

Roundtable Discussion

(1) Keynote speaker: Glenn Hubbard (Chairman of United States Council of Economic Advisors)

- One lesson to be learned from the experience of the United States is that tax system reform needs to be discussed in a long-running process that also involves education. In that sense, meetings like this are very important in that process. Tax reform disputes have been central issues both in the economics of tax reform and also in the political economy of tax reform. Both are important. Mainly, the former concerns economic efficiency, while the latter concerns simplification. However, there is empirical evidence that the complexity cost of tax codes in the modern era are actually quite high.

- The Tax Reform Act of 1986 (TRA86) was the result of two years of academic study conducted by the Ministry of Finance. The tax cut (EGTRRA) legislated last year was the result of several years of thought conducted by specialists in public economics.

- The lesson taught by the United States experience of tax reform is that tax changes have very important economic effects. They affect not only taxable income or tax revenues, but also labor supply (especially, secondary earners), savings, investment, and entrepreneurship and the willingness to take risks. Particularly, the effect of a marginal tax rate cut is considered big.

- The second lesson is that it is preferable to globally discuss elemental matters such as reducing the marginal tax rate, broadening of the tax base, capital income tax cuts, and others more than to dispute about specific forms.

- Third, tax reform brings significant economic effects. In the United States there are estimations of effects brought by the tax reforms implemented in 1981, 1986, and 2001. According to these estimations, the long-term annual growth rate of GDP increased by 0.1 percent and created the improvement effect of economic welfare.

- The final lesson is that major tax reform can be good not only for long-term economic growth, but also for the support of economic recovery.

- At present Japan's target is to increase the potential growth rate. To this end, it is good to decrease taxes that incur, particularly the highest deadweight loss such as real estate transaction taxes, capital gains taxes, and the high effective marginal tax rates associated with the income tax system.

- According to the recent evidence by Kenneth Kuttner and Adam Posen, the fiscal multiplier on tax system changes is much larger than that on spending. Capital income tax changes can provide important support for restructuring through their effect on asset values. And likewise, tax policies like the two-percent surcharge on

the choosing of consolidated tax drops by companies would be particularly unwise in an environment in which restructuring is to be encouraged.

- It is necessary to discuss focusing on three important principles of tax reform, and it's important to broaden the tax base while keeping the marginal tax rate low, to promote economic growth, and to simplify the system.

- There are at least five common misperceptions: that economic gains are negligible in any reform; that tax reform is regressive; that the differences between income and tax reforms and consumption tax reforms are large; that the transition costs are enormous; and that tax system reform is "all or nothing." These are all mistaken notions that have powerful counterarguments.

(2) Keynote speaker: Naosumi Atoda (Keio University)

- In Japan today, the disputes about the tax system reform conflict with the principles of tax system. In other words, the government's Tax Research Commission stresses fairness, neutrality, and simplicity, while the Council on Economic and Fiscal Policy puts weight on fairness, vitality, and simplicity. On my opinion, the most important principle of the current tax reform should be vitality. I think it is an important reform orientation to create new growth paths. In this connection, I think Chairman Hubbard expressed the same opinion.

- Another important point to remember is we should not interpret the tax system reform as something that will come easily; it is part of structural reform. This means the introduction of a tax system that facilitates changes in the country's industrial structure. It is also important to aim toward creating a "small government". This, for example, means the introduction of a tax system that cuts public works by the government and gives preferential treatment to private investment. Tax reform should emphasize research and development and aim for technological innovation.

- It is impossible to shrink toward "small government" under the premise of tax revenue neutrality. It is necessary to implement annual expenditure reform and tax reform together. Moreover, it is crucial to conduct tax system reform that will restore confidence in the Japanese economy.

(3) Keynote speaker: Takatoshi Ito (Tokyo University)

- My opinion concerning the tax reform is similar to Chairman Hubbard's. My worry, however, is that tax reform arguments in Japan will lead to arguments to cut taxes, and that may be slightly more controversial than tax reform. It is more likely that the tax cuts and public expenditure will grow due to political pressure.

- When disputing about flow (fiscal deficit and others), we should not neglect the size of stock (long-term outstanding liabilities). Since

the results of Kuttner and Posen are derived from long-time series data of the 1970s and 80s, when public finance was healthy, it is very questionable that these coefficients would apply to the 1990s and beyond. It is necessary to consider the 6 percent fiscal deficit with respect to GDP in connection with the 140 percent long-term outstanding debt with respect to GDP. This implies that without major reform, long-term outstanding debt will balloon to 200 percent in five or six years, which may well lead to bankruptcy. Moreover, if we take into account the existence of so-called hidden deficits, I could be underestimating the figures.

- Some people dispute that fiscal policy is effective for the stabilization of the economy, but I think that fiscal policy lost its effectiveness because of the rise in the debt-to-GDP ratio. Households and corporations anticipate substantial tax raises and pension cuts in the future; they thus start behaving with Ricardian neutrality. Moreover, the debt-to-GDP ratio continues to rise, and there is a smaller margin of policy error in the future. The risk of shock is increasing.

- People also exercise caution against the harmful effect of discretionary policy. This is often seen during the discussions of the supplementary budget, when, under the political pressure, the multiplier may be just one, but inefficient expenditures with more than twice the contingent liabilities are implemented. In this case, fiscal policy is rather likely to exert a negative effect on economic stimulus.

- Deficits that increased in the 1990s were due to tax reduction, not higher spending. It was more structural than cyclical. The structural deficit is about 3 percent of GDP. So even if the GDP growth rate goes back to a path of potential growth, you are left with a deficit. It is of course ideal not to do any damage to any economic recovery, but it is necessary to take aim at tax increases in the medium run. In Japan the tax-GDP ratio is low; high taxes are not a source of the problem. Consequently, the changing of tax items, tax rates, tax base, and other tax-related areas is important. But as a gross number, broad-based, across-the-board tax cuts are not the answer.

- The problem with the Japanese tax system is that there are many, many people who pay no taxes. About 1/4 of or what we call "salary men" are employees who don't pay income tax. We should not lower the top end of the marginal tax rate due to political pressure and neglect the broadening tax base.

- It is necessary to put the tax reforms in the context of not increasing the debt-to-GDP ratio. We should cut public works and probably actively reshuffle spending items from the very low multiplier projects to very high multiplier projects. Furthermore, Martin Feldstein's idea is to cut the consumption tax rate temporarily and then to increase it gradually (for example, cut the consumption tax to 3 percent now, but increase it by single-percentage increments until it reaches 8 percent). This may

be a good idea to stimulate consumption now, but we should try to get a medium-run tax increase. It is also important to close the loopholes of the consumption tax. It is also possible to cut the gift and inheritance tax rates to stimulate the smooth transfer of wealth from elderly people to their children and grandchildren. Maybe for now, we should cut public works and tax revenues by the same amount-which actually goes against the balanced budget multiplier theorem. This would be an unconventional approach, but one that, I feel, is a good suggestion for the medium-run, given that the debt-to-GDP ratio is so high.

(Kotlikoff)

- I would like to ask Chairman Hubbard: What do you think about the interaction between monetary and fiscal policy? Would you agree with my view that the government should print money, and buy back the existing government debt, in order to control the debt-to-GDP ratio?

- You would agree with raising taxes and broadening the tax base to decrease the deficit. Japan's recession is deep; competition from China and other parts of Southeast Asia is heating up, Japan has a falling labor force growth rate, and a slowdown in technological change is evident. This situation may continue for the next 10-15 years. It is necessary to take care not to repeat the experience of Argentina, which pursued temporal budgeting that eventually resulted in financial collapse.

(Hubbard)

- In Japan it is very important to link the discussion of fiscal and monetary policy. Provided that the current monetary policy in Japan remains insufficient to arrest deflation, it is difficult to think about the desirability of a tax increase right now. It is important to look at the fiscal health of Japan long-term. Moreover, I agree that it is necessary to cut public works spending, but I do not think that raising taxes in the short run would be in the country's interest.

- The comparison with Argentina is not appropriate as Japan is a large creditor, unlike Argentina. I think the question for Japan is that you have a more sound fiscal policy, and you must pursue a monetary policy that's aimed more at price stability than the current monetary seems to be.

(Kotlikoff)

- Japan would look worse than Argentina right now, if you include all the liabilities, the demographic issues, and the interaction with pensions. The savings behavior is different, yes.

(Auerbach)

- I wonder about the credibility of the policies that involve future actions. The Japanese people understand that fiscal policy is unsustainable and they will have a tax interest in the future. However, the policy should have no effect on the announcement of a future tax increase. It is necessary to begin the policy implementation in a simple form now. I think that increasing

consumption taxes may be the way to go in the long run, but taking into account the effect on individual consumption, a tax on savings is preferable to the consumption tax in the short run. It is also possible to cut government spending, accompanied by smaller tax cut.

(Hubbard)

- I do not think that a savings tax would be wise in the short run. Particularly, it is not expedient to increase a tax that's capitalized in asset values, which would be very good in an economy with fragile balance sheets. Raising taxes in the short run does not seem good.

(Auerbach)

- I meant not a capital income tax on dividends or interest, but a tax on savings flow. But I think that this tax would have a smaller effect on consumption as compared to a consumption tax. A tax on savings is not desirable in the long run. The desirable policy in both the long run and short run may be in monetary policy.

(Kotlikoff)

- Japan has tried Keynesian stimuli, but they have not worked; they only increase the nation's burden. Not dealing with these fundamental concerns could actually be making the situation worse.

(Ito)

- I think the role of economists comes in here. In Japan there are more Keynesians than real business cycle theorists. There was one

very influential economist who came from United States in 1997 and advocated the stimulus package very strongly.

(Patrick)

- It seems to me that the fundamental cause of the recession over the last ten years has been that savings have been so much greater than investment. Japan is such a large country; increasing exports in an economy this size is no simple matter. Until now, excess savings have been absorbed unproductively by investments in low-productivity sectors. It is important to consider how to absorb savings productively. If you want to reduce taxes, it is possible to levy a tax not on corporate income and dividends, but on retained earnings. Retained earnings are 100 percent savings, but part of dividends eventually gets into consumption. This might be an effective method to reduce savings in the short run.

(Saxonhouse)

- In 1997 the consumption tax rate was increased, as the Japanese government said. In the two quarters that preceded that increase, the economic conditions were good and a reactionary decrease occurred after the introduction. As Professor Ito was suggesting, it is necessary to raise the consumption tax gradually until the prospects of fiscal reconstruction become brighter. In this case the reaction to the previous period should not occur after the introduction.

(Weinstein)

- The major problem facing Japan is that it is caught in a deflationary spiral and the Bank of Japan is not pursuing a policy that is sufficient to end deflation. It is indispensable to consider how to use tax system reform as a way of generating consumption or generating price increases.

- It is necessary to pay attention when comparing government debt in the United States and Japan. In Japan the government itself holds large amounts of the bonds. The net debt does not exceed the half the gross debt. Moreover, net debt exceeds the amount of bonds held by the private sector. This is because the Bank of Japan holds such huge amounts of bonds. Taking this into consideration, you should use a little caution; a catastrophe in the Japanese economy could happen in the future.

(Hamada)

- Those who advocate an expansionary fiscal policy point out that public-related corporations hold the majority of public bonds. This is a fact, but these funds are financed again by the postal savings system of the people. So they are borrowing anyway.

- 37 percent of fiscal expenditures are financed by government bonds. This will be compensated by a promise from future taxpayers. But we cannot justify this situation now. It is necessary to do something.

- A decrease in the marginal tax rate is desirable for international competition and other reasons. It is also necessary to take a

lump-sum type of taxation like *gaikei-hyojun-kazei* - that is, external promises taxes regardless of economic activities - or reducing the minimum untaxable limit, but those choices are the most difficult politically.

- Dr. Hubbard said that the consumption and income tax do not make much of a difference. Are you considering all the inter-temporal effects in the future, or just more or less contemporary effects?

(Hubbard)

- Take a prototype for a consumption tax as being a flat tax and perfect income tax described in the textbooks. It can be said that consumption and income taxes do not have large a difference in distribution and effects, except for depreciation instead of expenditure at the firm level.

(Kashyap)

- It is important to be aware of the difference between net and gross debt. Many of the public corporations are still filing the same returns they were before; it is thus impossible to swallow the difference between net and gross debt as published figures. The postal savings system is considered to be 100-percent guaranteed, but in reality the quality of the collateral through different transactions is probably the same as that of the private-sector financial institutions. The government could force the local government to publish more transparent and reasonable accounts; it could really crack down, which would include instructions to local

governments.

- I would like to comment on Professor Patrick's proposal about taxing only retained earnings. The problem is that there are non-profitable firms that are not paying any taxes. The existence of these inefficient firms may lower the potential growth rate. It probably is important that, before we design a tax reform scheme, we come to some arrangement about why growth is so depressed.

(Kotlikoff)

- In the book edited by Professor Auerbach and myself, we considered generational accounts across the world in different countries, but Japan had the worst situation. We used four-year-old data, but now the situation is even worse. Therefore, we should not be talking about cutting taxes. It is essential to discuss how to restore confidence in the Japanese economy.

(Morinobu (Vice President of Policy Research Institute, Ministry of Finance))

- According to my calculations, the income tax base in Japan is about half that of the United States. This is primary due to the deduction of public pensions and social security contributions. In the future, the situation is expected to worsen due to the aging of the population. With this in mind, the biggest subject we face is not how to increase current tax revenues, but how to widen the tax base to prevent tax-revenue erosion in the future.

- In Japan today, capital gains taxes are very much unequal because they are based on deemed capital gain. The Ministry of Finance is considering revising this kind of taxation to a taxation based on realized capital gain. On the other hand, there is a policy-oriented opinion that says we ought to reduce the capital gains tax to shift from indirect financing to direct financing. The optimal concept to coordinate these two different issues is dual income taxation. The most important thing to consider in a capital gains tax is how to treat capital losses. Under dual income taxation, like that of the northern European countries, capital losses in the stock market can be offset from interest on dividends or even profits from real estate.

- It is reasonable to discuss tax reform within the framework of revenue-neutrality. Otherwise, tax cuts will increase. Moreover, many people in the Ministry of Finance think that the target of tax reform is economic growth, but judging from the experience of the past they tend to think that tax cuts are not really an efficient policy for economic growth. The important thing is how these tax reforms affect savings, consumption, economic growth, and other areas. This is often discussed in the government's Tax Committee.

(Harada)

- Tax reform in the Reagan Administration took place during a time of inflation. The Japan economy today is experiencing deflation. I would like to ask Chairman Hubbard if he thinks that a Reagan Administration type of tax reform would be successful in Japan?

- Professor Ito pointed out that Japan's fiscal deficit is a structural deficit that occurred due to tax reduction. I mean, if the Japanese economy is not in deflation, then tax revenues should be much higher. So I think this is not really a structural deficit, but a deflation deficit.

(Hubbard)

- The Reagan Administration tax cuts were really "bracket creep" with inflation. The recent tax cuts in the United States were real bracket creep. These tax cuts will be very effective in the future as well. Deflation is really a monetary phenomenon and that is a right venue for taking about deflation.

- I agree with the opinion that if there were no deflation, the fiscal situation of the Japanese would improve.

(Ito)

- I agree that in Japan there is reverse bracket creep. However, the deflation rate is 1 percent; at this moment, at least, it is not so serious.

- Deflation is fundamentally a monetary phenomenon, and its cure rests with the Bank of Japan. But given that kind of deflation, I think the fiscal situation will get worse, and that we have to do something about it.

(Auerbach)

- In connection with the capital gain tax, the chance of more fundamental reform can be missed in the discussion of the enhancement of loss deduction. Besides, even if a tax is imposed on realized gains, unlimited deductions should not be allowed.

(Akai)

- It was argued that a tax cut should not be considered, but if the inefficient expenditures are curtailed as the result of the reform on the expenditure side, it will be possible to cut taxes and, at the same time, maintain the soundness of public finance. In other words, it is fiscal neutrality reform.

(Hubbard)

- Many economists agree with the necessity to cut wasteful expenditures. It is clearly desirable, but its feasibility is really a political question.

(Kaizuka)

- The main reason for Japan's long-term deflation and economic slump was Japan's bubble economy; monetary policy was also very important. Nonetheless, the Bank of Japan was strongly affected by the decisions of the Ministry of Finance, and could not take prompt measures to deal with the bubble. There was also a delay also in response after the collapse of the bubble. On the other hand, large-scale public investments were made that led to substantial increases in the budget deficit.

- The interest rate has been reduced to almost zero, but the effect has been small because the ratio of base money to money supply is very high, and private banks are accumulating deposits in the Bank of Japan account. Restraints on monetary policy are clear. Provided the huge deficit, it is difficult to use fiscal policy. We need an approach different from the American one concerning the relationship of fiscal and monetary policies.

(Kotlikoff)

- If the Bank of Japan could print yen to a total of about 1.4 times GDP, it could purchase back all the official debt. Using monetary policy as a fiscal instrument like this would change the whole situation for Japan's long-term fiscal problems. I do not understand the argument that monetary policy has reached its limit only because interest rates are zero.

- The same policy should be implemented in the United States, as long-term debt is expected to increase due to the tax cuts conducted by the Bush Administration.

(Hubbard)

- In the case of Japan, there is no free lunch. If Japan's fiscal situation were unsustainable, moving that onto the Bank of Japan's balance sheet would be still a burden that Japanese taxpayers will have to bear.

(Kotlikoff)

- There is no free lunch in the sense that the seignorage profit and

taxpayers' burden would be balanced. But it is possible to impose taxes over a long-term period.

(Hubbard)

- I don't suggest that approach, but it is for the Japanese taxpayers to decide.

(Hamada)

- I am advocating about 30 percent of what Professor Kotlikoff says, but few people listen to me in Japan! It is difficult for me to understand, but most Japanese newspapers insist that deflation should be tackled through fiscal policy and structural reform.

- It's the only time that we can monetize public debt without harming people by inflation, but when to stop this monetization is a delicate problem. If somebody succeeds in generating inflationary expectations, the market bond rate and public bond rate will rise and the Bank of Japan and city banks will incur capital losses. In other words, somebody must bear the costs, as Chairman Hubbard says.

(Ito)

- There is no free lunch, but the price of the lunch could be different according to the present action. It is important to pursue an expansionary monetary policy and to raise taxes or, at least, not to reduce them. Otherwise, I think that the lunch we'll be eating five years from now will be extremely expensive.

(Ushijima)

- At present, the outright purchase of government long-term bonds by the Bank of Japan amounts to about a trillion yen per month. The annual amount is more than 10 trillion yen. It can be interpreted that the Bank of Japan has already monetized about one-third of the 30 trillion in new issuances of government bonds.

- Buying up all the outstanding government debt could lead to the destruction of fiscal discipline and a great deal of moral hazard, and eventually inflict serious damage on the Japanese economy in the long run. We have had some bitter experiences. This is why the law abates the monetization of new government debt by the Bank of Japan.

(Kotlikoff)

- There is a trade-off between present inflation and future inflation. You are now in such a convenient situation that prices may start to rise due to monetization of not 140 percent, but 30 percent of GDP. I think nobody would be opposed even if a 10-percent inflation were generated.

(Kashyap)

- I think Mr. Ushijima pointed out the mini hyperinflation during the postwar period. However, unlike today, at that time the starting point was not deflation.

- The Financial Service Agency does not disclose the actual situation with the non-performing loans. If prices rise and trigger a sharp increase in interest rates, the companies on the edge of bankruptcy would not be able to pay the interest on their debts, and the hidden non-performing loans would become evident. This is a very important point.

- It is not necessary to continue the buying operations until the amount reaches 140 percent of GDP.

(Weinstein)

- Even if the Bank of Japan purchased all the government bonds, 120 percent of GDP, in addition to those it already holds, Japan's gross debt would not change. This would mean only a change of ownership.

- According to a study on the balance sheets of public corporations, bad assets amount to around 10 to 20 percent of total assets. That is well below the implicit assumption of 100 percent of bad assets, which justifies this 140 percent number.

(Patrick)

- The most important issue is to pursue an aggressive monetary policy sufficient to change the expectations on price levels. It is enough to announce publicly that the buying operations will continue until deflation is defeated, rather than stating a target like 1 trillion yen monthly.

- The Bank of Japan seems to fear that excessive inflation expectations will be formed in the present situation of increasing excessive liquidity. The Bank of Japan should consider the measures it will need to take at the next stage, when inflation expectations become substantial.

(Kashyap)

- First of all, it is necessary to raise prices by 15 or 20 percent. Then, only once inflation has been realized, it is good to start talking about inflation targeting. The Bank of Japan should make efforts to raise prices and, if it gets out of hand, to adopt measures introduced by other developed countries. There is no reason to think that this would not work.

(Harada)

- It really seems to me that the Bank of Japan is screaming "Fire!" while a flood is raging.

- The relation between monetary policy and fiscal policy is complicated in a political sense. Politicians can increase public works while recession continues due to deflation, but if deflation ends, pressure on politicians to increase public works will lessen. I think this is the main reason why politicians do not put pressure upon the Bank of Japan to increase the money supply.

(Ihori)

- Monetary policy is extremely important, but the title of this

conference is “Tax Reform.” Let’s move back to this issue.

(Atoda)

- It is important to reduce the size of the Japanese government as much as possible. Most of the necessary infrastructure was in place roughly by 1982; what we built after that was more than necessary. Today, public investment occupies 6 percent of GDP, but it is necessary to cut it to 3 percent; the remaining 3 percent is for maintenance. And concerning the reduced portion of 3 percent, the argument is divided whether to use it to reduce the budget deficit or to use it for a tax cut.

- To revitalize the Japanese economy and put it on a new growth path, it is necessary to conduct tax system reform, including tax cuts. Investment and consumption should be stimulated. It is necessary to cut corporate taxes at first, and after that to broaden the tax base of income tax while reducing the marginal tax rate. To broaden the tax base, the argument should focus on the inequalities of tax burden, such as “Kuroyon,” by keeping track of income more clearly.

(Iwamoto)

- It is vital to raise taxes to achieve the sustainability of public finance, but that is a politically difficult proposition to make while many government expenditures remain insufficient. Consequently, in my personal judgment, tax system reform should not have been taken up this year. However, once the government has taken it up as a policy issue, discussion on the relation between sustainability and

the tax system is inevitable, and it is necessary to draw a conclusion. I would like to ask the parties concerned to reach a decision quickly on whether they will increase taxes in the future or whether they will leave this problem pending.

(Auerbach)

- On the premise of a future tax increase, it is also indispensable to consider how progressive it should be. If tax revenues take priority, it is better to crowd out the aspect of income redistribution because it would bring distortions. It is necessary to broaden the tax base if tax system reform is expected to increase tax revenues, but it will attenuate the progressiveness. This is probably a difficult political pill to swallow, but it is necessary to increase tax revenues in the future.

(Ihori)

- We have to close the session now. Dr. Hamada will make a concluding comment.

(Hamada)

- I think we reached a common understanding on the necessity to broaden the tax base and to lower the marginal tax rate. Dr. Hubbard expressed the opinion that we should aim for a more robust and stable tax system over the long run. I think the outcome of this conference will influence future discussions of our tax system through the channel of the Council on Economic and Fiscal Policy, among other venues.