



Control of social security expenses should be expedited.

Ensuring Escape from the Deflationary Spiral and to Again Increase Consumption Tax

- Outlook of the primary balance of the central and local governments
- Case where consumption tax rate was raised to 10% as originally planned

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< Key Points >

- The move to escape from the deflationary spiral also contributed to the improvement of the primary balance.
- The reduction of the deficit by half in fiscal 2015 is challenging, but the focus is on the next step.
- The rapid rise in social security expenses is more serious than the postponement of the tax hike.

With the postponement of the consumption tax hike and the dissolution of the House of Representatives, economic policy entered a new phase. Discussions have commenced on the evaluation of Abenomics in the past two years and the new outlook following the election. I wish to tidy up the points under discussion from the viewpoint of fiscal health.

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In terms of fiscal health, there is the objective of the primary balance. The move into the black will be achieved in and before fiscal 2020 by reducing the deficit as a percentage of GDP for fiscal 2010 by half in and before 2015. This is the objective that the Abe cabinet has pursued. The chart shows the forecast of the primary balance, which is included in the trial calculation concerning the medium- to long-term economy and government finance, which was submitted by the Cabinet Office to the Council on Economic and Fiscal Policy in July. As of the time of the trial calculation, the objective for fiscal



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2015 was expected to be achieved. The trial calculation was based on the assumption that the consumption tax rate would increase to 10%.

Accordingly, it is necessary to analyze the impact of the postponement of the consumption tax hike.

This objective of the primary balance is also the policy that was adopted by the Democratic Party of Japan (DPJ) government in 2010. The Abe cabinet followed this objective. As shown in the chart, the deficit was mostly not reduced in and before 2012 at the time of the DPJ government.

The deficit shifted to a significant improvement after the Abe cabinet commenced. This change has a deep relationship with the escape from the deflationary spiral. It is extremely difficult to achieve healthier public finances under deflation. Tax revenues decline under deflation. If the improvement of the primary balance under deflation is contemplated, the drastic reduction of government expenditure or tax hikes will be required. However, it is politically extremely difficult to implement it under the deflationary situation when the economy is in a slump. We can say that the Abe cabinet, which put a process in motion for escaping from the deflationary spiral, simultaneously opened the door to healthier public finances. Looking at the fiscal situation for fiscal 2012 before the commencement of the Abe cabinet, government bonds of 44.2 trillion yen that were issued exceeded general account tax revenue of 42.3 trillion yen (at the budget stage), showing an abnormal situation. This situation was resolved during the first two years of the Abe cabinet. According to the budget for fiscal 2014, tax revenue rose to 50 trillion yen, while government bonds issued amounted to 41.3 trillion yen. An increase in tax revenue is expected, so the account settlement will show improved figures.

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The results of the increase of the consumption tax rate to 8% in April 2014, not to mention the emergence from the deflationary spiral, are remarkable. The consumption tax hike was decided through the agreement of the three parties (Liberal Democratic Party [LDP], DPJ and Komeito) before the commencement of the Abe cabinet. The implementation of the consumption tax hike depended heavily on the economic stimulus measures that were thoroughly implemented by the Abe cabinet through the two arrows of fiscal policy and monetary easing in 2013.

One economist said that the fireworks display was too splendid in 2013, and that the economic indicators for 2014 therefore looked poor as a result. Excessive expectations for Abenomics resulted in disappointment that some people do not enjoy its benefits. The preliminary estimate of the GDP for July to September, which was worse than expected, also led to a stronger sense of disappointment.

However, it is a fact that the average GDP for January to September 2014 is higher than the average GDP for January to September 2013. By no means was there negative growth. Looking objectively at the current economic situation, we cannot say that there is no information suggesting a bright economic outlook for the next year and thereafter.

The current Japanese economy is displaying a situation with an extremely unfavorable balance. Corporate results remain at a record-high level. Nonetheless, investments have not grown as expected. Employment is close to full employment. Employees' remuneration has shown the



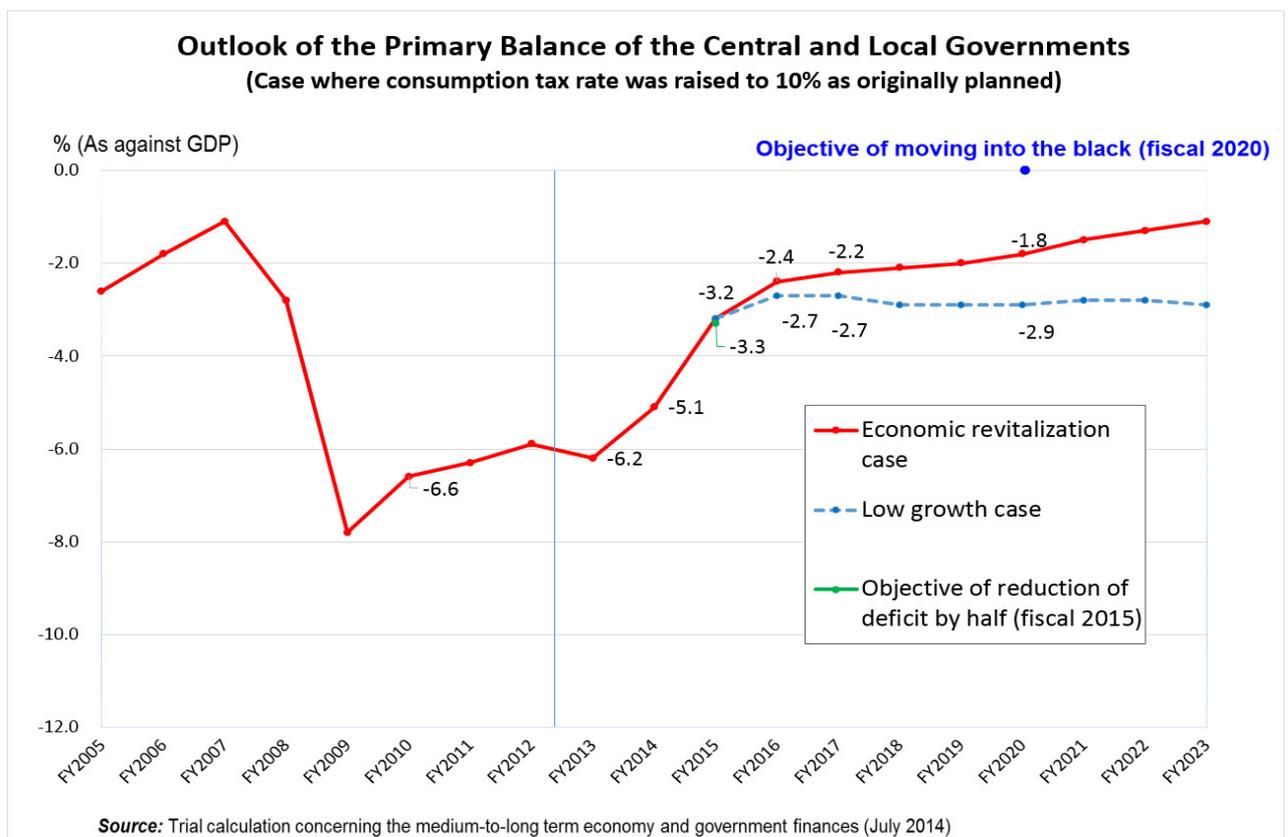
greatest growth in the past seventeen years.

However, wage increases have not kept pace with rising prices, and real wages have continued to decline. This was strongly attributable to the temporary factor of the consumption tax hike. It is hoped that wage increases will catch up with rising prices in the near future. The question is how to achieve steady corporate results and employment, thereby leading to increases in consumption and investments. This is an important point in revitalizing the Japanese economy for the time being. Many specialists have pointed out the importance of the acceleration of the growth strategy after the election. I think that this is true. If a flow is created where favorable corporate results will lead to wage increases, its impact will be considerable.

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In this situation, what should the strategy for healthier public finances after the election look like?

Attention will be given to how to fulfill the fiscal 2015 objective and the fiscal 2020 objective. With the postponement of the tax rate hike, the situation for attaining the fiscal 2015 objective is not looking good. Nonetheless, we cannot say that there is no possibility of its achievement through the revision of government expenditure and a rise in tax revenue. However, importance may have shifted from the fiscal 2015 objective to the fiscal 2020 objective.





This is the objective set in June 2010 under the DPJ government. More than four years have passed since then. The range up to fiscal 2015 as of then is closer to fiscal 2020, not fiscal 2015, as of now. Moving into the black is more important than the reduction of the deficit by half as a political objective.

As shown in the chart, according to the trial calculation undertaken in July 2014, given the growth scenario of Abenomics, a deficit equivalent to 1.8% of GDP will remain in fiscal 2020. If growth continues, a considerable rise in tax revenue is expected. However, it will be difficult for the rise in tax revenue to offset the increase in social security expenses attributable to the declining birthrate and aging population. This is the message communicated by this chart.

How was this message understood? I consider it to have been as follows: For the time being, the firm reduction of the deficit by half before fiscal 2015 would be targeted. After that, discussions about the revision of government expenditure such as the further reform of social security would be expedited, and discussions about an additional tax hike would be held if necessary.

I consider that this should be changed to the following interpretation due to the postponement of the consumption tax hike. The process for achieving the objective of moving into the black in fiscal 2020 should be specified. For that purpose, the revision of government expenditure focusing on social security reform will be expedited. It is not necessary to haul down the flag of the objective for fiscal 2015. It is more important to embody the measures for the fiscal 2020 objective.

In April 2017, the consumption tax rate will be raised to 10%. A decline in tax revenue due to the postponement of the tax rate hike is serious. However, its postponement will not have any impact on the fiscal 2020 objective. The primary balance is the difference between tax revenue and government expenditure, excluding government bond costs. As a result, if the consumption tax rate is raised as of that time, the postponement will not matter.

For the sake of healthier public finances, all of the following are indispensable: the thorough revision of government expenditure, a stable increase in tax revenue through escaping from the deflationary spiral and growth, and the securing of tax revenue through tax hikes. The consumption tax hike was postponed. However, the provision of the economy will not be enacted at the time of raising the tax rate in 2017. I hope that the tax rate will be raised at that time without fail. In addition, the further strengthening of the revision of government expenditure will be required.

The loss of around 8 trillion yen in tax revenue, which is equivalent to tax revenue for one and a half years based on the consumption tax rate of 2%, is serious. However, it is more important to look at how to address the problem of an abnormal increase in social security expenses by about 1 trillion yen per year.

Few people consider that the yield on government bonds will immediately rise sharply due to the postponement of the tax rate hike, because the Bank of Japan purchased a large quantity of government bonds. I do not consider that it is the real intention of the Bank of Japan to remove pressure from the government bond market. However, it is a fact that it provided ample time for the government's scenario for healthier public finances as a result. I hope that earnest discussions on the reform of social security will start to produce the effect of the control of government expenditure after the election.



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