Japan is a buy

The Abe Administration Should Ease The Impact of The Tax Hike — The key to reviving the Japanese economy is to reduce corporate taxes

KUMAGAI Mitsumaru, Chief Economist, Daiwa Institute of Research

Two Myths about the Consumption Tax

In late August 2013, Japanese interest was focused on whether the Abe administration would raise the consumption tax as planned. The government invited sixty experts to the prime minister's office and interviewed them regarding the pros and cons of a consumption tax hike and the necessary policies associated with the tax hike.


KUMAGAI Mitsumaru, Chief Economist, Daiwa Institute of Research

The second intensive review meeting on August 27, which I participated in and that the mass media called "a showdown," attracted attention, as four experts who were opposed to a consumption tax hike, led by Hamada Koichi, Tuntex Professor Emeritus at Yale University and a special advisor to the Cabinet, and five experts including me who supported a consumption tax hike, seriously discussed the issue.

The minutes of the meeting are posted on the website of the Cabinet Secretariat, and I would imagine that many people have already read them.

At the meeting, I pointed out that there are two myths regarding the previous consumption tax hike (in 1997).

The first myth is that the slowdown in the economy was mainly due to the consumption tax hike.

Consumer spending fell in the April–June quarter of 1997, when the consumption tax was raised, but in the July–September quarter, consumer spending recovered to the level right before the last-minute demand prior to the consumption tax hike (see Figure 1). The main reasons for the economic slowdown were the financial crisis (the Yamaichi and Takugin crisis) and the Asian currency crisis.

The second myth is that a consumption tax hike will ultimately reduce tax revenues.

It is true that tax revenues in Japan declined from 53.9 trillion yen in FY1997 to 51.0 trillion yen in FY2007, immediately before the Lehman crisis, but we should not overlook the fact that tax revenues fell 8.3 trillion yen during the period due to system reforms including the "Obuchi tax cut" and the transfer of tax revenues from the national government to local governments. Were it not for the effects of these system reforms, tax revenues in FY2007 would have risen to 59.3 trillion yen.

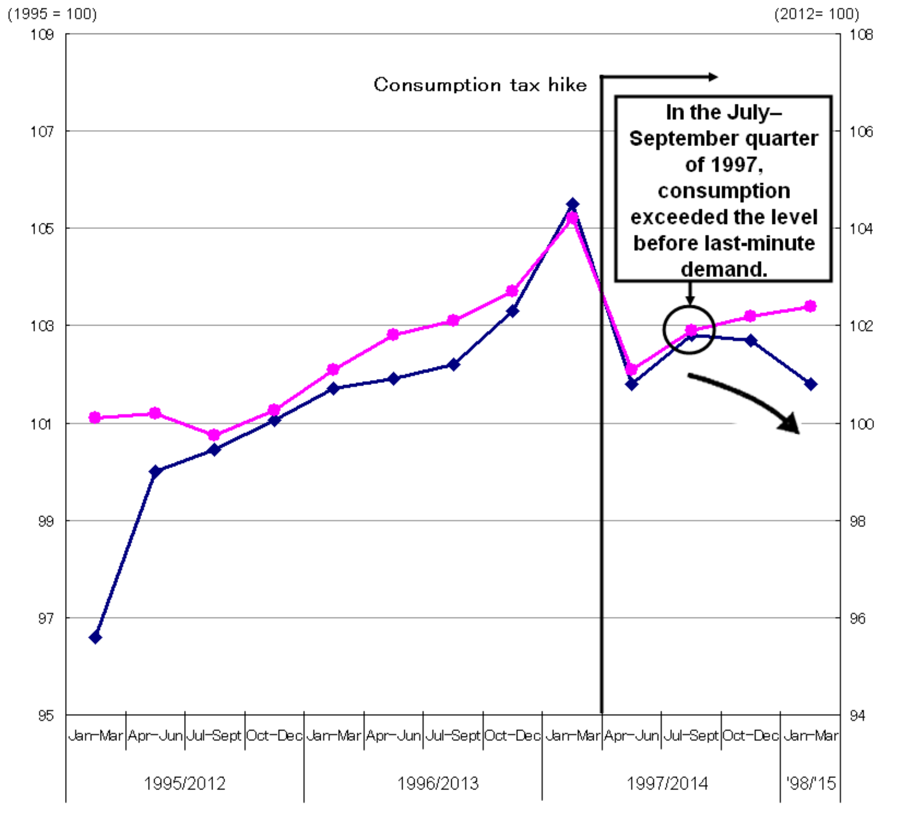
At the comprehensive review meeting, I said, "I have argued, using figures and data, that these two consumption tax beliefs are not true, and have not heard any convincing counterarguments. I would like to hear any counterarguments people may have at this meeting, or at least seriously discuss the facts at another time."

There were no counterarguments to my statement, which might have been considered provocative, from those opposed to a consumption tax hike.

In the end, the Minister of State for Economic Revitalization, Amari Akira, indicated some understanding of my views and said, "If there are any counterarguments, I would like you to submit them in writing."

I have not heard that any counterarguments were submitted to the government in writing.

Figure 1: Personal Spending Before and After The Consumption Tax Hike



Source: Created by the Daiwa Institute of Research based on Cabinet Office statistics

Postponing the Consumption Tax Hike Would Lead to the Failure of Abenomics

"It would be better if there were no consumption tax hike." I believe everyone in Japan feels that way.

However, I would like to point out that postponing a consumption tax hike is a terrible policy that would cause the first arrow (the monetary policy) and the third arrow (the growth strategy) of Abenomics to fail.

Abenomics consists of "three arrows": (1) an aggressive monetary policy, (2) a flexible fiscal policy, and (3) a growth strategy that encourages private sector investment.

Why would postponing a consumption tax hike cause the first arrow (monetary policy) to fail?

A precondition for the aggressive monetary easing by the Bank of Japan, headed by Governor Kuroda Haruhiko, is the maintenance of fiscal discipline. Aggressive monetary easing coupled with a loss of fiscal discipline would create the impression of debt monetization. To put it simply, foreign countries would consider the Bank of Japan's policy of buying 70% of newly issued government bonds as the Bank of Japan taking over the government's debt.

If global financial markets lost confidence in Japanese government bonds, it could create an ironic situation: No matter how many government bonds the Bank of Japan bought, long-term interest rates wouldn't fall. Moreover, the more government bonds the Bank of Japan bought, the more long-term interest rates would rise, due to concerns over the loss of fiscal discipline.

We should take special note of the fact that Governor Kuroda, who is responsible for the Bank of Japan's monetary policy, has said a few times that the consumption tax hike should go forward as planned.

Postponing the consumption tax hike would have an enormous adverse effect on the third arrow of Abenomics (the growth strategy). Prime Minister Abe Shinzo has said that he would like to make the current Diet session a "growth strategy Diet session." If the consumption tax hike were postponed (or if the consumption tax rate was changed from the original plan), the Diet would have to pass a new bill, and the current Diet session would become a consumption tax Diet session. In that case, the administration would not be able to release the third arrow very promptly.

The Reason for a 5 Trillion Yen Economic Stimulus Package

For the reasons described above, the policy the government has adopted, of raising the consumption tax by 3 percentage points as planned and implementing a 5 trillion yen economic stimulus package, is a very sensible policy.

This policy will have the same effect as a 1 percentage point consumption tax hike, because 5 trillion yen, which the government will appropriate for the economic stimulus package, is equivalent to a 2% consumption tax decrease.

Some people have criticized the policy, saying that the consumption tax rate should have been raised by 1 percentage point.

However, if the tax hike is reduced to 1 percentage point, the Diet must pass a new bill, as it would if the consumption tax hike was postponed, and that would become a big obstacle to the third arrow of Abenomics.

If the consumption tax rate is raised step by step, by 1 percentage point at a time, a number of practical problems would arise, including the following: (1) In the shipbuilding and leasing industries, for example, the administrative workload of companies would increase for their long-term agreements due to the different tax rates; and (2) subcontractors wouldn't be able to pass the increases in the consumption tax on to their sales prices.

Is the size of the planned stimulus package—5 billion yen—adequate?

The Daiwa Institute of Research estimates that the consumption tax hike will reduce real GDP by 5 trillion yen in FY2014. Of this 5 trillion yen reduction, 3 trillion yen includes the effect of the last-minute demand in FY2013. The reduction in real GDP, mainly caused by a decline in household purchasing power associated with the consumption tax hike, is therefore estimated to be 2 trillion yen.

To offset this decline in demand due to the tax hike, the appropriate size of a stimulus package is therefore 2–5 trillion yen.

It is also important to consider whether it will be necessary to issue government bonds in addition to an economic stimulus package. The government plans to consider the need for issuing additional government bonds in December. The upper limit of the stimulus package, 5 trillion yen, also implies that 5 trillion yen is the necessary amount for the government to avoid having to issue additional bonds (using an increase in tax revenues) in the fiscal year.

From the two viewpoints described above, I think that the government decided that implementing a 5 trillion yen stimulus package was the best possible policy for staving off a slowdown in the economy.

The economic stimulus package is well-balanced, and includes the following: (1) initiatives to reduce the sharp fluctuations that will be caused by the last-minute demand before the consumption tax hike (including benefits for home buyers, mortgage tax breaks, and the future abolition of the automobile acquisition tax); (2) benefits for low-income earners; (3) a reduction in investment taxes and corporate taxes; (4) tax reductions for companies that raise their wages; and (5) public investment. Unnecessary public investment under the pretext of protecting people’s lives and property should be strictly avoided, but truly necessary public investment should be steadily implemented in consideration of the cost-effectiveness of its immediate effects on the economy.

Partly due to the effects of the 5 trillion yen stimulus package, a slowdown in the Japanese economy will likely be avoided. I expect Japan’s real GDP growth rate to be 3.0% in FY2013 and 1.2% in FY2014.

Compared with 1997, when the consumption tax was last raised, the Japanese economy is very steady. Domestic demand, including public investment, personal spending, and housing investment, is expected to be particularly steady. However, we need to carefully assess the downside risks to overseas economies, especially China.

A Worldwide Trend in Tax Reform

The economic stimulus package will affect businesses more than households. Certain members of the media have criticized the stimulus package, saying that it is not appropriate to allocate extra tax revenue to businesses through a consumption tax hike and that the stimulus package favors the rich.

The Abe administration’s policy, however, is not wrong at all. For more than three years, the government of the Democratic Party of Japan implemented an income distribution policy, distributing child allowances, but the economy did not improve at all.

The internationally accepted procedure for implementing an economic policy is to formulate a growth strategy and then an income distribution policy. Even if it is necessary to implement an income distribution policy, the government should first raise the money to be distributed. To revive the Japanese economy, the government’s priority should be to revitalize companies by reducing corporate taxes among other means.

The share of labor in Japan (the ratio of the money distributed to individuals to the income a company earns) has remained roughly flat for the past twenty years.

What is most important for Japan is to reduce the effective corporate tax rate.

The worldwide trend in tax reform is stabilizing tax revenues through consumption tax hikes, while reducing the effective corporate tax rate to revitalize the economy. Considering the global trend toward reducing the corporate tax rate, in order to maintain or increase Japanese companies' competitiveness, it is desirable to reduce the effective tax rate while expanding the tax base. Reducing the effective corporate tax rate will stimulate corporate activities and send a symbolic message to foreign investors that Japan is changing drastically.

The stereotypical criticism that a corporate tax rate reduction favors businesses and the rich has been voiced.

This criticism, however, is based on a total misunderstanding of the essence of corporate tax.

Corporate tax is not paid by intangible juridical entities. It is ultimately paid by company stakeholders, including management, employees, shareholders, creditors, and customers.

A corporate tax reduction will therefore have a favorable effect on the entire Japanese economy.

For example, if a company's after-tax income increases, its capital expenditures and dividends will rise. Rising stock prices could help the economy break away from deflation and create a virtuous cycle. In the end, an increase in household income is expected to stimulate personal spending.

In the past, tax reductions in Japan for R&D and capital expenditures tended to be disproportionally favorable to large or exporting companies. This time, however, a reduction in the effective corporate tax rate is expected to help overcome deflation as a result of the benefits it will bring to a wide range of companies, including companies in the non-manufacturing industry and the service industry and small and medium-size companies.

We estimate that if the effective corporate tax rate is reduced by 10 percentage points, Japan's overseas production ratio will fall by 1.5 percentage points, and Japan's exports will increase by 2.3 trillion yen. An increase in exports will affect the macroeconomy and boost domestic production by 4.7 trillion yen. This estimate does not take into account the effect of the expected expansion of investments from abroad, among other factors. The actual economic effect of a corporate tax reduction will likely be larger.

Policies That the Government and the Bank of Japan Should Adopt

Lastly, I would like to point out some policies that the government and the Bank of Japan should adopt.

Since the start of the Abe administration, I have argued that Abenomics is an economic policy that can help the Japanese economy recover, and that the direction Abenomics is taking is absolutely right.

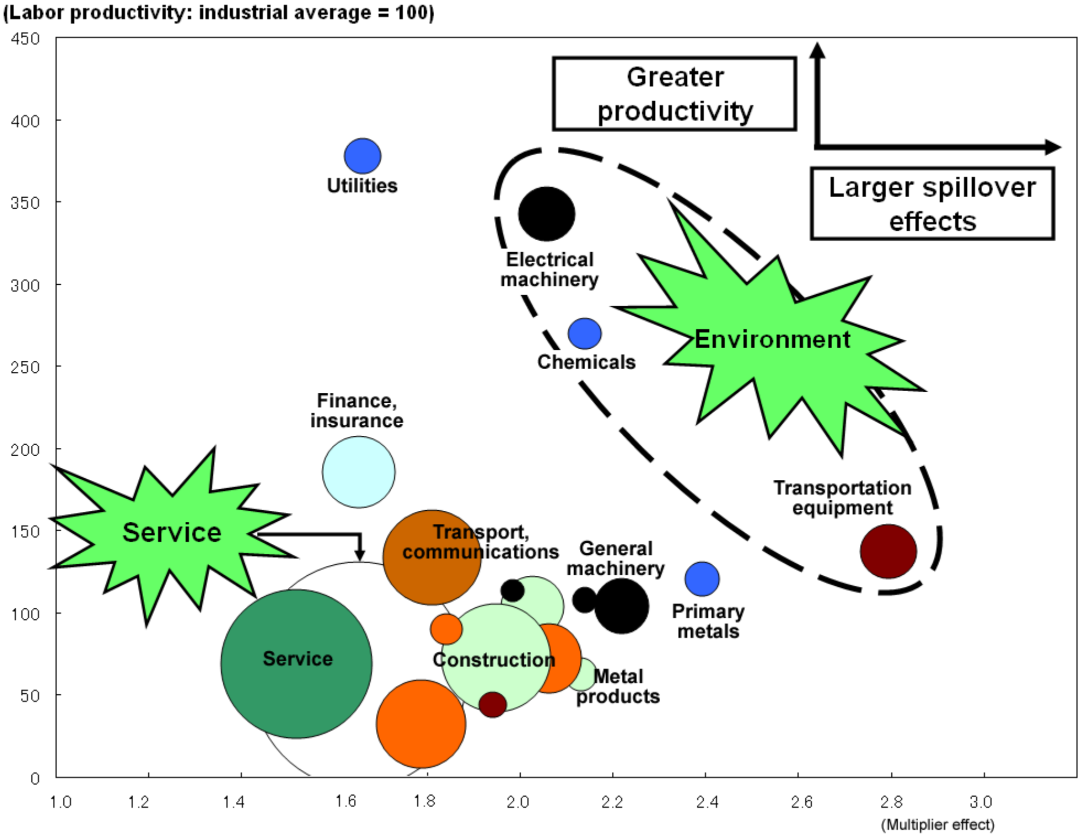
Of the three arrows of Abenomics, the first arrow, an aggressive monetary policy, has made an especially good start. Depending on economic conditions, the Bank of Japan plans to adopt an additional monetary easing policy around April 2014, when the consumption tax will be raised.

Now that the Bank of Japan has adopted an aggressive monetary policy, it is the government's turn to address economic challenges. The government is facing the following three challenges.

The first challenge is to maintain fiscal discipline.

Protecting people's lives and property is the most important job of the government. However, if the government gradually expands public investment under the pretext of safety and security, economic efficiency will decline, and the budget deficit will increase.

Figure 2: Labor Productivity and The Multiplier Effect



Note: Certain multiplier effects are estimates. The size of the circles indicates the number of employees.
Source: Created by the Daiwa Institute of Research based on statistics from the Ministry of Economy, Trade and Industry and the Cabinet Office

One urgent issue is to radically reform the social security system and stop rising social security costs, which are increasing by more than 1 trillion yen a year.

The second challenge is to strengthen the third arrow. Abenomics is focusing on economic adrenaline shots, including monetary policy and public investment. However, to achieve sustainable economic growth, the government needs to radically ease regulations in fields such as agriculture, medical and long-term care, and labor, where there are strong vested interests, or rock-solid regulations, and reduce the effective corporate tax rate.

Looking at Japan's industrial structure, the main growth fields in the future will be (1) the environmental field, which is efficient and has potential and spillover effects on other industries; and (2) the service industry, especially medical and long-term care, which has a higher employment capacity (see Figure 2).

In the graph, the size of the circles indicates the number of employees. The employment capacity of the environmental field (electrical machinery, chemicals, transportation equipment), which has high growth potential, is limited. The manufacturing industry accounts for only 18.8% of Japan's total workforce. To create jobs, the government needs to stimulate the service industry, especially medical and long-term care, primarily by approving treatments that are partially covered by insurance.

When the government develops an industrial policy, it should refrain from throwing money, including subsidies, at specific fields. As a pump-priming policy, the government must engage to a certain degree in areas that are characterized by long research periods and a lot of uncertainty, such as the development of iPS cells. The government's basic policy, however, should be to do its best to create an even playing field to encourage innovation in the private sector by easing regulations, as long as this doesn't create adverse effects.

The third challenge is to improve the income distribution policy to increase employees' income.

Empirical evidence says that in Japan an increase in sales will lead to wage growth, which in turn will boost prices. The typical pattern is that wages rise six months to a year after sales begin to increase, and consumer prices climb about six months after a rise in wages.

We need to note, however, that with globalization the pattern where an increase in sales precedes an increase in wages has been collapsing since 2000. The government definitely needs to implement a policy to enhance a transmission mechanism where an increase in sales will be appropriately reflected in a rise in wages.

The Abe administration has said that it will promote tax breaks for companies that distribute more income to their employees. This policy is a positive step, but to promote a transfer of income from the corporate sector to the household sector, the government has yet to create a mechanism, which could be called the inverse of the Wassenaar Agreement, where the government, labor, and management share the pain of raising wages.

I hope that the Abe administration will address these policy challenges instead of becoming complacent about its success so far.

Translated from "Nihon wa Kai-da! Abe-seiken wa Zozei Shokku wo Kanwa-seyo — Nihon Keizai Saisei no Kagi wa 'Hoji-zei' ni ari (Japan is a buy! The Abe administration should ease the impact of the tax hike. — The key to reviving the Japanese economy is to reduce corporate taxes," Voice, *December 2013, pp. 112-119. (Courtesy of PHP Kenkyusho)*

Kumagai Mitsumaru
Born in Tokyo in 1966. He received his master's degree at University of Tokyo Graduate School for Law and Politics, and assumed his current post in 2010. He has been ranked no. 1 in seven analyst rankings, and is a commentator on TV Tokyo's World Business Satellite and other TV programs. He has written a number of books, including *Passing China* (Kodansha) and *Shohizei ga Nihon wo Sukuu* [The consumption tax saves Japan] (Nikkei Publishing).
