may cause failure at any time. Japan must quickly devise and implement improvement measures.

Net Assets in Japan and Correlation with the Real Economy

According to the Annual Report on National Accounts for 2016, announced by the Cabinet Office, the value of net assets in Japan, including land and buildings owned by the government, companies and households, has trended downward since the bursting of the economic bubble in the early 1990s, as shown in Figure 1. Although the value of production assets, including capital and inventory investments, has trended upward while repeating ups and downs, the value of land has continued to fall after peaking in 1990, mainly because of land price drops. The decline in the value of net assets, which reflected the economic stagnation following the bursting of the

Figure 1 Breakdown of net assets



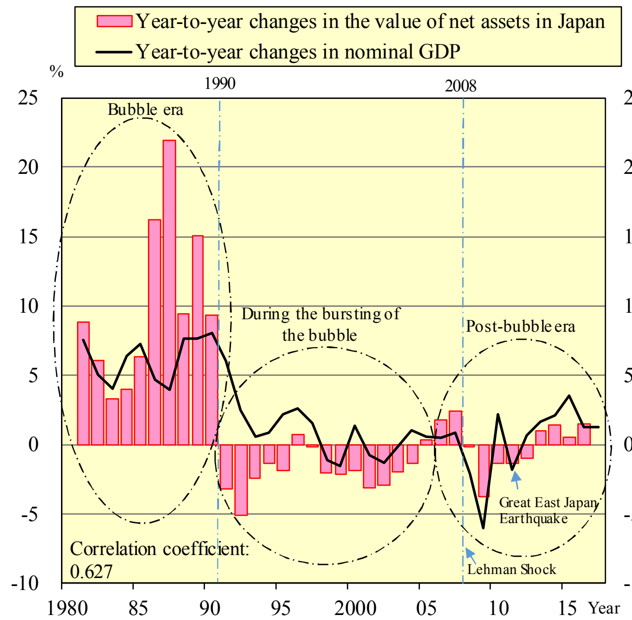
Source: Cabinet Office

economic bubble, further dampened the economy, setting back the post-bubble recovery. Japan has long remained trapped in a sense of stalemate, as one “lost decade” turned into two.

However, over the past several years, the value of net assets has been starting to rise moderately at long last. Over the five-year period from 2011 to 2016, the value of net assets increased by ¥184 trillion, or 5.8%. Looking at the asset amount by type, the value increased for all types of assets: an increase of 88 trillion yen, or 5.1% for production assets; an increase of 13 trillion yen, or 1.1% for land; and an increase of 83 trillion yen, or 31.4%, for external net financial assets. The value of external net financial assets increased due to growth in external financial claims, including foreign investments, loans, stocks and bonds as Japan continued to record a current account surplus. The increase in the value of net assets is gradually starting to make positive contributions to the real economy.

The correlation between the value of net assets and the real economy is depicted in Figure 2, which indicates year-to-year changes in the value of net assets and in nominal GDP.

Figure 2 Changes in the value of net assets and nominal GDP



Source: Cabinet Office

In the second half of the 1980s, which is characterized as a “bubble period,” the value of net assets continued to grow at an annual rate of between 10% and 15%, with the growth rate peaking at 22.0% in 1987. The increase in the value of net assets is attributable in large part to a land price upsurge, which was triggered by increased investment demand reflecting robust economic conditions. As the land price upsurge increased the value of assets owned by companies and households, consumption and investment grew, resulting in a virtuous circle of increases in consumption, investment and land prices contributing to one another. This economic impact is called a positive wealth effect. The value of net assets grew from 2,057 trillion yen in 1985 to 4,012 trillion yen in 1990, translating to an average annual growth of around 400 trillion yen. This means that the overall value of assets in Japan was increasing annually in an amount roughly equal to the size of the country's nominal GDP at that time, which was between 300 trillion and 400 trillion yen.

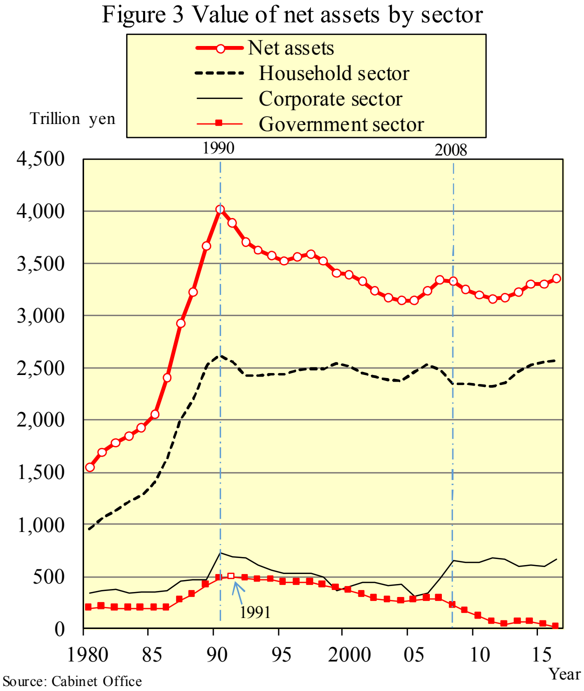
However, after 1991, when land prices started to fall in a reversal of the excessive rise, the "positive wealth effect" of net assets on the real economy turned into a "negative wealth effect" and the value of net assets continued to decline on a year-to-year basis until 2004. In the period of around 15 years since the bursting of the bubble, the land price fall has continued to reduce the value of net assets, creating a negative wealth effect, which has restrained consumption and investment. Moreover, decreases in the collateral value of net assets and in the amount of equity capital have constrained companies' investment behavior and financial institutions' lending stance. Companies' financial strength was drained by efforts to reduce nonperforming assets as the value of assets owned by them declined with the passage of time. As a result, the average annual growth rate of nominal GDP between 1992 and 2004 was only 0.6%, or one-tenth of the average growth rate in the 1980s (approximately 6%).

Since 2005, capital investment has increased in line with the economic recovery, and since 2013, land prices have risen, mainly in the Tokyo metropolitan area. Consequently, the value of net assets in 2005 recorded the first positive growth, 0.1%, in seven years. However, the value of net assets declined again later due to the adverse effects of the Lehman Shock in 2008 and the Great East Japan Earthquake in 2011. In 2012, the value of net assets started to grow again.

Net Assets in the Government Sector and the Current Fiscal Situation

One major problem for the Japanese economy is that the value of net assets in the government sector, which previously accounted for just over 10% of overall net assets, has been reduced to almost zero. By sector, the household sector is the largest asset holder with a share of 76.8%, as shown in Figure 3, followed by the corporate sector with a share of 19.8%. The combined share of these two

Figure 3 Value of net assets by sector



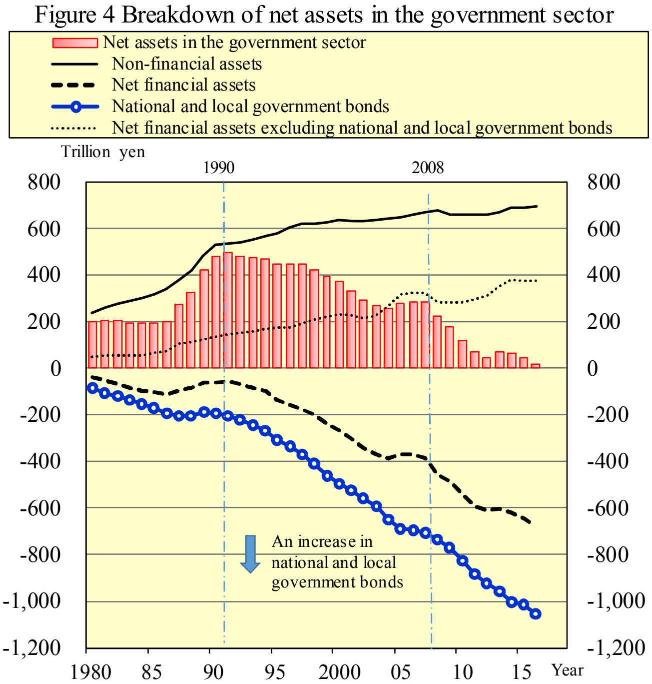
Source: Cabinet Office

sectors is 96% (2016).

Meanwhile, the value of net assets in the government sector, which previously had a share of just over 10%, declined from 496 trillion yen in 1991 to only 18 trillion yen in 2016, representing a decrease of 478 trillion yen, or 96.4%. The decrease in the value of net assets is equivalent to around 90% of Japan's nominal GDP. The average decrease was 11 trillion yen over the past five years and 27 trillion yen over the past 10 years, so it is highly likely that the government sector fell into a state of excess debt at some point in 2017 or 2018. In the case of private-sector companies, the state of excess debt could mean a very serious crisis that may cause failure at any time unless there is a supporter willing to provide additional financial assistance.

Figure 4 shows a breakdown of net assets in the government sector into non-financial assets and net financial assets and a breakdown of net financial assets into national and local government bonds and other assets.

Figure 4 Breakdown of net assets in the government sector



Source: Cabinet Office

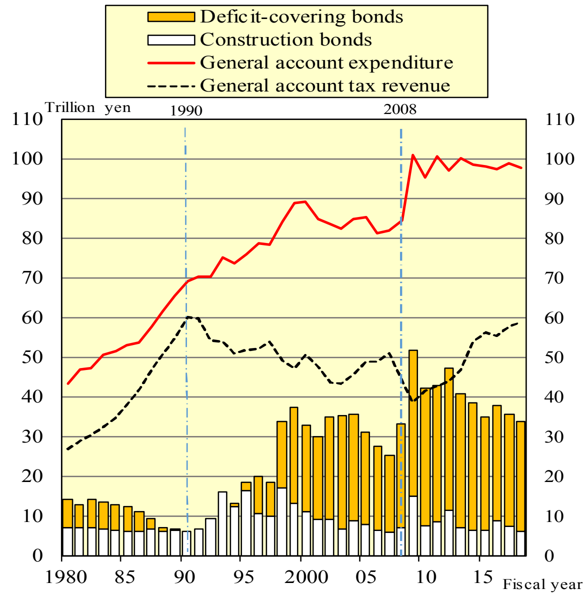
From this figure, it is clear that the outstanding balance of national and local government bonds has almost consistently continued to increase (a downward shift in the figure indicates an increase), resulting in a decline in the value of net assets in the government sector.

Over a 36-year period, the value of non-financial assets in the government sector increased by around 700 trillion yen. The value of net financial assets excluding national and local government bonds grew by around 400 trillion yen due to increases in foreign currency reserves, stocks and investment trusts. However, as the outstanding amount of national and local governments rose very steeply, by around 1,000 trillion yen, the value of net assets in the government sector has fallen to almost zero.

The reason why the outstanding balance of national and local government bonds continued to increase significantly is that the amount of expenditure remained far higher than the amount of tax revenue in the budget general account for a long period of time.

Figure 5 shows changes in the amounts of expenditure, tax revenue, and deficit-covering bonds and construction bonds issued in order to make up for the tax revenue shortfall. While the issuance of construction bonds leads to an increase in assets, the issuance of deficit-covering bonds merely increases the amount of debts. Until 1990, the growth in tax revenue remained higher than the growth in expenditure, temporarily shrinking the budget deficit. However, thereafter, the budget deficit grew again as expenditure continued to increase while the tax revenue declined further, and most of the revenue shortfall was made up with through the issuance of deficit-covering bonds.

Figure 5 General account expenditure and tax revenue, and deficit-covering and construction bonds



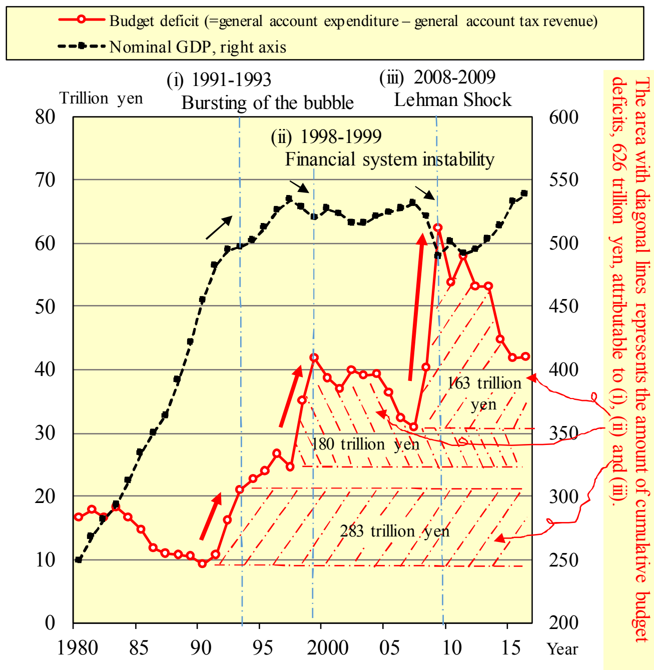
Source: Ministry of Finance

Two Causes of the Deterioration of the Fiscal Situation

There were two major causes of the continuation of the huge budget deficit.

One was that the government significantly increased public investment while reducing taxes collected from companies and households as an economic stimulus measure after the bursting of the economic bubble. Figure 6 shows changes in the budget deficit and nominal GDP. In Japan, the budget deficit grew significantly in three periods: (i) 1991-1993, immediately after the bursting of the bubble; (ii) 1998-1999, a period of financial system instability; and (iii) 2008-2009, immediately after the Lehman Shock. Even when fiscal pump-priming is implemented during a crisis, growth in

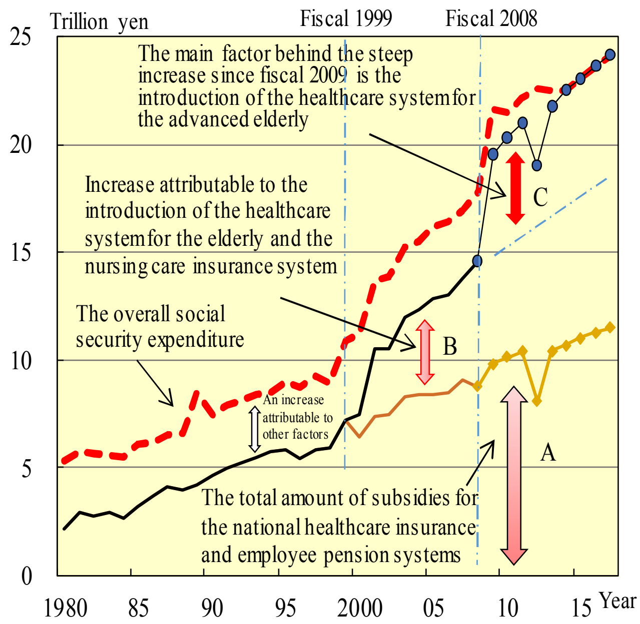
Figure 6 Budget deficit and nominal GDP



Source: Ministry of Finance, Cabinet Office the budget deficit will be temporary if the economy recovers. However, that was not the case during those periods, when the budget deficit snowballed due to expenditure increases and tax cuts. The combined increase in the budget deficit amount in the three periods is 626 trillion yen, which is equivalent to 54% of the combined budget deficit amount between fiscal 1980 and 2017, which is 1,160 trillion yen.

The other major cause of the budget deficit expansion is an increase in social security expenditure. The combined social security expenditure amount in the three periods is 489 trillion yen, which is equivalent to 42% of the total budget deficit amount. Figure 7 shows social security expenditure by major item. We created this figure by combining two datasets, one published by the Ministry of Finance and the other by the Ministry of Health, Labour and Welfare, as it was necessary to do so because of frequent changes in the itemization of social security expenditure. While the need to combine two datasets is in itself a problem, this figure makes clear that there are three factors behind the steep increase in social security expenditure.

Figure 7 Three major factors behind the steep increase in social security expenditure



Note: In fiscal 2009, the proportion of the national government's cost burden in basic pension expenditure was raised from one third to a half, with the additional cost burden included in "A" (approx. 3 trillion yen in fiscal 2009).

Source: Ministry of Finance, Ministry of Health, Labour and Welfare

The first factor is a continuous rise in the subsidies for the national healthcare insurance and employee pension systems (represented by "A" in Figure 7). The subsidies accounted for around half, 48%, of the total social security expenditure in fiscal 2017.

The second factor behind the steep rise in social security expenditure since 2000 is the introduction of the healthcare system for the elderly and the nursing care insurance system (represented by "B" in Figure 7) in fiscal 1999 and the healthcare system for the advanced elderly (represented by "C" in Figure 7) in fiscal 2008. The fact that the nursing care insurance system is a factor of the huge budget deficit is widely known because various discussions were held before its introduction. However, the public's understanding of the healthcare system for the advanced elderly may not necessarily be sufficient. Put simply, the healthcare system for the advanced elderly enables people aged 75 or older to receive public healthcare service at a very low own-cost burden rate: in principle, individuals pay only 10% of the total cost (the rate is 30% in the case of individuals with an income level similar to that of working-age people). As most people can receive healthcare service under this system at an own-cost burden rate of 10%, it is inevitable that the fiscal burden on the government will grow.

Three Solutions toward Fiscal Consolidation

Achieving fiscal consolidation by restoring the critical fiscal condition to health is a very important challenge for Japan. Unfortunately, however, measures so far implemented are unlikely to be effective in overcoming the challenge. While it goes without saying that it is essential to minimize wasteful spending, I would like to propose solutions from the following three viewpoints.

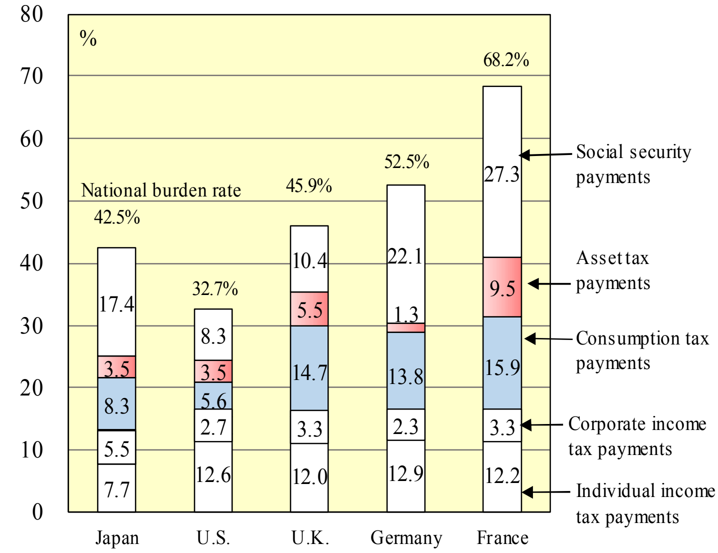
First, concerning the sharing of the social security cost, which is expected to continue increasing significantly, it is necessary to shift to a system that takes into consideration the value of assets, rather than the income level. Most elderly people have relatively small income on a flow basis as they depend on pensions. It is essential to quickly devise a system under which elderly people share the cost in accordance with the value of their financial and non-financial assets.

Second, it is necessary to consider how the consumption tax rate should be raised. In the past, the consumption tax rate was raised by a relatively large margin, 2 or 3 percentage points, at a time. As a result, the economic conditions turned down seriously after each consumption tax hike. In the future, it will be essential to mitigate the impact of tax increases by minimizing the margin of each tax increase and by applying reduced tax rates to some items. In the case of the 28 EU member countries, for example, consumption tax hikes have been implemented in much smaller increments than in Japan: the margin of increase was less than one percentage point in around 40% of the total of more than 100 consumption tax increases implemented in the EU countries and was between 1 and 2 percentage points in around 30%.

Third, Japan must devise a system to levy tax in accordance with the value of assets. The total value of assets in Japan, including financial assets, has already exceeded 10,000 trillion yen (10,496 trillion yen as of the end of 2016). The universal imposition of a 0.1%

tax on all assets would increase annual tax revenue by 10 trillion yen. Figure 8 shows a comparison between major countries in terms of the breakdown of the national burden (tax and social security payments). The share of asset tax revenue in national income in Japan is 3.5%, lower than the shares of 9.5% in France and 5.5% in the United Kingdom. If the share of asset tax revenue rises, the liquidity of assets will increase, and this change will create new opportunities to make investment and earn profits. Unless the existing systems are drastically reformed, it will be difficult for Japan to avoid fiscal collapse.

Figure 8 International comparison of the breakdown of the national burden (as a share of national income)



Note: The figures for Japan are those in fiscal 2017 and the figures for other countries are those in 2014.

Source: Ministry of Finance

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FINANCIAL FORUM 2018. Spring №120