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Economy

Consumption Tax Rate Hike and Social Security

Can Pension, Medical Care and Nursing Care Insurance Be Sustained?

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Now that it has been determined that the consumption tax rate will be raised from April 2014, discussions on the reform of the social security system have been underway. This report will reexamine whether pension, medical care and nursing care insurance systems can be sustained.

A consumption tax rate hike to 10% would still be a drop in the ocean
Benefit restraints and higher contributions from the elderly are necessary

Prime Minister Abe Shinzo decided on October 1, 2013 to raise the consumption tax rate to 8% in April 2014. The discussion about this hike in the consumption tax rate initially started from consideration of the Comprehensive Reform of Social Security and Tax initiated by the government of the Democratic Party of Japan, and the objective of the tax hike is believed to be to achieve sound and stable social security and stable financial resources, and regain a sound fiscal situation at the same time. With a scheduled tax increase to 8% in April 2014 and 10% in October 2015, will social security really be stabilized and the fiscal situation be reconstructed?

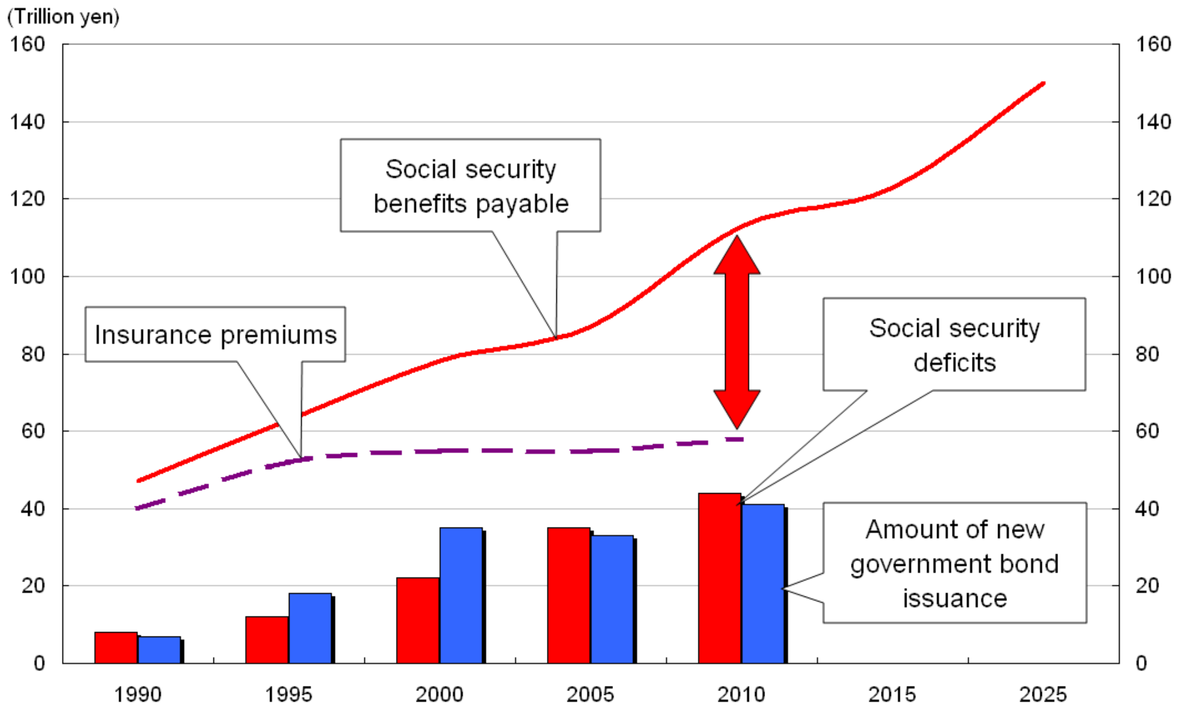
Even a 10 trillion yen increase in revenue will not be sufficient

Unfortunately, the answer is no. Firstly, although it is stipulated in the act that the additional tax revenue corresponding to an increase in the consumption tax rate will be used in the social security sector, this additional revenue will in fact be used in economic packages that will be introduced to prevent a downturn in the economic recovery that may occur as a result of the consumption tax rate hike. Since a 1% increase in the consumption tax rate means a rise in tax revenue of approximately 2.7 trillion yen, a tax rate hike from 5% to 8% will generate approximately an additional 8 trillion yen in revenue. However, of this revenue increase, the allocation of 5 trillion yen to public works and a reduction in corporate taxes is currently being examined as part of the official economic package, which will account for an amount equivalent to 2% in the 3% tax increase. Moreover, budget requests for the next

SUZUKI Wataru, Professor, Gakushuin University fiscal year have been made with no ceiling (budget request guidelines), resulting in a bloated amount, a record 99.2 trillion yen. This means that each ministry is effectively making budget requests by taking into account an increase in tax revenue from the consumption tax rate hike. If most of these requests are granted, even an increase in tax revenue equivalent to the remaining 1% of the tax hike will be wasted.

It is possible to take the view that revenues and expenditures are expected to be able to improve eventually because economic packages will be a temporary measure and the consumption tax rate will be further raised to 10% in the future. However, the second problem is that the scale and pace of the revenue increase will not be able to keep up with current developments. At present, social security benefits payable have reached a level exceeding 110 trillion yen, approximately one quarter of Japan's gross domestic product (GDP), and they are rising by more than 3 trillion yen every year. Given the advancement of the aging society, the pace of this increase is unlikely to slow anytime in the near future (continuous line in Figure 1).

Figure 1. The crocodile's mouth has opened on the back of the growing gap between social security benefits and social insurance premiums



Note : The social security benefits payable are projections for 2015 and 2025 made by the Ministry of Health, Labour and Welfare
Sources : The Financial Statistics of Social Security in Japan (for each annual issue) and the Budget Statistics (for each annual issue) of the Ministry of Finance

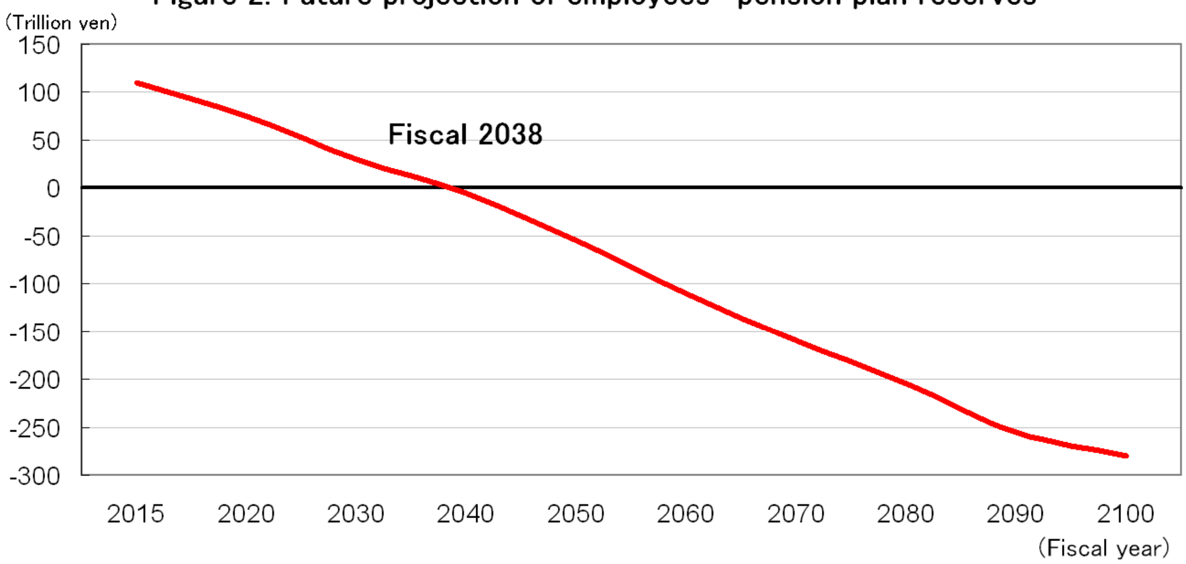
On the other hand, social insurance premiums (dotted line in Figure 1) have remained almost unchanged. As a result, the gap between social security benefits payable and social insurance premiums has been growing increasingly wider. The extent of the crocodile's open mouth, which is caused by the gap between these revenues and expenditures, is the amount of deficits in the social security budget (the white bar graph in Figure 1). Amazingly, the deficits are almost equal to the nation's budget deficit (the amount of new government bond issuance; the blue bar graph in Figure 1). In other words, the main reason for the rapid increase in the government's debts is the deficit of the social security budget. Accordingly, improving the imbalance between benefits and payments in the social security system will simultaneously become the key to the reconstruction of the country's fiscal conditions.

The expected hike of the consumption tax rate is part of efforts to narrow the gap in the crocodile's mouth. If the consumption tax rate is raised to 10% in 2015 as scheduled, tax revenue is expected to rise by approximately 13.5 trillion yen, and it is believed that an amount equivalent to 4% out of the 5% increase will be steadily allocated to the social security budget. However, it is clear that even financial resources of more than 10 trillion yen will not be able to fill the gap in the crocodile's mouth. In fact, the upper jaw of the crocodile is continually widening at a pace of 3 trillion yen per annum, and an increase in tax revenue of a mere 10 trillion yen will be swallowed up in a matter of three or four years. Even consumption tax rates of 8% or 10% will be a drop in the ocean.

The national pension will run out of resources in 2040

Thirdly, pension finance, the issue the public is currently most concerned about, is not going to become any better after the scheduled consumption tax rate hike. At present, the basic pension is structured in such a way that a half of its financial resources come from tax contributions (national expenditure), and revenues added from the scheduled consumption tax rate hike are expected to finance part of these pension contributions. However, these revenues have apparently already been included in the government's 100-year safe pension plan. The financial program has already included a rise in tax revenues, so there will be no impact in the future.

Figure 2. Future projection of employees' pension plan reserves



Note: Provisional calculation made by the writer based on the OSU pension simulation model; On a present discounted value basis as of 2010; Based on the assumption that the macroeconomic slide is adopted from 2015 to 2037

Sources: Prepared by the writer

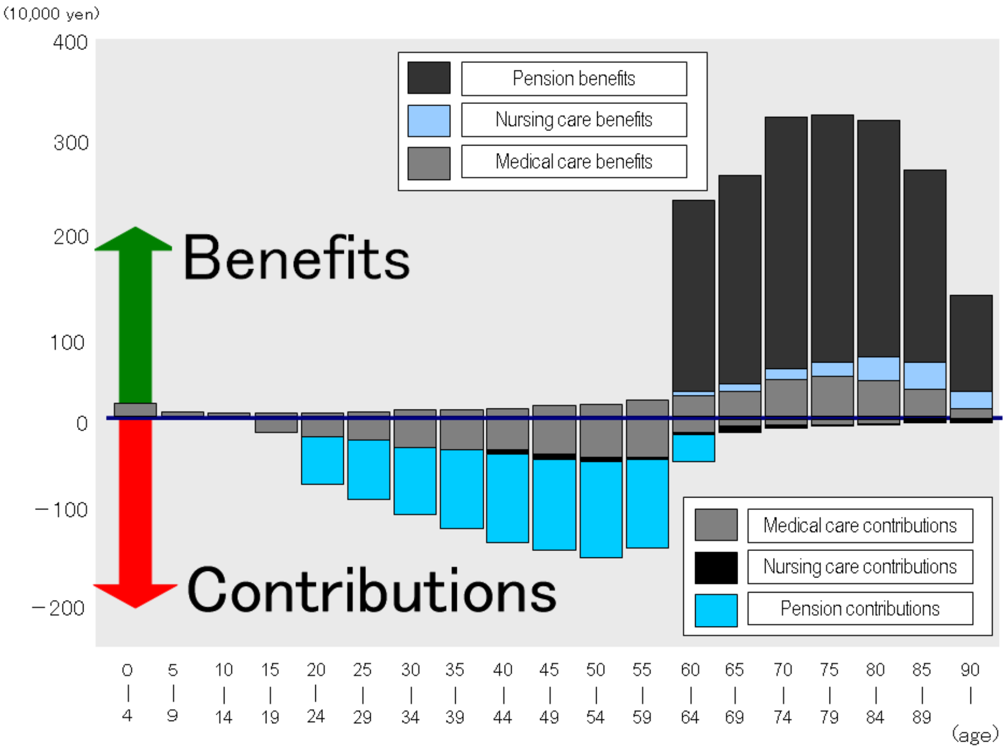
If so, what will happen to the real pension finance? Although the economic situation has improved due to the effects of Abenomics, the general picture remains very severe. Based on the future projection made using the OSU model, the most popular pension simulation model in Japan, employees' pension plan reserves will apparently become depleted in fiscal 2038 (Figure 2). National pension reserves are also likely to become depleted by 2040.

As Abe repeatedly advocated during the Upper House election, the pension fund achieved investment returns of as much as 1.2 trillion yen in fiscal 2012 due to a recent rise in stock prices thanks to the effects of Abenomics. However, Japan's pension finance has the original structural problem that pension expenditures are far higher than insurance premiums, regardless of the performance of investments. Considering the chronic situation in which pension reserves are reversed every year in the order of several trillion yen, the recent rally of stock prices is merely palliative, and not a cure.

Widening gap between social security benefits and social insurance premiums

To only cover the amount accountable for national expenditures in the crocodile's mouth in social security finance, consumption tax will need to exceed 25% by 2050. Should the crocodile's open mouth be completely filled in, eventually we will need to prepare to accept a consumption tax of around 35%. That rate is likely to be unrealistic, considering how difficult it was politically to raise the rate to only 8%.

Figure 3. The elderly make almost no contributions to social security payments
(Benefits and contributions by age in terms of social security)



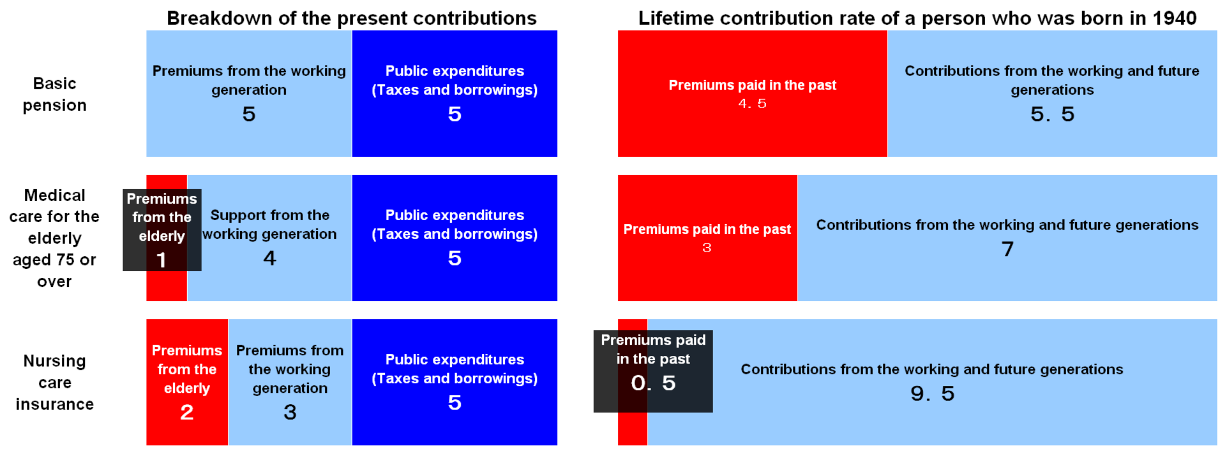
Note: Provisional calculation of the annual amount per person; Contributions are limited to insurance premiums (excluding the contributions made by public expenditures).
Sources: Prepared by the writer

Needless to say, there are other efforts aside from raising consumption tax that need to be taken to stabilize social security finance. First of all, it is necessary to streamline social security and make an effort to lower the crocodile's upper jaw (social security benefits) as much as possible by striving to contain benefit payments. On the other hand, it is also essential to make an effort to raise the crocodile's lower jaw (social insurance premiums).

Why has the crocodile's lower jaw almost never been raised in the first place? The main reasons for this are a fall in the number of the working generation who support social security due to the declining birthrate and a decline in wages that form the basis for collecting social insurance premiums given the deflationary economy. To put it the other way around, the elderly, who are the main beneficiaries in the present social security system, are not taking on a burden that is appropriate for what they are receiving. Figure 3 shows the situation of the beneficiaries and contributors by age in the present social security system. The figures in the area above 0 are the annual benefits received, and those below 0 are the contributions made. The figure illustrates the fact that the elderly are in fact contributing almost no medical care or nursing care insurance premiums, not to mention pension premiums.

Figure 4 further analyzes this situation from a different angle. Based on the total benefits of 10 for each basic pension, medical care for the elderly aged 75 or over and nursing care insurance, the figure shows the extent to which the elderly are paying their own expenses. Contributions made by the elderly, comprising only the part in gray on the left graph, are zero in terms of basic pension and merely 10% in terms of medical care for the elderly aged 75 or over, and 20% in terms of nursing care insurance. The balance is mostly paid through premiums and taxes from the working generation and borrowings to be paid in the future.

Figure 4. Breakdown of social security expenses for the elderly (based on the total benefits at 10)



Sources: Prepared by the author

The conclusion that the present elderly generation is receiving benefits that significantly exceed the premiums it has paid remains almost the same, even taking into account the premiums that the elderly paid in the past. For example, in the case of 73-year-old people who were born in 1940, the premiums that they paid in the past (on a current value basis) only support just over 40% of the basic pension that they receive in their lifetime, approximately 30% of medical care for the elderly aged 75 or over and merely 0.5% in the case of nursing insurance.

As it is known that approximately 60% of Japan's household financial assets, with a value of approximately 1,400 trillion yen, are held by the elderly, most elderly at the present time are not socially vulnerable, in contrast to the image they had in the past. There is therefore plenty of room with regard to well-off elderly people who possess substantial assets to adopt measures of (i) reducing the large amount of public spending and raising contributions and premiums, (ii) reducing pensions or strengthening the taxing of pensions, and (iii) collecting expenses from the inheritance of assets.

As we have now learned that even the consumption tax rate hike will not achieve reliable social security, it is necessary to seriously examine other measures aside from the consumption tax rate hike.

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