Japan Center for Economic Research – Medium-Term Economic Forecast

A 19% Consumption Tax Will Turn the Primary Balance Positive

— Japan Will Fail on the Price Stability Target.

— Improve the export environment through the TPP.

KUWAHARA Susumu, Principal Economist, Japan Center for Economic Research

<Key Points>

*It is appropriate to raise the consumption tax rate in annual increments of 1% until fiscal 2025.

*An increase in wages will trigger a positive economic cycle, leading to higher growth.

*With the consumption tax hike, a current account deficit will be avoidable, due to low growth in imports.

The economic outlook has been improving, but that does not mean that longstanding problems have been addressed. Challenges of fiscal consolidation and the ending of the deflationary economy remain incomplete. This report will examine what kind of scenarios Japan can design to achieve steady economic growth while focusing on achieving a steady fiscal situation on a priority basis, what issues need to be dealt with to achieve those scenarios, and the outlook of the Japanese economy to fiscal 2025. (Refer to the table.)

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The consumption tax rate will be raised to 8% in April 2014. However, even if the consumption tax rate is raised again to 10% in October 2015, it will not be nearly enough to reconstruct Japan's fiscal situation. The central and local governments' primary balance is likely to remain in deficit at around 3% of nominal gross domestic product (GDP). (Refer to the figure.)

Forecast of Major Economic Indicators (Average annual growth rate: %)

Indicator	FY2011-15	FY2016-20	FY2021-25
Real gross domestic product (GDP)	1.2	0.9	0.7
Private final consumption expenditure	1.2	-0.2	-0.7
Private corporate capital investment	2.2	2.7	2.4
Public-sector fixed capital formation	1.4	-1.4	0.0
Exports of goods and services	2.7	4.3	3.5
Imports of goods and services	3.8	2.0	1.3
Nominal gross domestic product (GDP)	1.0	0.9	0.7
Consumer Price Index (overall)	0.9	1.4	1.5
Compensation of employee per capita	0.5	0.8	1.0
Household sector saving rate *	-3.4	-5.2	-6.2
Primary balance (% of Nominal GDP)*	-4.1	-1.2	0.3
Current accounts (% of Nominal GDP)*	1.4	1.2	1.0
Crude oil price (WTI in dollar/barrel; Calendar year) *	97.9	128.0	165.7
World real GDP (Calendar year)	4.0	3.7	3.1

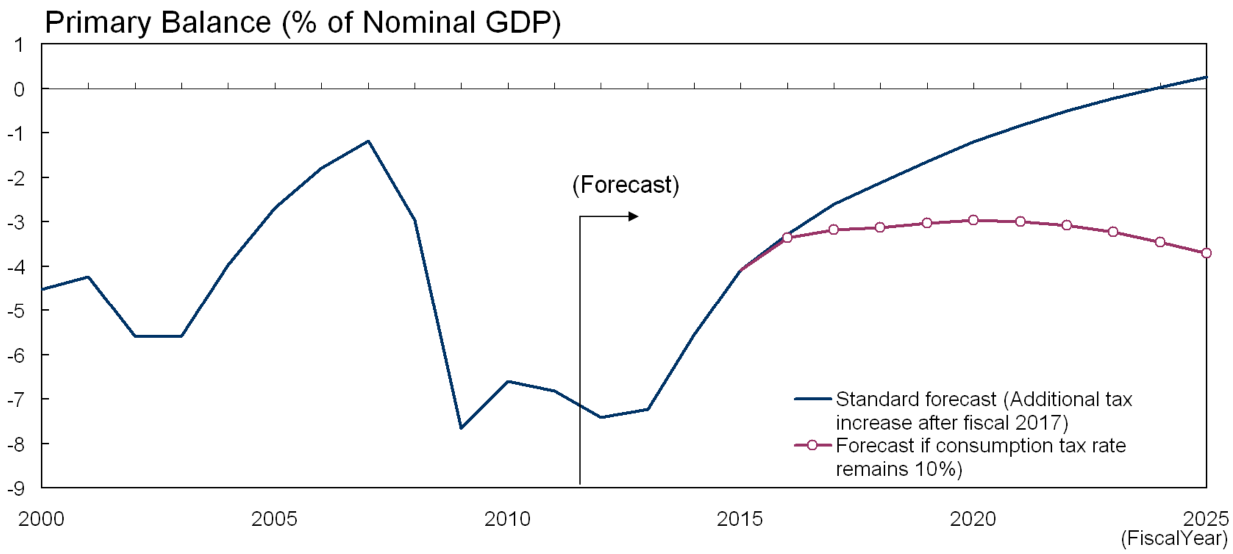
***Notes*:** Consumer prices include the consumption tax. Real world GDP is an average weighted by the ratio of exports from Japan. All figures with a * are those of the final year.

Japanese government debt is already twice as large as Japan's GDP, making Japan the most indebted of the developed economies. Therefore, although Japanese government bonds are currently being financed steadily, if investors ever question the government's ability to repay its debts in the future, it would be entirely possible that Japan would fail to find buyers of its government bonds, facing the same sort of fiscal crisis that Greece has been experiencing. As a minimum, the Japanese government needs to make its primary balance positive, and it has set fiscal 2020 as a target for doing this.

Is this target realistic or unrealistic? First, let's look at the percentage increase in the consumption tax rate that will be needed. The current fiscal deficit of 3% of GDP almost equals tax revenues from a 6% consumption tax rate. However, given the annual increment of social security expenses and the fact that, if taxes are actually raised, tax revenues decline, then with the contraction in demand, another 8% rise in the consumption tax will be required to achieve fiscal surplus in fiscal 2020.

Next, let's look at the schedule for tax rate increases. After the tax hike in October 2015, if a decision on a further tax hike is made after monitoring the economic situation, the consumption tax rate will be raised again in fiscal 2017 at the earliest. Therefore, it will be difficult to raise the tax rate by 8% in the remaining four years. Yet, if the rate is raised by 2% each year over the subsequent four years, the economy will unavoidably slow.

Taking these factors into account, the Japan Center for Economic Research has prepared for the following scenario. From fiscal 2017, the consumption tax rate will be raised by 1% every year and a primary balance surplus will be achieved in fiscal 2025, the final year of the center's medium-term forecast. At that time, the consumption tax will be 19%. The reason for the tax rate exceeding the level estimated in fiscal 2020 is still an increase in social security expenses. The center believes that the consumption tax rate needs ultimately to be raised to 25% to maintain a positive primary balance after that time.



***Sources*:** Cabinet Office "National Accounts" - Preliminary calculations have been made by the Japan Center for Economic Research.

Annual increments of 1% are designed to bring about two positive aspects. One aspect is a step-by-step increase in the tax rate will be able to keep the negative impact on the economy to a minimum. This increase will also be able to reduce economic volatility by deterring last-minute demand before the tax hike and the contraction in demand after the tax hike. The other aspect is that a commitment to planned tax rate hikes in the future will give the market confidence. If a political decision is required to be made for each tax hike, fiscal consolidation will inevitably slow. Tax increases of 1% will of course impose additional burdens on practical implementation. However, if a large tax hike results in an economic downturn, the drawback will be more serious than the burdens added by a phased tax hike.

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Under the scenario described above, how would the economy progress? First, the burden on households will inescapably increase. The savings rate in the household sector is turning negative. Partly due to an increase in the number of households whose expenditures exceed income as a result of the aging of Japanese society, the extent of the negative savings rate in fiscal 2025 is likely to exceed 6%. That means that households will start drawing down their savings. Consequently, consumer spending on an actual base excluding price fluctuations is expected to trend lower.

Second, it will be difficult for the Bank of Japan to achieve its 2% price stability target for some time. Putting aside its direct impact on prices, a higher consumption tax weakens consumption and will function to suppress prices. As a result, consumer prices will only rise at the 1% level, even including the price hike from the higher consumption tax.

Prices may rise if wages are increased. Over the last twenty years, even when corporate earnings and the employment environment improved, that did not lead to an increase in wages. If wages are raised at a rate that exceeds the burden from the higher consumption tax, the overall economy will start following a positive cycle. A rise in consumer spending will not only help achieve improved economic growth, but will also trigger an increase mainly in charges for services that involve relatively high labor costs, making it easier to achieve the price target. This will also help reduce the ratio of government debt to nominal GDP.

A tax hike will involve a number of difficulties but will also generate benefits. The benefit is that the country overall increases its savings. While households reduce their savings, the government will reduce its deficits at a rate faster than the decline in households' savings (which achieves a contraction in negative savings). As a result, any rise in real interest rates will be contained, which should help the Bank of Japan achieve the intended results from its aggressive monetary easing.

Let us examine now the growth potential of the Japanese economy. First, private capital stock, the foundation of production capacity, will remain at a level commensurate with the size of the economy because capital investment will be stimulated and grow. Meanwhile, although an increasing portion of public capital stock will reach its replacement period, if the scale of public investment in fiscal 2010 is maintained, public capital stock will generally remain stable until fiscal 2025 without impairing economic growth.

However, after fiscal 2025, should public investment remain at the current level, the existing stock will not be able to be replaced. As a result, before fiscal 2025, a number of regions, depending on the area, will be forced to select the social infrastructure that they intend to maintain. While dealing with fiscal consolidation, it will be difficult to increase the public investment budget. It is essential to develop methods to effectively maintain and manage social infrastructure as soon as possible.

Human capital is also an important production factor. It is true that the decline in the labor population is an adverse development, but there is room for this adversity to be overcome with quality labor. The Survey of Adult Skills of the Organization for Economic Co-operation and Development (OECD) published in October 2013 showed that Japan had the most qualified adults among the participating countries. However, although there is no substantial difference between men and women in adult skills, opportunities for women in Japanese society remain limited, and the high level of adult skills is not being translated into economic outcome. Establishing a social environment in which women can play key roles will be an effective growth strategy.

With stagnant growth in consumption as a result of the consumption tax hike, if exports do not grow, investment will not increase either, resulting in an economic slowdown caused by sluggish demand. Therefore, it is necessary to improve the export environment to ensure economic growth during the period of fiscal consolidation. On these grounds, it is essential to conclude the Trans-Pacific Partnership (TPP) as early as possible. The TPP will also encourage investment in Japan. Corporate tax cuts will also bring about an expansion of investment in Japan and improve the global competitiveness of Japanese companies.

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Growth in exports has recently been sluggish, despite the correction to the strong yen as a result of the introduction of Abenomics. This appears to reflect slow overseas economies. When the global economy stages a recovery in the future, exports will begin to grow.

Meanwhile, imports are expected to grow at a low rate in the medium-term. This reflects a lack of growth in consumer spending. Moreover, with the development of the shale revolution, energy prices are expected to remain slightly lower than the existing forecast level. Further power savings are also expected to be achieved, and this forecast expects that power consumption will be cut by 17% by 2025 compared with power consumption in 2010. As a result, imports of fossil fuels will be controlled.

Mainly because of the improvement in the export environment and the low growth in imports, Japan is expected to avoid a current account deficit during the forecast period. Japan needs to continue to focus on achieving power savings and take other initiatives to use energy more efficiently, so that it can ensure that energy issues do not hinder its growth.

The hurdles to end the deflationary economy are high, but an average growth rate of 1% should be maintained during the forecast period. The Japanese economy has the potential to simultaneously achieve fiscal consolidation and economic growth. Both the public and private sectors must take advantage of this potential and act to stimulate growth.

Translated from "Shohizei 19% de Zaiseikurojika (Conditions for wage increases: Close consultation between labor and management)," Nihon Keizai Shimbun, *p. 27 December 5, 2013 (Courtesy of Nihon Keizai Shimbunsha)* [2013]

Note**:** Full version of Japan Center for Economic Research – Medium-Term Economic Forecast is available on the following site. http://www.jcer.or.jp/eng/economic/medium.html

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