Challenges confronting Abenomics and Japanese public finance
—Fiscal consolidation must start by squarely facing reality—

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Abstract
The LDP-New Komeito coalition government is currently promoting, under Prime Minister Abe, economic policies often dubbed “Abenomics” which combines “three policy arrows,” including “aggressive monetary relaxation,” “flexible fiscal policy,” and “growth strategy that encourages private sector investment.” Of the three arrows, the current government is devoting its fullest effort to the first arrow: aggressive monetary relaxation. As a result of these initiatives, there has been a continued trend of a weaker yen and higher stock prices up to the present, led by market expectations for Abenomics. Although this market behavior is actually providing a political boost to the current administration, Japanese public finance faces a host of challenges including fiscal and social security reform. First, we analyze the ultimate percentage of consumption tax rate to achieve fiscal stability in Japan, and whether fiscal consolidation dependent solely on economic growth without tax increase or cuts in expenditures would be successful. In addition, we perform a simple analysis of the total asset (percentage of GDP) of the Bank of Japan in the future, if the BOJ continues to promote “New Phase of Monetary Easing” (both in terms of quantity and quality).

Keywords: government debt, fiscal sustainability, consumption tax rate, social security cost, Deficit Gamble, Quantitative and Qualitative Monetary Easing

JEL classification: H2, H50, H51, H55, H62, H68, E52

1. Introduction
The LDP-New Komeito coalition government that marched back into power in the general election in December 2012 is currently promoting, under Prime Minister Abe, economic policies often dubbed “Abenomics” that combines “three policy arrows,” including “aggressive monetary relaxation,” “flexible fiscal policy,” and “growth strategy that encourages private sector investment.” Of the three arrows, the current government is devoting its fullest effort to the first arrow: aggressive monetary relaxation. This is why the government and the Bank of Japan issued a joint statement, clearly specifying that they set the inflation target at 2%. They also made clear that they would work in collaboration to exit deflation; Bank of Japan is set to continue its bold monetary easing measures, while the government promotes growth strategy by implementing regulatory reform.
As a result of these initiatives, there has been a continued trend of a weaker yen and higher
stock prices up to the present, led by market expectations for Abenomics. Although this market
behavior is actually providing a political boost to the current administration, Japanese public finance
faces a host of challenges including fiscal and social security reform.

As a matter of fact, the Japan’s government debt (as a percentage of GDP) has exceeded 200%
due to a rapidly aging society with a falling birth rate, and it has already reached a new high,
exceeding the prewar peak that caused drastic inflation in the years immediately after the end of
World War II (Figure 1). This is attributable, as is well known, to the aging progressing at a much
faster rate than the growth rate; the rapidly swelling social security costs year after year; and the
chronic financial deficit, thus making the fiscal and social security reform an urgent issue.

In implementing the reform, the main focus should be social security. However, the social
security reform currently being studied by the government is often criticized as insufficient.

It is because the rise in the consumption tax of about five percentage points alone will serve no
useful purpose in addressing the rapidly growing sum of social security spending—such as that for
the pension, medical, and elderly care insurance programs—and a certain amount of constraint is
inevitable. The sum of social security spending that stood at approximately 84 trillion yen in fiscal
2003 grew to approximately 110 trillion yen in fiscal 2013 due to progress in aging (see Ministry of
Finance, 2013. Japanese Public Finance Fact Sheet page 33 for details). This 110 trillion yen
accounts for over 20% of nominal GDP. Although the figure varies widely, ranging from an annual
increase of approximately one trillion yen to approximately five trillion yen during the ten years
between fiscal 2003 and fiscal 2013, the stark reality is that the sum of social security spending has
swollen at an annual average pace of 2.6 trillion yen. If the sum of social security spending continues
to increase at this pace, the revenue sources that can be secured through the consumption tax hike of
about five percentage point (i.e., approximately 1.3 trillion yen) is likely to be eaten away in about
five years.

Moreover, the sum of social security spending for fiscal 2013, costing 110 trillion yen, consists
of approximately 60 trillion yen social insurance premiums, approximately 10 trillion yen revenue
from asset management, and the shortfall of approximately 40 trillion yen is to be paid for with
public funds from local and central governments. However, social insurance premiums have leveled
off for some years due to the declining productive-age population, and the amount covered by public
funds from local and central government tends to increase sharply. Of such amount borne by public
funds from both local and central governments, the public funds from central government on social
security spending have steadily increased by approximately one trillion yen per year. This has led to
a widely-shared belief that the social security costs increase by approximately one trillion yen at an
annual average. However, this is thought to be an optimistic outlook. The reason is, if the sum of
social security spending continues to increase at an annual average of 2.6 trillion yen, and the total
revenue of the social insurance premiums remains constant, there is no denying that the public funds
from central government on social security spending will also start to show a growth similar to that
of the sum of social security spending.

Moreover, under the current public financial circumstances, the tax revenue is not enough to cover the central government share of the public funds, and over half of it is being credited to the next generation through the issuance of government bonds. That is, far more social security benefits are being paid out than can be afforded by taxes/contributions. Either curbing benefits or increasing taxes/contributions is inevitable in order to strike a balance.

Under such circumstances, Prime Minister Abe made a political decision in October 2013 to increase the current consumption tax rate of 5% to 8% in April 2014 in accordance with the Comprehensive Reform of Social Security and Tax Law enacted in the Diet in August 2012. The market is now turning its eyes to a political decision concerning another consumption tax hike in October 2015 (from 8% to 10%). Even if the consumption tax rate is increased to 10%, an additional burden of cuts in social security costs and tax increase is inevitable.

This is due not only to the issue of the sum of social security spending that increases at an annual average of 2.6 trillion yen but is also because the issue of the cost of interest payments will come up to the surface. The long-term interest rate is declining due to monetary easing measures taken by the Bank of Japan (Figure 2). However, as pointed out by S. Kawamura (2011), with the amount of outstanding government debt rising rapidly, the cost of interest payments—about 9 trillion yen at the moment—is expected to increase by roughly 8 trillion yen over the next 10 years to reach approximately 17 trillion yen, even if interest rates on government bond remain constant. As a result, Japan’s fiscal deficit will continuously be placed under pressure to expand, even taking into account the planned increase in tax revenue due to the consumption tax hike.

Against the backdrop of an ongoing weaker yen and higher stock prices, there is a prevailing perception in the media that Japan’s economy would recover without experiencing pain, if moderate inflation of 2% can be achieved. But this is an illusion. Although it is needless to say that the combined initiatives of economic growth, tax increase, and cuts in expenditures is vital in seeking fiscal consolidation, fiscal consolidation will not be realized through economic growth alone. Now that Japan’s government debt (as a percentage of GDP) has exceeded 200%, tax increase and cuts in expenditures are inevitable. This is the reality although it is regrettable to make such harsh remarks when there are heightened expectations for Abenomics and some positive moves have started to appear in the flagging Japanese economy. The three policy arrows being pushed forward under Abenomics are certainly important. That said, in order for the Japanese economy to recover, it is absolutely necessary that many people in Japan increase awareness of this reality, and take a bird’s eye view of where they stand.

2. Fiscal consolidation solely dependent on economic growth is impossible

Growth is absolutely critical; there’s no question about that. Having said that, let me first explain the reason that fiscal consolidation solely dependent on economic growth is impossible. On January 20, 2014, the Cabinet Office published the “Economic and Fiscal Projections for Medium- to Long-Term
Analysis” (hereafter “Medium- to Long-Term Estimation”). The estimation includes two projections: an economy recovery scenario (i.e., conventional “growth strategy scenario”) and a reference scenario (i.e., conventional “prudent scenario.” According to the prudent scenario, it is projected that even if consumption tax is raised to 10%, Japan’s primary balance would be a deficit equivalent to about 3% of GDP in fiscal 2020 (Figure 3). Leveraging this projection, we considered the following equation that indicates changes in government debt (as a percentage of GDP).

Changes in the government debt (as a percentage of GDP)

\[ = - \text{Primary balance (as a percentage of GDP)} + (\text{interest rate} - \text{growth rate}) \times \text{current government debt (as a percentage of GDP)} \]  

(1)

The interest rate of this equation (1) represents a yield on government bonds (long-term interest rate). If 0 (zero) is plugged in for the government debt (as a percentage of GDP) on the left-hand side, -3% derived from Medium- to Long-Term Estimation is plugged in for the primary balance (as a percentage of GDP), and 150% (= net debt as a percentage of GDP) is plugged in for the current government debt (as a percentage of GDP) on the right-hand side to obtain \( x \) \((x = \text{growth rate} - \text{interest rate})\), \( x = 2\% \) is derived. This means that if the growth rate is higher than the interest rate by over two percentage points, fiscal consolidation solely through the means of economic growth is made possible. In other words, if the interest rate remains at the current level (around 1% long-term interest rate), fiscal consolidation would be possible without tax increase or cuts in expenditures assuming that the growth rate of over 3% is achieved.

So, what is the probability that the growth rate exceeds interest rate by as high as over two percentage points? Figure 4 shows a histogram of the interest rate – growth rate based on the OECD data on growth rate (nominal) and long-term interest (nominal). The graph shows that interest rate > growth rate occurs with greater frequency. The probability of interest rate – growth rate \( \leq -2\% \) is merely 7.6% (165 out of 2,195 samples).

What’s more, this is a probability for a single year. The “interest rate – growth rate \( \leq -2\% \)” must be achieved every single year in order to carry through fiscal consolidation solely through the means of economic growth. Such probability in two consecutive years is 7.6% x 7.6% = 0.57%, and in a ten consecutive year time span, close to zero. All told, fiscal consolidation dependent solely on economic growth without tax increase or cuts in expenditures is virtually impossible, and such an attempt is nothing less than a “Deficit Gamble” as pointed out by Ball et al. (1998). On top of this, a failure would have to be covered by future younger generations.

3. Consumption tax in excess of 25% would be required even if moderate inflation of 2% is to be attained
Secondly, let me explain the reason why a consumption tax rate in excess of 25% would be required to ensure fiscal stability even if Abenomics succeeds and moderate inflation of 2% is achieved. A useful reference in this regard is the calculation presented by R. Anton Braun of the Federal Reserve Bank of Atlanta and Professor Douglas H. Joines of the University of Southern California (Braun and Joines, 2011). The effects of achieving moderate inflation of 2% needs to be compared with an unfulfilled scenario (hereafter “base scenario”) in order to ascertain such effects.

For this purpose, Braun et al. estimate as a base scenario that the consumption tax rate would have to be ultimately raised to 33% if Japan is to achieve fiscal stability with a one-time permanent tax increase in 2017 without suppressing social security costs, which would otherwise be increasing at a pace of more than one trillion yen per year. They also estimate that the consumption tax rate would have to be ultimately raised to 37.5% if the tax hike is postponed by five years from 2017 to 2022. Since the difference between 33% and 37.5% is about five percentage points, each year of delay in tax reform translates into a one percentage point increase in the ultimate consumption tax rate in order to achieve fiscal stability. This is the “cost of postponing reform.” The longer it is postponed, the higher will have to be the ultimate consumption tax rate. The ultimate consumption tax rate is 35%, according to Professor Gary Hansen of the University of California, Los Angeles (UCLA), et al. (Hansen and Imrohoroglu, 2012), whereas the author et al. estimate, according to analyses of the OLG model, that it would have to be raised to a peak of 33.5% (Oguro and Shimasawa, 2011).

The common understanding (or consensus) underlying these studies is that raising the consumption tax rate to 25% would not be enough to ensure fiscal sustainability in the case where no measures are taken to suppress social security costs.

In the meantime, Braun et al. also estimate that the ultimate consumption tax rate would have to be raised to 25.5% based on a scenario in which moderate inflation of 2% is achieved.

If moderate inflation of 2% is achieved, the ultimate consumption tax rate required for achieving fiscal stability would decline by about 7.5 percentage points, which indicates that moderate inflation does have a certain effect. In other words, seeking to exit deflation and achieving a 2% level moderate inflation is significant in the sense that the monetary policy provides indirect support for fiscal and social security reform. Even so, Japan must squarely face the reality that the ultimate consumption tax rate would have to be raised to over 25%.

Furthermore, this ultimate consumption tax rate is based on the calculation of a one-time permanent tax increase in 2017. It is considered that, in reality, a gradual increase scenario is more realistic as a one-time permanent tax increase is a politically difficult measure. This is why, from the standpoint of seeking fiscal stability, Braun et al. also analyze a scenario in which the consumption tax rate would be gradually raised in parallel with the following Alternative Policy Instruments and later decreased only after the aging has passed its peak.
**Alternative Policy Instruments**

(1) Achieve moderate inflation (2% inflation)
(2) Increase medical copayment for individuals over 74 to 20%
(3) Remove the floor on public pension benefits (e.g., pension benefits in model case $\geq 50\%$ of working generation’s average income)
(4) Reduce government purchases by 1% of GDP

The calculation of the above Alternative Policy Instruments is shown in Figure 5. Increasing medical copayment for individuals over 74 to 20% and removing the floor on public pension benefits are certainly tough reform measures. However, this figure suggests that the consumption tax rate would have to be raised to a peak of 32% even if the country successfully carries through such reforms and achieves its 2% inflation target.

Moreover, the consumption tax rate of 32% disregards reduced tax rates for food articles. If such reduced tax rates are to be approved, an even higher consumption tax rate would be required to make up for the decline in tax revenues.

The above calculation results clearly suggest that a prevailing perception in the media that Japan’s economy would recover without experiencing pain if moderate inflation of 2% can be achieved is an illusion, and confronts us with the fact that additional pain of cuts in social security costs and tax increase would be inevitable in order to prevent financial crisis. That is to say that Japan will need to continuously implement fiscal and social security reform even after it has implemented gradual tax increase in 2014 and 2015.

4. **Significance of performing a long-term estimation of Japanese public finance**

We must note, however, that it taken as long as about 15 years for the consumption tax hike bill to be enacted since the first rise in 1997. If you look back on the political process of the past, reaching a political consensus over stepped up efforts for fiscal and social security reform would not be easy. A sense of crisis among the public is indispensable to reach a political consensus. However, one of the reasons inhibiting the rising sense of crisis seems to be affected by the non-disclosure of a long-term estimation of Japanese public finance by the government and ruling parties.

The year 2013 registered an approximate 3% annualized real GDP growth rate. Coupled with the good news that Tokyo was named the host city of the 2020 Olympic Games, an upbeat atmosphere is being felt in the Japanese economy. However, it is too early to take an optimistic stance and think that the country’s public finance problems can be solved by the upcoming tax increase. Because even if the tax increase is implemented as planned, public finance would soon fall into a difficult situation unless social security reform is carried out assuredly.
Such an outlook can be easily confirmed by extending the period of the Medium- to Long-Term Estimation of the Cabinet Office. As mentioned earlier, the Cabinet Office disclosed two scenarios: an “economy recovery scenario” and a “reference scenario.” The Medium- to Long-Term Estimation uses as its base scenario the economy recovery scenario, in which the average real growth rate would be 2.1% and 3.4% in nominal terms over the next ten years. However, this is a fairly bullish premise compared with a 1–2% nominal growth rate projected by private research institutes, and is optimistic in relation to the fiscal outlook. This is why the economy recovery scenario is often criticized among experts as being unrealistic.

Rather, it is a standard practice to adopt a premise of a prudent growth rate according to a global standard-based fiscal outlook. For the reasons mentioned above, a “reference scenario” based on a prudent growth rate is shown in Figure 6 with estimations over an extended period of time.

The lines in the graph indicate from top to downward results and estimation of (1) primary balance of the central and local governments (as a percentage of GDP, on the left hand side scale), (2) fiscal balance of the central and local governments (as a percentage of GDP, on the left hand side scale), and (3) outstanding debt of the central and local governments (as a percentage of GDP, on the right hand side scale). The black lines indicate Medium- to Long-Term Estimation (reference scenario) of the Cabinet Office, and the red lines indicate the author’s simplified estimation based on a reference scenario over an extended period of time.

In contrast to the red lines (the author’s projection), the black lines (Cabinet Office’s projection) are terminated in the middle as the Cabinet Office estimation is disclosed only up to fiscal 2023. The author’s simplified estimation and that of the Cabinet Office are not exactly the same; the black lines (Cabinet Office’s projection) and the red lines (author’s projection) are slightly different. However, it is clearly shown that the trends of the primary balance, fiscal balance, and outstanding debt of the central and local governments are similar up until around fiscal 2015.

This is because the author included the following in its projection premise as is the case with the Cabinet Office: (1) tax increase planned for April 2014 (raising the rate from 5% to 8%) and (2) tax increase planned for October 2015 (raising the rate from 8% to 10%).

However, the question is the real picture of public finance in fiscal 2015 and beyond. The government has pledged to the international community to halve the primary balance deficit (as a percentage of GDP) in fiscal 2015 from the fiscal 2010 level and achieve a surplus by fiscal 2020. However, similar to the Cabinet Office estimation, the author’s simplified estimation also indicates that the primary balance is projected to be in deficit in fiscal 2020, and that the chances of achieving such targets are slim.

Moreover, as all members of the “Babyboom Generation” will be elderly aged 75 or over in fiscal 2025, the social security costs are projected to increase sharply. If the current system remains unchanged, medical cost and elderly care cost, in particular, are expected to balloon starting around
that time. Under the influence of such circumstances, according to the author’s long-term estimate (simplified estimation), the primary balance of the central and local government (as of the percentage of GDP) would decline to a deficit of 7.9% in fiscal 2050 with outstanding debt of the central and local governments (as a percentage of GDP) reaching approximately 500%, even if the fiscal 2014 and 2015 consumption tax rate increases are implemented. Thus, the fiscal situation would be extremely severe.

In order to balance the primary balance in fiscal 2050, an additional 16% tax increase (in consumption tax-equivalent) would be required, which means that the current 5% consumption tax rate would have to be increased to 26%. It is no exaggeration to say that a large part the increase is concerned with social security costs that continue to swell over mid- to long-term.

The above estimates were based on a tax increase of five percentage points. It is apparent, however, that securing revenue sources of that level would not be enough to cope with the rapidly swelling social security costs in the future. Although a long-term fiscal estimate is essential in performing analysis or holding discussions on middle- to long-term social security costs, the government and the ruling parties have not yet so far issued one.

On the other hand, long-term estimates on public finances are published by countries abroad. It is well known, for instance, that the European Commission issues “Fiscal Sustainability Report.” The Commission also prepares and issues “Aging Report” every three years, in which the social security costs (pension, medical, and elderly care insurance programs) as a percentage of GDP are estimated up until 2060.

Also, the Congressional Budget Office (CBO) of the US performed an estimate for the next 75 years (until 2087) as part of its “Long-Term Budget Outlook 2012,” and issued two scenarios: the “baseline scenario” and “alternative scenario.”

Furthermore, the HM Treasury of the United Kingdom publishes each year a long-term fiscal outlook over the next 30 years in the “Illustrative Long-Term Fiscal Projections” following the enactment of Finance Act in 1998. To complement the projections (to be exact, as an appendix to the “Pre-Budget Report” that reveals budget policy), it has continued to issue every year since 2002 a “Long-Term Public Finance Report” for the next 50 years or so.

5. What exit strategy should be taken for monetary policy?

In relation to the 2% inflation target promoted under Abenomics initiatives, sufficient discussions need to start now regarding the exit strategy for the monetary policy in the course of interest rate being normalized after achieving success in exiting deflation and implementing growth strategy.

Discussions on this topic deeply concern the “quantity theory of money.” The quantity theory of money states that money stock has a proportional relationship with the price level, and is expressed by the identity below:
Money stock × velocity of money = price level × real GDP  \hspace{1cm} (2)

The “real GDP” on the right hand side is precisely transaction volume, but is often substituted by real GDP. The right hand side of the equation (2) indicates “nominal GDP” ( = price level × real GDP). If the “money stock”-“monetary base” relation equation (money stock = credit multiplier × monetary base) is substituted in the left hand side of this equation, the following is obtained.

\[
\text{Nominal GDP} = \text{velocity of money} \times \text{credit multiplier} \times \text{monetary base}
\hspace{1cm} (3)
\]

Figure 7 below is an expression of the relation equation (3) based on Japanese data. As is obvious from this figure, the ratio of monetary base to nominal GDP is stable until around 1990 before the bubble economy burst. For instance, the monetary base was approximately 40 trillion yen and the nominal GDP approximately 440 trillion yen in 1990. However, the average value derived from the nominal GDP divided by average monetary base, i.e., the average value derived from “velocity of money × credit multiplier” according to equation (3) was approximately 12. (Note: Similarly, the ratios of monetary base to nominal GDP in the US were stable until immediately before the Subprime Shock.)

This relation has collapsed after the economic bubble burst in and after 1990. For instance, the monetary base was around 120 trillion yen in 2012, whereas the nominal GDP stood at approximately a mere 475 trillion yen, which were triggered by a sharp decline in the velocity of money and credit multiplier. These values will inevitably decline in a current situation like Japan where the interest rate is close to zero. As a result, the quantity theory of money does not come into effect and the prices do not increase despite the Bank of Japan’s initiatives to increase monetary base. The monetary base stood at 190 trillion yen in November 2013; the situation is likely to remain unchanged for a while. The possibility of the quantity theory of money not necessarily coming to effect in such current circumstances as in Japan, where the soundness of “velocity of money × credit multiplier” is collapsed, has been pointed out by economists including Keynes.

In his “General Theory of Employment, Interest and Money,” John Maynard Keynes wrote that the quantity theory (of money) comes into effect in times of full employment, but is not appropriate in a situation where non-voluntary unemployment exists. He explained that the changes in the quantity of money can change not only the prices but also the current debt ratio of the banks and even the velocity of money. We may conclude that the quantity of money and prices change in a way indicated by the quantity theory of money only under the premise that all of these factors are constant. (Gilles Dostaler; “Keynes and His Battles”)}
However, the whole picture would change in the course of exiting deflation and the interest rate being normalized. In that particular instance, the quantity theory of money comes to life again with a possibility that the value derived from “velocity of money” × “credit multiplier” of equation (3) would gradually come close to the normal value of about 12.

In the case where the monetary base is 190 trillion yen, the nominal GDP would need to be as much as 2,280 trillion yen according to equation (2). However, if the real GDP does not change much, the price level would need to be almost quintupled (= 2,280 trillion divided by 475 trillion yen) as “the nominal GDP = real GDP × price level.” Therefore, there is a risk that such inflationary pressure would gradually become apparent.

If the Bank of Japan aims to bring inflation under control in such circumstances, it would need to withdraw in large quantity its notes that are being pumped into the country’s market so as to bring the monetary base back to an appropriate level. There are mainly two means to do this. One is to increase the interest rate of the reserve deposits, and another is to sell off the government bonds. However, both measures are likely to trigger increase in interest rates. Therefore, sensitive handling would be required, while taking into account the anticipated impact on long-term interest rate (including the term structure of interest rates) and on the financial system, as Japan is burdened with government debt (as a percentage of GDP) in excess of 200% and a large share of the government bonds are being held by financial institutions including banks. For these reasons, these measures would not be so easy in practice.

In relation to public finance, in particular, although a long-term interest rate increase of up to two percentage points is within the scope of assumption (e.g., according to the Ministry of Finance “Budget Projections in FY2012 Budget Policy”) if the rate should exceed three percentage points under inflation pressure, a sharp increase in the cost of interest payments would have to be suppressed, thus making the exit strategy for the monetary policy considerably difficult. In some cases, the risk of not being able to fully control inflation may become apparent. In relation to the financial system, the “Financial System Report” issued by the Bank of Japan in October 2012 disclosed an estimate that under the assumption of the simultaneous increase of long-term interest rate by one percentage point, major banks would have valuation loss of 3.7 trillion yen, regional banks 3 trillion yen, and Shinkin banks 1.6 trillion yen. Under an uncontrollable inflation situation, the impact of an increase in the long-term interest rate on financial system must also be kept in mind.

Figure 8 shows projected trends in total assets of the Bank of Japan (as a percentage of GDP) in case it continues to purchase long-term government bonds under the current “Quantitative and Qualitative Monetary Easing.” While the total asset (as a percentage of GDP) of the FRB of the US, ECB (European Central Bank), and BOE (Bank of England) in the third quarter of 2013 were between the range of 20% to 25%, Japan stood out by recording approximately 43%. However, if the
Bank of Japan is the only one to continue its New Phase of Monetary Easing (both in terms of quantity and quality), while the FRB and other central banks start to reduce quantitative easing as an exit strategy for the monetary policy, the total asset (as a percentage of GDP) of the Bank of Japan might reach approximately 76% by the end of 2016 and over 80% in the following year.

As discussed above, monetary policy is likely to conflict with public finance at a time when the country seeks to exit deflation. The price to be paid is not a problem in the short-term, but is likely to cause a major problem in a long run. Hence, adequate measures need to be developed now on an exit strategy for monetary policy while ensuring consistency with the drastic fiscal and social security reform.

6. What role is most required of politics now?

Based on the above discussions, of the “three policy arrows” of Abenomics, comprised of “aggressive monetary relaxation,” “flexible fiscal policy,” and “growth strategy that encourages private sector investment,” the second arrow, “flexible fiscal policy,” would have to be switched over to “drastic fiscal and social security reform” quickly and in a flexible manner so as to indirectly reduce the anticipated negative impact of the reform by means of appropriate monetary policy and growth strategy.

However, the reason why drastic fiscal and social security reform does not at all seem real is that politicians almost inevitably avoid making a choice on the overall framework for social security (benefits and taxes or contributions), and the media’s attention quickly drifts away from the big picture and focuses on small details.

In democratic Japan, it is ultimately us, the people of Japan, who have driven our politicians and bureaucrats to adopt such policy. Nevertheless, many people would not have a chance to stop and think about public finance in their daily lives; moreover, they would be puzzled if they were to be held responsible for it.

Everyone wants to get more of what they are entitled to receive, and they prefer less of what they are obliged to pay; it is a natural human emotion. However, as the economic adage goes, “there is no such thing as a free lunch,” if everyone continues to behave in such manner, it would lead to financial collapse in the near future, and the society would come to a deadlock.

This is why politicians, elected as representatives of the public, must, from a whole nation perspective that includes future generations, appeal to their people and convince them also of the need to take painful political measures such as cuts in spending and implementation of tax increase. Furthermore, so-called “specialists” including bureaucrats, mass media, academics, and critics would have to offer people food for thought, as they are in a better position to learn more of the reality of public finance.

As a matter of fact, however, many politicians continued to put off asking the public to make a painful choice. Such a situation seems almost the fate of politicians who are constantly under pressure in advance of the next election. Such failure of democracy is not unique to Japan; it is a
globally observed phenomenon, including in US and Europe. However, the signs are especially formidable in Japan which is facing an exceptionally serious fiscal situation.

There is also a tendency among the mass media and influential individuals to take advantage of the public’s simple desire to avoid burden or pain, and create a tone that is easily accepted rather than the correct tone. And this tone penetrates certain segments of the public and guides the general opinion in the direction of further shifting of the burden onto future generations.

There should be diverse opinions and arguments concerning political measures. However, we are deeply concerned that this tone of the discussion about the current Japanese public finance that overly contradicts reality or is supported by paper-thin evidence is linked to the public’s desire and is spread widely.

What politicians should be presenting to the public in this regard are the following three options from which to choose: “high benefits for high burden,” “low benefits for low burden,” and “middle benefits for middle burden” (“burden” here refers to taxes/contributions). Mistakes in strategy cannot be offset with tactics. No matter how refined in details the discussions are, reform is doomed to fail eventually if sufficient discussion on the overall framework fails to take place and the existing problems of the social security system—i.e., far more benefits being paid out than can be covered by contributions—left unaddressed.

What matters in reform discussion is the order in which it takes place. In other words, before going into details such as the specific design of pension schemes, discussions on the overall framework for pension benefits and contributions must occur, based on the premise that “the levels of benefits and contributions are kept equal.” Although such discussions may be somewhat sketchy, it is desirable to discuss the overall framework and set the level of benefits (which equals the level of taxes and contributions) first and, only then, move onto details.

The “high-benefits-for-high-burden” scenario, in which no effort will be made to suppress the rise in social security costs, should be the starting point in discussing the overall framework. As was explained in the latter part of Section 3 in this paper, according to a gradual tax increase scenario, the consumption tax rate would have to be raised to a peak of over 30% even if a constant 2% inflation is realized, and fairly rigorous cuts in spending including social security costs is implemented. Hence, at such deliberations as the Council on Fiscal and Economic Policy, the government and ruling parties must accordingly present a clear picture of the burdens that would have to be borne ultimately by taxpayers in order to achieve fiscal stability under that scenario, including the possibility of raising the consumption tax rate to about 30%, based on their official calculation.

Only then, and if it is determined that the “low-benefits-for-low-burden” scenario, one in which a hike in the consumption tax rate would be kept to 10 percentage points, be considered as an alternative option, should they calculate and provide the size of the cuts in expenditures that would have to be made in order to achieve fiscal stability. According to our rough calculation, it would be necessary to reduce expenditures by about 50 trillion yen, an amount equivalent to foregone revenue
that could have been generated by a 20 percentage point hike in the consumption tax rate. Most of this reduction in spending would have to be made in social security costs, which would otherwise be increasing at a pace of more than one trillion yen per year.

Currently, a total of 110 trillion yen in social security benefits—such as those for the pension, medical, and elderly care insurance programs—are paid out every year, of which about 70 trillion yen is covered by the revenue of insurance premiums and asset revenue, and the remaining 40 trillion yen by public funds. The latter would have to be reduced significantly, resulting in drastic cuts in benefits.

If it is concluded that both scenarios are undesirable, then the “middle-benefits-for-middle-burden” scenario is the only remaining option. As explained in this paper, even under this scenario, it is likely that the consumption tax rate will have to be raised to above 20%. Value-added taxes (VAT) in Europe are 20% on average, 25% in Sweden, and around 20% in the United Kingdom, France, and Germany. Suppose that Japan needs to raise the consumption tax rate to 30%, but 25% is the feasible limit in reality. In this case, it is necessary to implement an additional 15 percentage point hike in or after fiscal 2015, on top of the planned five percentage point increase. At the same time, Japan must reduce its expenditures by about 12 trillion yen, an amount equivalent to revenue lost by not levying an additional 5% in consumption taxes.

Japan also needs to consider raising the pension eligibility age in light of the moves in the United States and Europe (Italy is planned to raise it to 69 years old, the United Kingdom to 68 years old, and the United States and Germany to 67 years old). It is also inevitable to consider implementing drastic social security system reform—such as bolstering the pension taxation and increasing the self-pay portions of medical and nursing care service fees—to suppress a future increase in social security costs to half of the expected natural increases (20 trillion yen) over the next 20 years.

In any event, far more benefits are being paid out than can be afforded by taxes/contributions paid today, and “political leadership,” in its true meaning, is to discuss and determine the overall framework in the face of this dire reality. This is not to deny the importance of discussing details, but such discussion should not come first. It is the role of politics—the most important one at the moment—to select and enforce the overall framework, as administrative agencies, which are vertically structured and thus inclined to pursue partial optimization, are not cut out for such task. Indeed, this is the decision that is most strongly and urgently needed from Japanese politicians.
References
Figure 1: Ballooning Government Debt to GDP

Figure 2: Long-term Interest Rate and Monetary Base

Source: Bank of Japan and Ministry of Finance
Figure 3: Economic and Fiscal Projections for Medium to Long Term Analysis, 2014

Source: Cabinet Office, Government of Japan (January 20, 2014)
Figure 4: Histogram of “Interest rate on GB—Growth rate of GDP”

Source: OECD Statistics

Figure 5: Consumption Tax Rate Trajectory

Source: Braun and Joines (2011): Revised
Figure 6: Long-term Estimation of the Prudent Scenario by Cabinet Office (2014)

Figure 7: Relationship between Monetary Base and Nominal GDP

Source: Cabinet Office and Bank of Japan
Figure 8: Trends in Asset / GDP of Central Banks in Major Developed Countries

Source: BOJ, FRB, ECB, and BOE