Tax and Spending Priorities for Sustainable Economic Growth of Japan
A kick-off Presentation

Takashi OMORI
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Despite the economic recovery, there are **two remaining challenges**.

- **The large fiscal debt.**
  With the expectation that the population aging will require larger spending for pension, medical services, etc., fiscal sustainability remains a major concern and may be limiting the growth of private consumption.

- **Deflation.**
  The Consumer Price Index slightly below its level one year ago, despite the continued efforts of by the monetary policy.

- **Two issues are interrelated**: through
  - risk premium on the interest rates
  - fiscal drag
  - conditional nature of the so-called macroeconomic adjustment
  - loan insolvency, etc.
Aim of this paper

• To set a base for discussions and suggestions, by presenting the main points of discussion of the medium- and long-term scenarios made by the Cabinet Office (based on a model).

• Not to defend them.
Medium-term Scenario : Appendix A

• The Reference Scenario for the “Reform and Perspective“

• The “Reform and Perspectives“ was approved by the Cabinet and seeks for non-negative primary balance by early 2010’s for central and local governments combined.

• Covers up to 2012FY (as the PB then turns positive).
Long-term Scenario : Appendix B

• Projection attached to the
  “Japan’s 21st Century Vision“

• The “Vision” was submitted to the Council for Economic and Fiscal Policy by a group of experts in April 2005.

• Covers up to 2030FY

• Identical to the Medium-term Scenario up to FY2012.
Main points of the Medium-term Scenario

• The primary balance of the central and local governments combined, which is -4.4% of GDP in FY2004, will become nonnegative in FY2012.

• The conventional deficit decreases gradually from -6.7% in FY2004 to -4.0% of GDP in FY2012.

• The accumulated debt to GDP will rise from 137.3% in FY2004 to 147.7% in FY2009, but declines thereafter to 146.9% in FY2012. This is because the interest rate applicable to the debt is lower than the nominal growth rate, mainly for the following two reasons:
  - a substantial part of the debt is financed through bonds with shorter maturity than 10 years.
  - interest payments are largely determined by the past lower interest rate when the bonds were issued.
Main points of the Medium-term Scenario: Continued

- The **real growth** rate will be around **1.5-1.6%**, a little lower than 1.9% (then estimated 2.1%) in FY2004.
- The **nominal growth** rate will gradually accelerate from 0.8% in FY2004 to **3.9%** in FY2012.
- The core CPI **inflation** will edge up from -0.2% in FY2004 to **2.7%** in FY2012.
- The **current account** surplus will remain large, at **4.9%** of GDP in 2012FY.
- Nominal long-term **interest rate** (10years JGB) will rise from 1.6% in FY2004 to **4.6%** in FY2012.
Main points of the Long-term Scenario

• The real growth rate around 1.5%. (2% per capita )
• The current account surplus gradually decreases to 1~2% of GDP as the balance of goods and services turns negative.
• The primary balance of the central and local governments combined will be about +2% of GDP in FY2030.
• The debt/GDP ratio will decline to 119~131% in FY2030 depending on the cases.
• Expenditure on social security will rise from 15.4% in FY2005 to 20.5% of GDP in FY2030, due to an increase in medical and long-term care.
Main points in discussion

(1) Pace of Fiscal Consolidation

• An annual 0.5% improvement in the primary balance in terms of the GDP ratio.
• Some say this is too slow. Others fear deflationary effects (that may be stronger in Japan, because of the smaller built-in stabilizer, and weaker Ricardian equivalence etc.)
• This is related to fiscal multiplier of the model and the balance between the supply/demand factors. (There, supply side dominates because of the "export drive term".)
• The negative effects of higher tax burden on private demand would be compensated by stronger export growth over the medium term.
• This is the basic reason why Japan can achieve the fiscal target in the simulation.
Main points in discussion

(2) Criteria for Fiscal Sustainability

- The desirable pace of fiscal consolidation is also dependent on how close we are to a possible catastrophe, and how serious such a catastrophe would be.

- This has long been discussed, not only for Japan but also for other countries. Three points look important.
  - whether a domestically-financed debt is more sustainable than the debt financed by foreigners.
  - whether or not the internationalization of the capital market has pushed up the sustainable level of debt.
  - whether the observed economic variables, such as inflation, long-term interest rates, saving ratio, or their combination are reliable indicators to show how close we are to the cliff.

- Given the fact that the debt level is unprecedented, the conventional econometric analyses may not be so helpful in addressing these questions and we seem to need a complementary approach.
Main points in discussion

(3) Population Aging and Social Security

- The assumption on social security was criticized in two opposite ways.
  - We should seek for further slimming
  - Should be given priority as a base for consumption

- The model incorporates the standard population projection:
  - A small recovery in fertility, life expectancy in 2015 will be 79.05 for M and 86.51 for F, and the ratio of the aged (65~) will be 26.0% in 2015 from 19.4% in 2004.

- The recent reform on public pension
  - The stepwise increase in the contribution rate,
  - “macro-economic adjustment (M.A.)”
  (0.9% annually due to the number of workers and the increase in life expectancy)
  price indexation less M.A. for those already eligible
  wage indexation less M.A. for those who become newly eligible

- Because of this M.A., total pension payment as the GDP ratio is expected to be stable over the long run.
Main points in discussion

(3) Population Aging and Social Security - continued

- Medical and long-term care: natural increase

- In order to capture the demand-side impact of aging and pension policies etc., the household sector was divided into three categories in the model:
  - younger generation households with working heads
  - elder generation households with / without wage income

- The propensity to consume is highest from pension income, then wages, and lowest from interest income.

- Therefore, the combination of heavier burden and larger pension payment (large government) would push up the average propensity to consume, but would not push up the growth rate, as generous pension would lead to lower labor participation by the aged and reduce the potential GDP.
Main points in discussion

(4) Assumption of Continued Emphasis on Expenditure Cut

• Although it has been decided that the priority should be given on the expenditure side up to FY2006, it is left undetermined how to continue the deficit reduction beyond then.

• In the projection, despite the rapid increase in medical care, the size of the government, measured as the GDP ratio of the tax and security burden plus fiscal deficit, is projected to fall slightly.

• This is mainly because of the two assumptions
  - continued reduction in infrastructure investment: -3.0% annually
  - compensation of government employees: -0.5% slower than wage

• There are people not satisfied with such a nature of the projection. Some argue that further continued cut of public expenditure is no more feasible. Others insist that we should openly examine and present how much expenditure cut is feasible and how much should be born in the form of higher taxation.
Main points in discussion

(5) Taxation

- Criticism that the projection is too optimistic in estimating future tax.

- Although no major tax reform has been incorporated in the scenario, temporary tax relieves were assumed to be abandoned as scheduled previously, and some minor tax increase was assumed as it had already been agreed. This is why the ex-post elasticity is higher than the implicit GDP elasticity for tax (1.1 ~ 1.2).

- Which tax? Recent attention is rather concentrated to consumption tax.
  - effective corporate tax rate is high (further outsourcing)
  - more progressiveness in personal income tax would give distort incentive
  - consumption tax rate is still much lower than other developed countries. Quantification of the first and second is important but not easy.

- As for social security contribution, one focus is evasion from the obligatory contribution to the first pillar of the public pension system.
Main points in discussion

(6) Potential Growth

- Since the main focus of the medium-term scenario is fiscal deficit, it may not be a good idea to assume an optimistic recovery in total factor productivity, although Japanese firms have recently regained confidence on their competitiveness.

- A modest assumption was made such that the TFP growth will gradually recover to
  the average level (1990FY~ but excluding 1997-8FY) + 0.2% (up to 2010FY, the effect of better ICT utilization)
  0.2% was derived from a cross section study

- Although TFP is the key factor for the medium real growth rate, it seems not much focus was given to this particular assumption.
Main points in discussion

(7) Nominal Growth, Deflation and Monetary Policy

• Much discussion and criticism on nominal growth projection.

• The projected increase of the GDP deflator, 0.5% for FY2006 for example, is based on two things:

  - the (level of) GDP gap, that has become smaller because of the recent economic recovery and the recent high replacement/stock ratio as a result of restructuring

  - the zero-interest policy

    Partially reflecting the inflation rate that would be realized under normal conditions

If money is insensitive to interest rate under deflation, we need other policy measures including quantitative easing and we have to carefully examine their effects.
• It takes time for the long-term rate to catch up with the nominal growth rate, but it does exceed the nominal growth rate after FY2010.

This is because the long-term interest rate is explained, in the model, by the distributed lags of short-term interest rate and CPI, government debt as the GDP ratio, and the US long-term rate.

• There was also a discussion on the historical and theoretical relationship between the nominal growth rate and long-term interest rate.

If we take the very long average, the former is higher than the latter for the G7 countries except Germany. A standard equilibrium growth model indicates that they are equal. This is why this equality was assumed in the long-term simulation for the "Vision" after 2013FY.
Main points in discussion

(9) Multiple Scenarios

• The reference scenario for the "Reform and Perspectives" had just one scenario in the past three times.
  - we should have a case with major tax increase (tax increase case)
  - what would happen if such efforts were not made (non-reform case)
  - we should present a case in which things turn out worse (pessimistic case)

• A non-reform case was added to the basic (reform) case in the scenario revision at early 2005. However, despite the explanation, some people misinterpret it as a pessimistic case, and regarded it as a sign that the Government is loosing confidence to accomplish the fiscal consolidation.
Future is uncertain in terms of economic environment and, to a certain extent, in terms of future policy decisions.

What is the best approach to deal with these uncertainties, while at the same time maintaining the credibility of the scenario?
Summary: Issues for discussion -2

- Japan’s fiscal debt has many characteristics
  - large size
  - dominance of domestic financing
  - rapid aging of the population
  - possible inefficiencies in the public sector

- How should we best measure the fiscal sustainability and what should be the long-run target variable for fiscal consolidation?
Summary: Issues for discussion -3

• The path of fiscal consolidation may be "narrow" between the two constraints.
  - The pace has to be quick enough to avoid catastrophe
  - At the same time, we should not to overkill the economy.

• If a conventional economic model is insufficient as a tool to find where and how narrow such a path is, what is a practical alternative approach?
Summary: Issues for discussion -4

• Getting out of deflation is still one of the most important policy agenda for Japan. But the number of deflationary observations is limited, and deflation depends much on people's expectation.

• What are the practical and effective anti-deflationary policy measures?

• How can we construct good estimates of the effects of such policy measures?

• How should we project the relation between nominal growth and the long-term interest rates, when the long-lasting deflation ends?
Summary: Issues for discussion -5

• As the choice of various policy options after FY2007 will soon be given more attention, reasonable estimates of pros and cons of each option are needed.

• How can we best estimate the supply-side effects of tax reforms, while taking sufficient account of international factors?

• Should the long-term growth be the major criteria for choosing from various policy options? What other factors should be taken into account?
Thank You

Takashi OMORI